Giverny Capital Inc.

2001 ANNUAL REPORT

[Note: This annual report has been translated from my native French for the benefit of English Canada, USA managers, friends, and potential clients.]

For the year ending December 31st 2001, our return was 15% compared to 0% for our benchmark (a weighted combination of five indexes, three American and two Canadian) and –6% for the S&P 500. These returns all include around +5% due to the variation of the Canadian dollar.

Since starting the fund, September 1st 1993, our annual return has been 23.5% compared to 13.6% for our benchmark and 15.9% for the S&P 500.

Year	Giverny	Benchmark *	+/-	S&P 500	Vs S&P
1993-1994	**25%**	4%	20%	8%	17%
1995	**50%**	24%	26%	36%	14%
1996	**27%**	23%	4%	21%	6%
1997	**40%**	29%	11%	39%	1%
1998	**20%**	19%	1%	38%	-18%
1999	**13%**	16%	-3%	14%	-1%
2000	**13%**	3%	10%	-6%	19%
2001	**15%**	0%	16%	-6%	21%
Total (in Canadian $)	**481%**	**190%**	**291%**	**242%**	**239%**
Annual return	**23.5%**	**13.6%**	**9.9%**	**15.9%**	**7.6%**

* : Weighted combination of 5 indexes including the S&P 500 in the US and the TSE 300 in Canada.

These results are good but not as good as they look. The continuous fall of the Canadian currency since 1993 has added around +3% per year to our annual return. It is interesting to note though that our return has been quite similar for our Canadian securities and our U.S. securities, which is about 20% a year.

These results are in line with our initial objectives, which were stated in 1993 as “a 20% annual return and/or 10% better than the indexes”. At that time, there were much more opportunities than today (we could then buy great companies at less than 10 times earnings). Also, I was younger and less realistic than I am today! To illustrate how ambitious (and unrealistic) this objective was, we can remind ourselves that very few money managers over the years have sustained 20% annually. Over the last 10 years, only 7 mutual funds in the U.S. (out of something like 7000) have returned 20% a year. And they are 7 specialized funds. For general equity funds, only 9 funds have returned more than 18% a year for the last decade.

In a recent Fortune article, Warren Buffett explained why stocks in aggregate are destined to return much lower gains in the next decade. Of course, it's hard to come out with precise figures but something like a range of 5 to 8% a year would look realistic to both Mr. Buffett and me. Making 20% a year in such an environment is close to impossible. Even making 5% more than indexes is a very ambitious goal. But this is what we'll aim for in the next decade. So we would be very happy to earn 10-12% on our capital in the next years.

Even if these new objectives look more realistic, I could be wrong in more than one way. I can't promise results, both for stocks in general and for our relative performance. You can be certain of at least one thing though: I have my own money in the same stocks as you. So we're in the same boat! Many investors would concur that they sometimes have their counselors ride in yachts as they are still sailing in rowboats. This is not the case at Giverny Capital.

The Year 2001

The year 2001 was the first one since we've started this fund that "our boat" sailed through the rough water of a recession. As soon as we decide to become a businessman (woman) – and this includes owning part of companies which are commonly know as "stocks" – we have to accept one fact of life: recessions are inevitable in our capitalist system. That's why I look for businesses that should survive these kinds of periods (although thinking they are "immune" is most of time an illusion) and even perhaps increase their market share as weaker competitors go under! It's during these periods that we can distinguish winning companies from the other kind.

The steep decline that followed the September 11 attacks and the subsequent rise of stocks remind us that, in the universe of stock markets, it is better to buy in rainy days than in sunny days. Because when the sky is all blue, stocks are often changing hands at prices that *reflect* the fact that a majority of investors (!) believe that the sky will stay blue forever. In recessions and other crisis, it's the opposite: many will sell their stocks at any price thinking that never again will the blue sky return. To be able to keep in perspective stock market's sunny days from rainy days is a quality that is quite useful to develop.

Technology stocks

In the fascinating world of technology stocks, the depth of the decline in 2001 is only equal to the boom years of 1999-2000. Fabulous excesses (see the 1999 annual report) that existed in the Internet universe have vanished. In fact, not only has the excesses vanished, many companies have vanished themselves. Businesses that are linked to the semi-conductor universe have seen their revenues fall by 50%. Those within the telecom industry have seen similar fall but they were worsened by the high level of leverage. Many of these companies are losing money and for a lot of them, survival is now a daily fight. At this moment, there are few signs of a recovery. But in the long run, there is no reason to believe that the "technological

revolution" has ended. It is – in my opinion – probably only a pause but it's a deep and long one. Patience seems in order.

In spite of this, over the years we have done quite well with our technology businesses. We had purchased some at very attractive level. For example, we bought Intel [Q:INTC] at 9 times earnings and Sun Microsystems [Q:SUNW] at 5 times in 1994. Although, we did sell at some point most of our shares of such enterprises (see the 1999 report again!) at prices that carried very high P/Es, the main problem in technology stocks is not valuation in itself. It is the changing nature of the businesses (and so the valuation that is attached subsequently to it). And it's even truer today than any time before: product cycles are now often less than a year. For example, Cisco Systems [Q:CSCO] had to take a $2 billion inventory charge in a single quarter. In such an environment, it is hard to have even a faint idea of what a technology company will look like in 10 years.

I still believe that the Internet is probably the most important industrial revolution in many decades. But we still have to be very selective because a growing industry is not synonymous with profitability. On the contrary. To have a little perspective on that, here is a passage of a *Reader's Digest* article published in October of 1983 entitled "The computer: the servant of the future":

It is believed that annual sales of personal computers will go from $350 million (M) in 1983 to some $2 billion (G) in 1987. In June 1982, Commodore was the market leader with 23,000 units sold for $28M followed by Apple and Tandy with $20M each. But new comers are plenty: Atari, Timex Sinclair and Coleco are now looking for a piece of the action. Also, Osborne is now putting on the market a portable computer that could be stored in an attaché-case.

This article – would you believe? - is only 18 years old. Sales growth of PCs turned out to be much higher than anticipated even by the most optimistic forecasters. And what kind of return would an investor had received would he had bought all the companies mentioned? Probably, he would have lost almost all of his investments? The best stock would have been Apple Computer [Q:AAPL], which is today still the same price as it was 15 years ago (and they stopped paying dividends in 1997).

But it is good to know that some technology companies did manage to do very well over the years and even overcome profound changes in their environment. Companies like Hewlett-Packard [N:HWP], Motorola [N:MOT] and Texas Instruments [N:TXN], which became public in the late 1950's, have rewarded their investors enormously. Motorola, for example, has returned 20,000% over 44 years (a stock that Philip Fisher has held – to my knowledge – since the beginning) even if the stock is at the same level as 8 years ago. Some companies did build business models that are quite solid and moats around their castle that are – in rare case – quite large. Microsoft [N:MSFT], Applied Material [Q:AMAT], Intel and even a smaller company like Cognex [Q:CGNX] comes to my mind.

But like "traditional" businesses, five factors have to be taken into consideration when judging the fundamentals of technology companies:

- The business model (market share, product innovation, etc.).
- The financial (balance sheet and profit margin) structure.
- Quality of management.
- Long-term growth perspectives (which are linked to the first three).
- Market valuation compared to intrinsic value.

Of course, without having clear views of the first four factors, the valuation exercise is futile. Past profits only rewards past investors not today's buyers. And it is future earnings that make up intrinsic value.

Even though it is an hard task, my electrical engineer background has helped us (so far) make decent returns in that universe. So we did take advantage of the "crash" in NASDAQ securities to buy back two companies that we sold almost entirely in 1999-2000: Cisco Systems [Q:CSCO] and JDS-Uniphase [Q:JDSU] (I've written in length about these two companies in the 1997 and 1998 annual reports). So we still have something like 20% of our capital invested within this fascinating universe.

Our businesses

I have the simplest of taste : I only like the best. - Oscar Wilde

M&T Bank [N:MTB]

Our largest holding is - as it was last year - M&T Bank. 2001 was another great year for our Buffalo bank: EPS were up 13%, return on assets were 1.7% and return on equity at 28%. It would be hard to find a better banker than Robert Wilmers (although Fifth Third Bancorp's management is quite outstanding). I've rarely seen such a strong business performance (EPS CAGR of 18% since 1982) that is so unknown. And M&T is much bigger now than a few years back (at that time, it was called First Empire State). M&T has now $27 Billion in assets and a market capitalization of around $5B. And even though they have this superb financial track record, outstanding management and rock-solid balance sheet, the stock still trades at 14 times earnings, even after an increase of 100% in the last months.

Cognex [Q:CGNX]

We have owned Cognex since 1996. I've talked to you about its CEO, Robert Shillman, many times over the years. After a great year in 2000, Cognex could not escape its industry problems in 2001: sales were down 50% and profits almost nil. But what matters really is the moat around its castle. And I can tell you this: before the current downturn, Cognex had little competition (now very few down from 120 when it started). After the current "depression", Cognex should emerge with an almost monopoly. But until that glorious day comes, it is good to keep in mind that the company has no debt and around $300 million in the bank ($6.6 per share

versus a year end close of $25.6 for the stock). The company bought back some stock in 2001 and so did we.

Bed Bath & Beyond [Q:BBBY]

The year 2001 was not easy for many retailers. But our most important weighting in that industry did quite well. Bed Bath & Beyond increased its EPS by 27%. We first acquired shares in 1998 during the "Asian" crisis (along with shares of another retailer, Fastenal). Since then, the stock has tripled: high growth in EPS combined with an expanded P/E is a joyful experience.

Those who know me, know how much I like good stories (particularly when the "hero" becomes rich!). The story of BB&B and of its two founders is quite interesting. At the end of the 1960's, Warren Eisenberg and Leonard Feinstein, two employees of Arlans, decided to start their own houseware store. In 1971, Eisenberg opened a small store in New Jersey near his house. Feinstein did the same in Long Island. The first years were hard (as it is for most businesses) but after six years, they decided to open a third store. Both men had a golden rule: never would the company use debt to finance its expansion. So the growth was – at first – quite slow. The business plan was simple: when they had enough money in the bank, they would open a new store. So in 1985 they had 22 stores and in 1987, the opened their first "superstore". The secret of the company was simple: they had a decentralized structure combined with a great level of autonomy for their store manager.

With 37 stores in operation, BB&B came public in 1992 at split-adjusted price of $1 per share. In 9 years, stores count increased 10 fold (still without debt). EPS grew 30% per year (12 fold) and market value increased 20 fold. To illustrate how rare such a performance is, we can look at old charts of Wal-Mart's [N:WMT] and see that they grew from 1985 to 1994 at a 27% annual rate. Even Kohl's [N:KSS], the latest superstar of retailers, has grown "only" by 28% a year since 1992. But, its growth potential is not as impressive as Wal-Mart's: management believes that they could grow to 800 stores in the U.S. So for the time being, growth projections are still quite good. Since 1992, the stock has changed hand at quite high P/Es. It looked warranted so far but a few times, every two years or so, the stock loses some ground and we can increase our investment at attractive levels (mostly for new partners). So we bought shares of BB&B again when the market reopened (following 9/11) at the end of September.

Yahoo! [Q:YHOO]

My purchase of a small weighting in Yahoo! at the end of 2000 was – to this day – not particularly rewarding. The company went from a "sure grower for many years" to one with sales down 30% and profits vanished. I still think that the company does have some important franchise value and that the long (long) term perspectives are impressive. But as for all other tech stocks, patience is needed. And it is also a little soon to view Yahoo!'s purchase as a mistake.

Progressive Corp [N:PGR]

In 1999, I've explained in length the reasons behind the purchase of shares of this Ohio car insurer. These reasons are unchanged. We are partners with great people that are building an impressive business that even challenges GEICO in direct selling. Progressive is now the number one car insurance seller on the Internet . After two difficult years, profits were solid in 2001 and the stock has more than doubled since our purchase.

Le Groupe BMTC [T:GBT.A]

In the U.S., there are much more quality companies than in Canada. On the other hand, disparities between intrinsic value and market value are often quite large in Canada. So "value" investors can make a good living in Canada although our own way of seeing value as a long-term economic wealth creation is more an handicap in Canada. That is because very few companies in Canada have sustained high EPS growth for many years. The ideal situation would be to find a great business by U.S. standard at a Canadian price! Many years ago, we did find it in BMTC Group.

We first purchased BMTC in 1995 (the day of the Quebec referendum) at $3.50 per share. In 7 years, the stock has increased 5 fold (26% a year) to close at $17.50 in 2001 (the company made a dutch tender offer of $18.50 to $21 at the beginning of 2002 and the stock climbed to $22). Not bad for a company that a client once referred as "dead wood" (isn't it the kind of wood that makes the best fire?). The secret of the success of BMTC? As most of the time, it is a great CEO: Yves Des Groseillers.

Although we did well over the years, the stock's rise has not been linear at all. At the beginning of 2001, the stock was at $9, its lowest level in three years. During that time frame, EPS had increased from $1.00 to $1.80. Since the company had around $2 a share in cash, BMTC was trading at something like 4 times earnings. It would have been quite a challenge to find such a business in the U.S. at these kinds of ratios. But our patience did prove rewarding. BMTC is now our largest Canadian investment.

The (few) transactions of 2001

We don't like to sell. Like Philip Fisher, we would like to research and buy so well we never have to sell, but we did some selling in 2001. First, we sold what was left of the shares of Hewlett-Packard we did not sell in 1999-2000. The company is in a kind of existential crisis and is looking for new ways to grow, not necessarily intelligent ways! Clearly, the PC business has not been good for HP. So instead of recognizing their mistake and get out, they decided to buy out Compaq (although I sold months before this announcement). Mr. Warren Buffett used to say: "When you're in a hole, the worst thing to do is continue to dig". I'm curious to see how the merger will work out…although we will watch the outcome from the stands.

We also sold, late in the year, our shares of Liquidation World [T:LQW]. We had held these shares for eight years and made five times our money. But I think that there could have been even more potential. When we bought the stock, LW had only 15 stores and they're up to 95 now. But lately, growth has slowed. From 1993 to 1998, annual EPS growth was 33% but from 1998 to 2001, it was only 4%. Philip Fisher insisted on one important factor that often prevents small companies from becoming large companies: depth in management. Liquidation's CEO, Dale Gillespie, is a great businessman (and a great human being) but running 50 stores is one thing; running 250 stores is another. I think that – in its present form - the company can probably grow 7 to 10% a year. That is not enough for us to attain our ambitious objectives.

We acquired shares of two new companies, both in the technology field. The first one is a company I've been following since 1998. In the annual report of that year, I've written in the section "Mistake *du jour*" that I considered buying shares of Vitesse Semiconductor [Q:VTSS] at $9 in October of that year. The stock had doubled quickly afterward. In the years that followed, the company continued to show impressive growth combined with net margins of 30%. The stock touched $100 at the beginning of 2000. It failed to $15 in April of this year and I started to buy some shares. Vitesse is a leader in high-speed integrated circuits. Lately, it has developed a new IC technology for products that could carry information at 48Gbs (48,000,000,000 bits per second) or OC-768. At such speeds, silicon begins to falter. Vitesse is using for such speed a new material called Indium phosphide. Although, Vitesse is a solid company, the risk is far from low. Applied Micro Circuits – for example – has a different approach (entirely based on silicon) and could eat Vitesse's lunch at some point. But up to this point, Vitesse has a tremendous track record.

We also acquired shares of Level 3 Communications [Q:LVLT]. Level 3 has built - at a cost of $14B - one of the World's best optical networks. The company is not profitable yet and has lots of debt. So, it is not typical of our holdings. It is my grand admiration for Walter Scott Jr. that made me break my own rules. James Crowe, Level 3's CEO, built a few years back the successful company MFS Communications (bought out by WorldCom – or was it still named LDDS Communications at that time? – in 1996). Mr. Scott Jr. is on the board of directors of another of our holdings, Warren Buffett's Berkshire Hathaway [N:BRKb].

Level 3 went from $130 in 2000 to $12 at the beginning of 2001. At that price, it seemed to me that the risk-reward ratio was in our favor. I knew that the risk level was high. And I was not wrong. The stock continued its slide to $2 to end the year at $5. Lately, the company bought back around a quarter of its debt at 30 cents on the dollar. So I felt a little more secure and increase our holding. Our cost is now $6.50. But considering the risk involved, I decided to limit the weight in our portfolios to 3%.

Owner's earnings

As you know by now, Giverny Capital is not like other money management firms. We evaluate the quality of an investment by focusing on the growth in intrinsic value instead on market price. Growth in intrinsic value in one year is based on the growth

in EPS and changes in the long-term perspective of this variable. In the long run, the stock market tends to reflect those two parameters.

In 2001, our portfolio return was 10% (without changes in currencies). Our owner's earnings were down 10%. It is – by far – our worst year since 1993 but we could find some comfort in the fact that the companies that make up the S&P 500 have seen their earnings, in aggregate, fall by around 23%. Our median ROE was around 18%, which is not too bad. Our long-term objective is a combined ROE of 20%.

For 2002, I expect strong growth in our earnings. Our stocks are trading at around 20 times those predicted earnings. This level of valuation compares to 19 times for long bonds (yield of 5.4%) and to 22 times for the S&P 500. So the near term potential for stocks in general (including our own) looks very limited (of course, it is not a market prediction in any way, a futile activity that is widely spread worldwide).

Our portfolio continues to be highly focused. Ten stocks make up 75% of our fund's value. We owned these ten companies last year. At Giverny Capital, focus and low turnover goes hand in hand. In fact, we have owned four of these ten stocks for more than five years now.

Our investment philosophy doesn't reflect the conventional approach toward portfolio management. To own few stocks, to avoid some industries that we know nothing about and to ignore market fluctuations is a sensible approach but that is far from being widely used in the industry. But that doesn't disturb us a bit: since our beginning we have known that "being different" is the first ingredient of success (although there are many other ingredients needed!). I was very much influenced by John Templeton's maxim: "It is impossible to obtain a performance superior to the average unless you do *something different* from the average".

Mistake *du jour*

This yearly tradition in our annual report was very much influenced by Berkshire Hathaway's 1989 annual report. In it, Warren Buffett itemized his most important mistakes "of the first 25 years". I enjoyed this chapter so much that I decided to work hard to create "material" for this section of our annual report (on an unconscious level).

Seriously, as usual, this section could be quite long. Last year, I decided to attribute three yearly medals in honor of our Olympic tradition!

Bronze Medal: Mattel [N:MAT]

I've had a long relationship with this company. First, as a child, I was in contact with many of its products. Barbie, Fisher-Price and Hot-Wheels are brands that I can understand their strengths and weaknesses (I want to add that I've never owned a Barbie!). When I bought shares of Mattel five years ago, I had studied its history since the beginning (I've even bought a nice pink book on the history of Barbie!). I had read old Value Lines and all the annual reports I could find. So I got to know all

about their problems in 1973 and in 1983 and the fantastic turnaround orchestrated by John Amerman in 1988 (in 10 years, earnings went up 10 fold). This turnaround was helped by a brilliant leader at the Barbie division: Jill Barad.

Miss Barad became CEO in 1998. Capital allocation is a different talent than salesmanship (or I should say saleswomanship). That could be the reason that she made a enormous mistake at that time by purchasing *The Learning Co.* I decided to sell all our shares at $24 at that moment. In 1999, the stock fell as low as $10. In our annual report of that year I wrote: “For now, we won’t buy shares even at this depressed level. If there is some cleaning done at some point, we could become shareholders again in the future. We never know!”.

And I’ve continued to follow the story from the stands. Miss Barad was kind of fired and Mr. Robert Eckert, ex-president of the Kraft division at Philip Morris [N:MO], took over. Since I had owned Philip Morris in the past, I was well aware of Mr. Eckert’s brilliant work at Kraft. As Mattel’s CEO, he quickly did the right things: he “gave away” The Learning Co. and focused the company back into promoting and building its strong brands. He also reduced the debt level. Strangely, for months, the stock did nothing and stagnated at $10. To me, the EPS power was at least $1.25 to some point in 2003. So, the stock looked to me as trading at half its intrinsic value. I’ve even talked about it to some friends as an example of a great turnaround. Suddenly, the stock went up 70% to attain $17. You and I did not make a dime on it because I never bought any shares back.

I’d like so much to give you some excuse for this mistake. But I can’t find one.

Silver Medal: Health Management Associates [N:HMA]

We had owned shares of HMA (which owns and manages rural hospitals in Southern United-States) for a year or so in 1999. The company has a focused business plan and a long-term horizon in its management. Most importantly, they take good care of their clients (patients), the communities involved, their employees and their stockholders. I had sold in early 2000 because the company had released a so-so quarter but most importantly because there were some new laws for Medicare reimbursement being discussed in Washington for which I could not precisely weight the effects on HMA. Being a Canadian is a handicap in understanding U.S. legislation (although many Americans would perhaps admit they don’t understand either). But HMA had a business model solid enough to withstand such changes and earnings rebounded. The stock went up 50%, which – in a year of a bear market – is quite impressive. So in light of the recent results and continued strong prospects, I decided to buy our shares back. But we paid 25% more than the price we had sold at. Clearly, I lacked patience toward a good company that deserves our capital.

Gold Medal: First Data Corporation [N:FDC]

Mattel and HMA were minor mistakes compared to my decision to sell First Data in 1999, at $45, a small profit compared to our 1997 purchased price of $35. This was a major mistake. If I had to teach a course on how to build an ideal business model

– with 4 or 5 other examples – I would first teach about First Data. First Data gets of few dollars for almost every card transaction (debit or credit) in the U.S., first from the card issuer and then from the merchant that sold the service or the product. Beyond intrinsic growth in the traditional consumer market, First Data is a strong player in Internet transactions. But – strangely – the best business of First Data is the old Western Union. WU has a near monopoly in the cash-transfer industry. It kind of sounds dull but this market is growing quite fast. Around 20% of Americans do not have a bank account. Most of these are immigrants that still send lots of money back to their former countries, where they often have families that are still there.

Back in 1997, I studied FDC's fundamentals in detailed. I had concluded that it looked like an investment with very promising long-term rewards. I started to buy shares. But in 1998-99, the company had some problems and had to do some changes in its business model. Certain businesses they had acquired from First Financial Management we're divested but still, FDC's growth seemed stalled. I decided to sell and invest in something else! Selling at that time was not that bad a mistake (just a small one!). But at the end of 2000, I was still following FDC and the fundamentals looked good again. Growth had returned to its former level but the stock was still trading at a very reasonable valuation. I then wrote an article in "Les Affaires" newspaper on the improved perspectives of the company. But why didn't I buy back the shares previously sold? I would have paid about 20% higher than the price at which I had sold. Suddenly, the stock moved up and almost doubled in an 18 months time frame.

Patience Patience Patience

In my free time, I listen to some old Wall-Street Week TV shows (I keep quite an extensive personal archive). In 1996, Louis Rukeyser interviewed the legendary Philip Carret and asked him what was the most important lesson of his 75 years of experience. Carret answered just one word: "Patience". As my three medals this year demonstrate clearly, lack of patience is still a main cause for economic losses.

Conclusion : «The Art of Investing »

Pierre Péladeau, the famous Quebec businessman (now deceased), used to say, « Business is an art ». It's a *cliché* but what he probably meant is that being a good businessman requires mind opening, creativity and lots of patience. Also, being a master artist is often being a contrarian (although you rarely see this label on art movements) or in other words: to rebel against what is perceived as conventional. The Montreal artist Marc Séguin said this very short phrase on Art: "It's an affirmation. Period". In that line of thinking, an artistic stock picking method would then be an affirmation by the manager on the kind of companies that are, in his eyes, at the *avant-garde* of businesses: Those companies (and people) that will create the wealth of tomorrow. And with time, the really artistic manager tends to develop his own personal way of selecting stocks and building portfolios. The famous investor Philip Fisher, then 89 years, said in a Forbes interview in 1996: "I want to know: Who is working on the things that others are barely aware of? I want companies that

welcome dissent, rather than stifle it, that don't penalize people who criticize what management is doing". Philip Fisher is not just a great artist, he is a master!

Like art, portfolio management can rarely be done in teams (or worst in committees). We can add experience but we lose in personal creativity. Like Warren Buffett once said: "My vision of a group decision is to look into a mirror". Good artists also know that their number one enemy is the comfort that celebrity and success can bring. Marc Séguin added that after a successful show, he then would start on a totally new pictorial path. So to really continue to move forward, as a money manager, we have to find a balance between two emotions that are seemingly opposite: Self-confidence and humility. Of course, self-confidence is crucial to properly judge a company and its leaders. Also, it is the cornerstone of the huge patience often needed for a stock to be rewarding. Moreover, without self-confidence, it can be quite challenging to be able to purchase a stock that Wall Street rejects (and these are sometimes the best buys).

But at the same time, humility is widely needed: at the moment of analysis (to be humble enough to recognize what you know from what you don't), when errors occurs and also – ironically – after one or two great years of performance. The market has a way of punishing, rapidly and severely, lack of humility.

Humility is important because it is the essence of reason. The famous philosopher Eric Fromm explained why in his marvelous book "The Art of Loving":

"*The main condition for the achievement of love is the overcoming of one's narcissism....The opposite pole of narcissism is objectivity; the faculty to see things as they are...The faculty to think objectively is reason; the emotional attitude behind reason is that of humility. To be objective, to use one's reason, is possible only if one has achieved an attitude of humility, if one has emerged from the dreams of omniscience and omnipotence which one has as a child. I must then try to see the difference between my picture of a person and his behavior, as it is narcissistically distorted, and the person's reality as it exists regardless of my interests, needs and fears*."

What can be said about the art of love is true in the art of investing. In fact, genuine love - in a more personal way – is an essential part of any human creation. Woody Allen once said: "In order to be a jazz musician, you have to listen to a lot of jazz. And that's an act of love. You don't think, I'm listening to study it. You just listen because you love it…and gradually you learn. You really learn everything valuable through osmosis. It's the same with play-writing or movie-directing or acting. You love either reading or watching films or plays or listening to music. And in some way, over the years, without making any attempt, it gets into your blood, into the fiber of your body".

The art of investing is made out of the same framework.

I wish you the best of times for 2002.

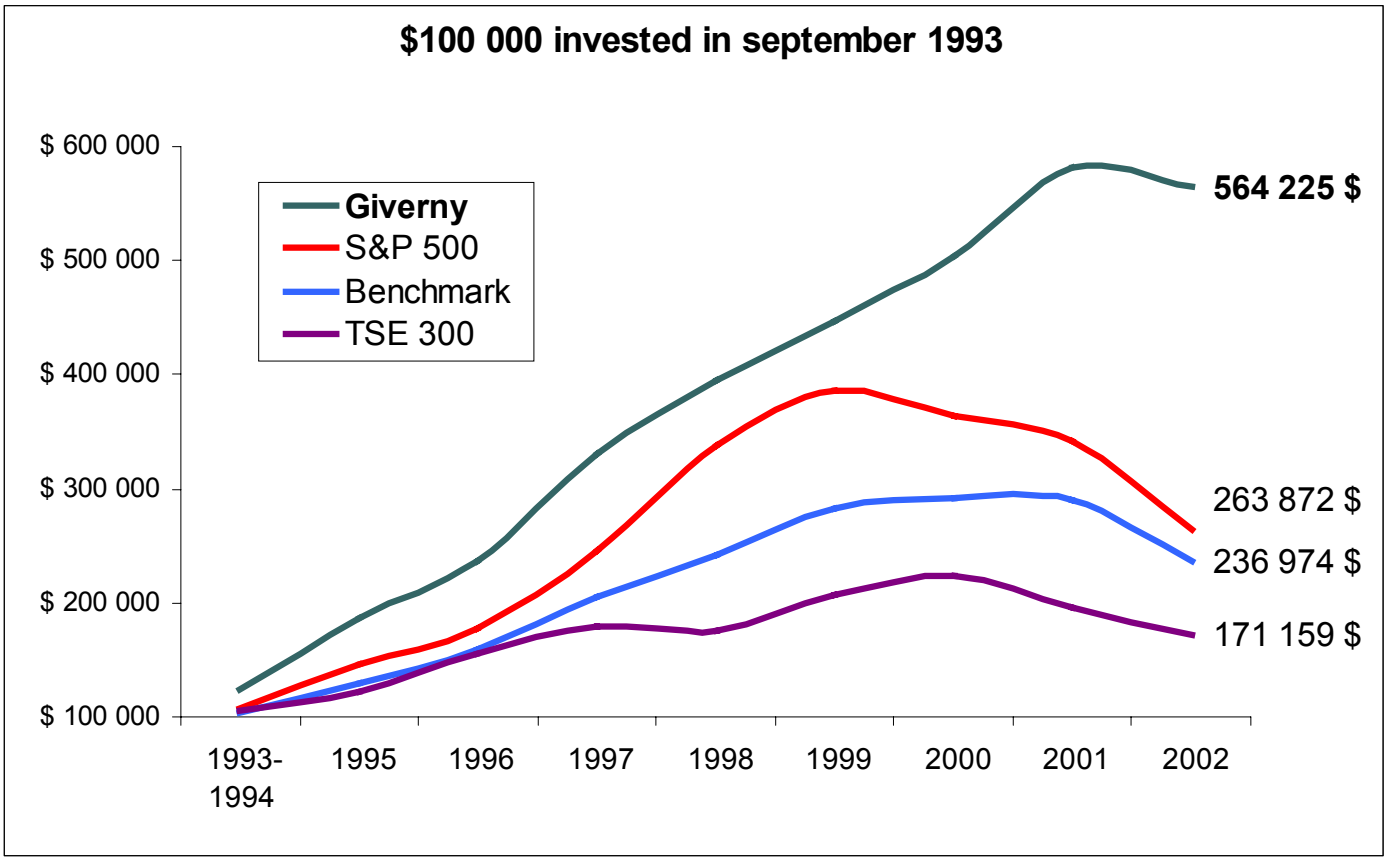
François Rochon

President and money manager.

Giverny Capital Inc.

We welcome additional clients so please pass this annual report along to interested parties.

Giverny Capital Inc.



Annual Report 2002

Giverny Portfolio – Annual Report 2002

For the year ending December 31st 2002, our return was -3% compared to -18% for our benchmark and -23% for the S&P 500. These returns all include around -1% due to the fluctuation of the Canadian dollar.

Since starting the fund, September 1st 1993, our annual return has been 20% compared to 10% for our benchmark and 11 % for the S&P 500.

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1997	40%	29%	**11%**	4%	39%	**1%**
1998	20%	19%	**1%**	7%	38%	**-18%**
1999	13%	16%	**-3%**	1%	14%	**-1%**
2000	13%	3%	**10%**	4%	-6%	**19%**
2001	15%	0%	**16%**	6%	-6%	**21%**
2002	-3%	-18%	**15%**	-1%	-23%	**20%**
Total (in Can $)	**464%**	**137%**	**327%**	**29%**	**164%**	**300%**
Annual return	**20.4%**	**9.7%**	**10.7%**	**2.7%**	**11.0%**	**9.4%**

* : Weighted combination of 5 indexes including the S&P 500 and the TSE 300.

As I said last year, these results are good but not as good as they look. The continuous fall of the Canadian currency since 1993 has added around +2.7% per year to our annual return. It is interesting to note though that our return has been quite similar for our Canadian securities and our U.S. securities which is about 18% a year.

The year 2002

As you may have noticed, the year 2002 was again difficult, for corporations and investors alike. At the bottom of September, the total lost for the S&P 500 since March 2000 was more than 50%, its biggest decline since 1973-74.

On the other hand, our portfolio's return – although not positive in absolute dollars – was 15% better than our benchmark. These results should be considered satisfactory since our long-term objective is to obtain an annual return 5% better than the indexes. Also, for the third year in a row, we did almost 20% better than the S&P 500, a phenomenon we will probably never live again in our lifetime.

In a bear market, we can read all sorts of stories to explain stocks collapse. But in fact, the abrupt fall of the S&P 500 and the NASDAQ in the last three years can be linked primarily to a general shrinkage in P/E ratios. In the 1998 annual report, I explained why I believed that the "smaller stocks" would do better in the future than the largest capitalization of the S&P 500. I noted at that time that the valuation differences were astronomical. The largest 40 companies in market cap – which represented

50% of the weight of the index - were trading at 33 times earnings and all the other 460 were trading at around 18 times. Lately, this gap has been rectified. Now, stocks in general trade at around 17 times earnings which – in an environment of long-term bonds of 5% – looks quite reasonable.

As I often mentioned in the past, I must add this warning: It would be unrealistic to think that odds favor us in maintaining a 20% annual return in the future or even a 5% added value versus the indexes, our ambitious goal. But as I promised you since day one, I have my own money in the same stocks as you do, so we're in the same boat. Our boat, I must add, is bigger than last year. From 1993 to 1997, we were four partners (at that time the model portfolio was called the Key Fund). When I founded Giverny Capital in 1998, we were eight partners (the name we give to "clients"). At the end of last year, we were up to 20. At the end of 2002, we are now up to more than 100 partners (knock on wood!).

The Rule of Three

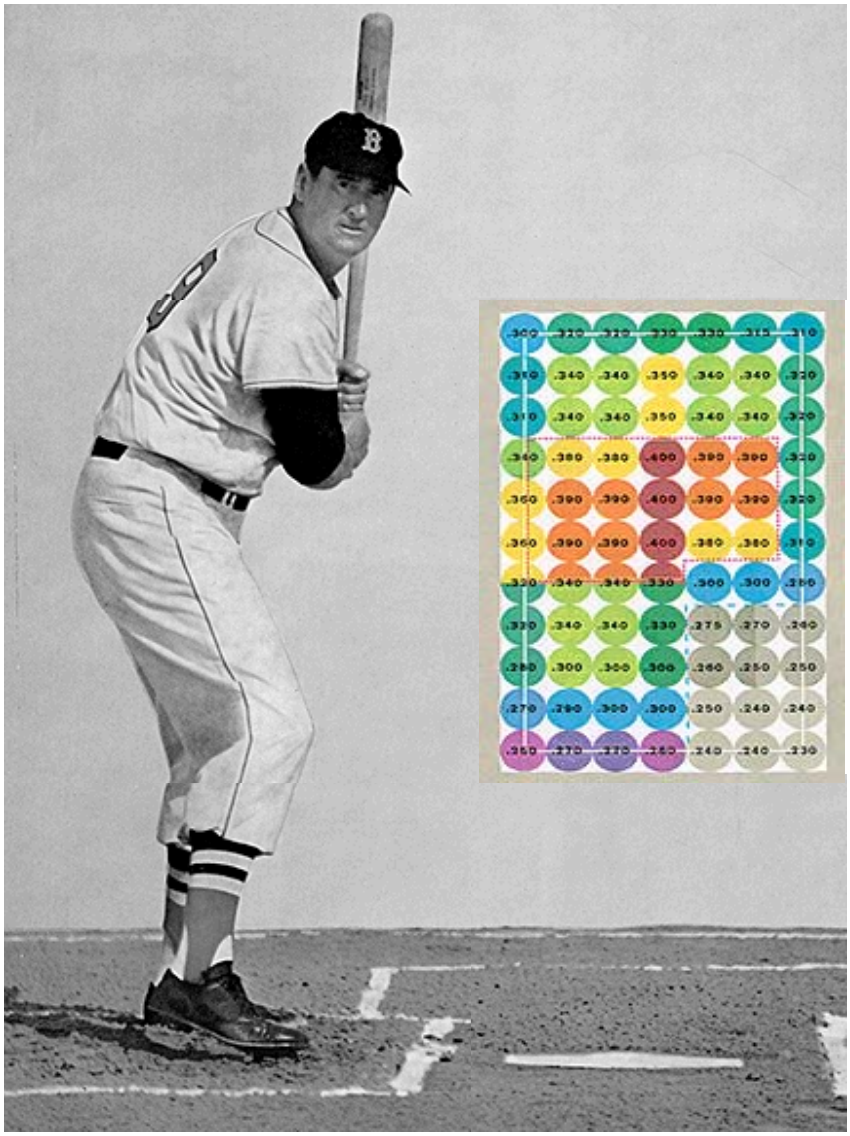
In every bear market, we see lots of investors throwing out the towel! They swear to never touch stocks again…until the next bull market. Since day one, I emphasized how inevitable stock market corrections are. I even wrote many times that they were "partners" in our quest for superior returns. So, we should not fear them but acknowledge right from the start that we will live through many corrections over the years. We should even try to benefit from them as much as we can.

In fact, I believe that there are stock market realities that should be accepted when we decide to become equity holders. I named those "The Rule of Three": One year out of three, the market will go down (by more than 10%). On stock out of three that we will buy will be somewhat disappointing. And one year out of three, we will under perform the indexes. I don't have scientific facts to offer you to explain this rule. That is why it is an empirical conclusion: it can be observed, it can't be explained. But it can be psychologically useful as knowing this rule will help us navigate through market storms. By accepting in advance that we will have tough years (in absolute terms or relative terms) and that stock mistakes are a cost of being in business, we are better prepared what they do happen. Being better prepared will help us to act in a rational way in such instances. Also, it is futile to try to predict the sequence of events. The best strategy is to be always invested in stocks and to focus on improving our selection process.

Another point: the Rule of Three is not linear. We can have three good years in a row (like 2000-2002) and then under perform for two or three years. For example, the Sequoia Fund – managed brilliantly by Bill Ruane's team – under performed the S&P 500 in the first four years of its existence from 1970 to 1973. After that, it delivered one of the best performances of all time. Another example is the Chest Fund managed by John Maynard Keynes from 1928 to 1945. After three years, its total performance was -48% compared to -36% for the British stock market. But over 18 years, he obtained an annual return of 9% compared to -1% for the British market. Keynes under performed six of those 18 years or one year out of three.

Ted Williams and the Art of hitting

Being selective and discipline are two essential qualities to become a good investor. And no one has illustrated it better that the fantastic baseball player Ted Williams, who sadly passed away in 2002.



Source: The Science of Hitting

Ted Williams played with the Boston Red Sox from 1939 to 1960. Ted was obsessed by the art of hitting a baseball. He wanted to be the best at it. Obviously, he had great physical strengths but first and foremost he had great mental strengths.

He carefully studied each of his batting presence. He divided the strike zone into 77 sub-zones corresponding to a baseball surface (see figure above) and calculated his batting average for each zone. He then he became extremely discipline, swinging only the balls he knew were in his favorite spots. He finished his career with a .344 batting average, fourth on the all time list. He was also the last player to hit better than .400.

Ted's philosophy is not out of fashion in today's baseball, an era of homerun quests. If you followed Barry Bond's achievements lately (73 homeruns in 2001 and a batting average of .370 in 2002), you could notice how discipline a hitter Barry is. In 2002, he broke all historical records by obtaining 198 base on balls. The way he calmly looks at every pitch without swinging on bad balls is a pleasure for the eyes…and a nightmare for opposite pitchers.

For stocks investors, the lesson is simple: to maintain a superior average, we have to buy stocks that are in our favorite zone, that we can value. And the stock market gives us an incredible advantage that neither Ted or Barry could ever dreamed of: We can decide to let go a pitch that is in the center of the strike zone without having a strike being called upon us. Every day, the market throws us pitches: Bombardier at $5, GE at $30, Intel at $18, etc. We have the luxury to wait for a ball that is – for us – big as beach ball. And as Barry Bonds does it so well, there is nothing wrong in looking at pitches that are simply not in our favorite zone. For example, oil and gold stocks aren't in my radar, whatever their prices or the geopolitical climate.

Our businesses

Quality means doing it right when no one is looking. - Henry Ford

M&T Bank [N: MTB]

Our Buffalo Bank had another great year. Its return on assets reached 1.7% and its return on equity (ROE), 29%. Earnings per share (EPS) were up 11%. M&T also announced an important acquisition last fall: Allfirst Financial. It is difficult to evaluate the future impact of this merger but I have great confidence in the judgment of Robert Wilmers, M&T's CEO. In the banking industry, I trust Mr. Wilmers' judgment more than anyone else's. M&T stock did well in 2002, climbing 10% in line with intrinsic value. This superb bank is still our biggest holding.

Groupe BMTC [T: GBT.A]

Our furniture retailer had another great year in 2002. EPS were up by more than 50%. The strong real-estate market in the Province of Quebec gave a good push to sales but BMTC did also very well in tougher years. Since we first acquired shares in 1995, EPS are up 26% annually, or by a factor of five folds. The stock has faithfully rewarded shareholders by climbing from $2 to $14 in 7 years. The company is still debt-free with excess cash. Competition is increasing (more honey brings more bees) but I would not think of fighting in the same market as Mr. Des Groseillers, BMTC's CEO. He's the best at what it does. The newspaper *Les Affaires* recently published an all-star list of four Quebecker stocks. BMTC was one of them. And even after all this, the stock is still trading at around 10 times earnings. Some things never change! BMTC is still our biggest Canadian holding.

Progressive Corp [N: PGR]

Progressive is a car insurer located in Mayfield Village, Ohio. It was probably our company that had the best intrinsic performance in 2002. Premiums were up 30% and the combined ratio was down to 92%, an exceptional ratio. The industry's average is higher than 100%. EPS were 45% higher and its ROE reached 20%. Strangely, the stock was unchanged in 2002 (although in a year when the S&P 500 is down 22% it's not that bad). Still, PGR is twice the level we acquired it at the end of 1999. Long-term perspectives still look very good.

Cognex [Q: CGNX]

It's been six years since we first acquired shares of Cognex. So far, we had ups ands downs but it has not been very rewarding yet. It was another tough year for our "machine vision systems" company. Cognex could not escape the depression that has hit the entire high-technology field. It lost money for the first time in its history. In spite of all this, I still have great confidence in Robert Shillman,

Cognex's CEO. I believe that Cognex is increasing its market share and when the market recovers, it will fully benefit from its efforts and patience. No top manager got a bonus in 2001 and Mr. Shillman reduced his salary from $310 000 to $89 000. Stock options were also down. Mr. Shillman still owns 13% of the outstanding shares, so he's in the same boat as ours.

I really understand this company (after six years, you would hope so) and when the stock went under $15, it seemed to me like a ball right in the center of my favorite batting zone!. Cognex is our second largest holding. The only thing left to do it to be patient. The industry will turn, it's not a matter of "if", it's a matter of "when". Cognex has the balance sheet and cost structure to withstand the crisis.

Bed Bath & Beyond [Q: BBBY]

It was our fourth year of ownership in shares of Bed Bath & Beyond. The company had a fantastic year with EPS up 40% (after 10 years of consecutive growth of 30%). Since our first purchase in 1998, EPS are up three fold. The stock is up by 250% since then. We had acquired most of our shares during a market correction linked to an Asian crisis in October 1998. Hey, who remembers that one today? We did take double advantage of this correction by buying another of our retailer, Fastenal, at a third of its current quote.

Like I said before, market corrections do have their bright sides!

<u>Transactions of the year</u>

In 2002, no market sector was more depressed than technology. Although our purchases in this sector so far in this bear market has not prove very rewarding, I still believe that the "technological revolution" is not over. Andy Grove, Intel's chairman, said last year: "Just wait five years and you'll see!". And I can wait. But it is imperative that we do choose companies that have strong moats that will permit them to be still market leaders in five years. Many companies – which I believe are of that caliber – were trading at quite attractive level this year. It was even difficult to decide which ones to choose. So I decided to adopt a "basket" approach and buy eight of these businesses. I bought back shares of Intel I had sold a few years back. And for the first time, I bought shares of Microsoft and Applied Materials, two enterprises which I had admired for so many years. So, we still have around a quarter of our portfolio in technology companies.

Our focus approach, though, is still intact. We have around 70% of our assets invested in 10 stocks.

Johnson & Johnson [N: JNJ]

If you have a good memory, you'll remember that in 1994, I almost bought shares of J&J. At that time, growth prospects were great and market valuation very low (around 12 times earnings). My inaction was a terrible mistake. And I even found a way to do worse. I had bought shares of Cordis Corp in 1993 at around $27. In September 1995, J&J acquired Cordis in a stock transaction worth $109 per Cordis share. But since J&J had doubled that year, I thought that the stock was too expensive and decided to sell our stocks instead of exchanging shares (and I paid huge amounts of income taxes).

Since then, J&J is up 200% compared with an increase of 50% for the S&P 500. If I had took J&J's stock, we would have a total return on our Cordis purchase of more than 1100% in a period of almost 10 years (this is 28% annually). And we still would have not paid a single penny to the governments

besides taxes on dividends. In spite of heavy remorse toward J&J, for obvious reasons, I had always continued to follow the company closely. And last summer, we had a chance to acquire shares at a good price when there was an FDA investigation at their Puerto Rico plant.

J&J has tripled its earning power in the last 8 years and its growth prospects are still impressive. My only consolation is to say to myself that it is never too late to invest intelligently.

Sales in 2002

We did not do much selling in 2002. Sometimes, I decide to sell one stock because I simply found another company I want to acquire shares of. When I believed that Cognex was at a very attractive price, I sold shares of Yahoo!. It seemed to me that when valuations when taken into account, Cognex's stock was a better use of our capital.

Postmortem 1997

One of the things I admire at J&J is that the company always does a postmortem after an acquisition. Few companies do so for obvious reasons: in most cases, they would have to conclude that an error was perpetrated. It's not all managers that are "able" to assume such responsibilities.

In the section "Mistake du jour" in my annual reports, I force myself to review past purchases (and non-purchases) that did not turn as good as expected. It is good also to review past sells after a sufficient lapse of time has gone by. This year, I would like to do postmortems on two important selling decisions of 1997: Bombardier [T: BBD.B] and Sun Microsystems [Q:SUNW].

In 1997, Bombardier made up around 20% of our portfolio but in mid-year, I decided to cut this weight to 2%. This is what I wrote then to explain this bold move:

...lately, we sold most of our shares for three reasons:

1. *It seems that the future prospects are not as solid as in the last five years as the company looks more sensitive to economic slowdown.*
2. *The market valuation has become high, in spite of the point 1.*
3. *The departure of Raymond Royer – whom I consider the real brain behind the success of Bombardier – is definitively not positive.*

After, we had sold 90% of our stocks, Bombardier shares went up 300% in the three years that followed. I then considered this sale as a mistake and it was recognized as such in the "Mistake du jour" section in the 1999 annual report. But I added this comment at the end of the phrase: "…*But the real test for the long term business model of Bombardier would be a recession."*

In 2001-2002, a deep recession did hit the airline sector and Bombardier was strongly affected. The recessionary environment was amplified by the higher level of debt at Bombardier and some problems with acquisitions in the transport division (Adtranz). The stock fell from $25 to $5, a lower level than the one we sold at in 1997. Bombardier Capital also had "diworsefy" (Peter Lynch's expression for bad diversification) and had to take lots of charges. It is far from clear, as I write those lines, how long it will take for Bombardier to get back on the growth path.

There are lots of conclusions from this epic. First, it takes years to measure the impact of a top managerial change. So it can take years to judge the quality of an investment decision. Those who believe that they are quite witty because of a few years of strong performance – for a stock or for the owl portfolio – should develop a strong auto-scepticism reflex (and if from time to time I forget it, Bernard Mooney, my long-term friend and partner, is not far to put me back in line).

There is another important conclusion toward Bombardier or the stock market in general. In 1993, when growth prospects for the five years to come were strong, the stock was trading at around 10 times earnings. In 2001, with more leverage on the balance sheet and a tough environment starting to unfold, the stock was trading at 30 times. Too often, investors are more inclined to look at the rearview mirror than the windshield.

On Sun Microsystems, in 1997, I wrote this phrase: *"...In 1994, we acquired shares of Sun Microsystems at $5.25. At that time, the company was earning $0.50 a share and had $2.50 in cash (no debt). So the real P/E was around 5x. With new high-margin products being put on the market (servers), Sun prospects were better than ever. But its stock was trading at the lowest level it ever traded. In the three years that followed, EPS went up to $1.89, a 278% jump. In spite of this, I decided to sell our shares because I believed that Sun's future could be affected by Intel-HP alliance in developing a new 64 bits CPU (central processing unit). And Sun's stock is now trading at $52, a 900% rise. The uncertainty is not reflected in its higher P/E. I now prefer Intel's stock…."*

After this sale in 1997, Sun's stock went up ANOTHER 1000% in the three years that followed. At its October 2000 high, Sun's P/E had reached 100x. And that was a few months before EPS started to decline. The P/E was 10 times the level of 1994 in spite of quite lower growth prospects in the years to come. When I say that the market is manic-depressive, here is a clear example. And the re-evaluation that followed was abrupt for Sun's stockholders: the shares went from $60 to $3 in the last 24 months.

As for Intel, we did make a satisfactory profit even though the stock is now the same price as in 1997. When the stock reached high valuations in 2000, I started to sell. What is interesting is that it's only in 2002 that Intel finally put on the market its 64 bits chip (named Itanium) and is now threatening Sun's market share (Dell Computer servers are gaining market share at a rapid pace). Again, as for Bombardier, it took five years for the reasons I sold our shares to materialize As the legendary investor Phil Fisher would say: "*It is easier to know WHAT will happen than WHEN it will happen*."

Now I am not proud that these two companies have fallen from grace. That means that my initial buying was not that brilliant! I owned Bombardier and Sun for five and three years respectively. For a while, these were great businesses. But the lesson for me is that things change. Seldom do businesses stay great for decades. So we have to always keep an opened mind and not lose track of the fundamentals of a company we own shares in.

Owner's earnings

As you know, Giverny Capital is different from the other money management firm in some respect. We measure the quality of an investment not on short-term market gains but by focusing on yearly earnings growth and long-term fundamental prospects. Over a five years period, the stock market will tend to reflect those two variables. Warren Buffett has long used this method to measure the intrinsic value contribution of Berkshire's stock holdings. Besides W.P. Stewart & Co, I seldom seen other firms make such a calculation. For most of our competitors, the short-term market performance is the supreme judge. We try to be ourselves the judge of our underlying business performance.

In 2002, our stock's quotations were on average mostly unchanged. But our owner's earnings were up around 18-20% and our ROE was 18%, which is a very strong global performance from our businesses.

In some cases, the discrepancy between market performance for one of our stock and its underlying increase in intrinsic value was quite large. For example, as I wrote above, Bed Bath & Beyond increased its EPS by 40% but its stock was up only 3% for the year. Health Management Associates grew its earnings by 21% and the stock was actually down 3%. But in the long run, if the company does well, the market's quotation will eventually catch on. At Giverny Capital, we like such temporary gaps in valuations and we try – within a reasonable level of transactions – to profit from them.

***** WARNING *****
The following section contains sentences that could offend some readers

Mistake *du jour*

If you close the door to mistakes, the truth will stay outside - Rabindranâth Tagore

This section, as always, could be very long. I limit myself to Olympic like medals that are yearly attributed to the top three mistakes of the year. In 2002, we make a backward assessment of mistakes that happened in 1999-2000 but whose consequences on our return this year were awful.

Bronze medal: Heartland Express [Q:HTLD]

It's the second time that this company is mentioned in the "mistake" section. In 1999, I wrote: "…*Our adventures into the marvelous world of trucking, with the investment in Hearltand Express, were not very profitable. I should have learned my lessons about the competitive nature of the industry after we had been shareholders of Groupe Goyette in 1993. But as Malcom Forbes once said: To make a mistake is human. To repeat it is human too!…*"

The funny thing, retrospectively, is that the mistake was not to have invested in the trucking industry but – again – a cruel lack of patience.

I had invested in HTLD in 1998. I then believed that Heartland was an enterprise of the type I like to label "Oasis in the desert": a great company in a lousy industry. Net margins stood at 12% compared with 2-3% for the industry. Not counting the excess cash, Heartland was earning 40% on equity.

Such an extraordinary business performance was linked to Heartland's low cost operation. And the company was acquiring lots of competitors to sustain a high growth rate: In the last 15 years, the annual growth in EPS had been 20%. As usual, such an accomplishment was made possible by brilliant management. Heartland was led by Russel Gerdin, its CEO. Mr. Gerdin was earning $300 000 a year with no bonuses, a salary unchanged since 1986. He owned 40% of the outstanding shares. And the company had no stock options plan (I like that). Mr. Gerdin was clearly in the same boat as its shareholders.

So why – oh why – did I sold our shares in 1999? The company had a few flat quarters as management could not fin acquisition candidate at a reasonable price. I then thought that Heartland was becoming a

slow grower and I decided to sell. I simply lack patience. The company finally did make some acquisitions and EPS went from $0.57 in 1999 to $0.85 in 2002. The stock has increased by 200% in 3 years. Mr. Gerdin and the more patient shareholders were highly rewarded. But not us!

Silver Medal: Expedia [Q:EXPE]

When the stock market goes down 50%, there are few places to "hide". But Expedia's stock is up 500% in the last two years. I started to follow the company as soon as it went public in 1999. I knew the company well as I used their Internet site (plane ticket retailing at discount) quite often. The company was founded by Microsoft and looked well managed on its own. But I have this rule to wait for a small company to show a profit before investing. Nevertheless, I followed Expedia closely.

In the fall of 2000, the company had its first quarter with a positive cash flow and I believed that the company could become profitable in a quarter or two. The stock had fallen from $60 to $10. The company had $5 in cash and I believed it could earn $1 per share in a not too distant future. So at $10, the stock looked quite attractive. And as I was studying the company, a client called me to ask where to invest some excess cash. And I talked to him about Expedia and he acquired some shares at $10. And before I could decide what to sell in my other accounts to buy Expedia for all clients (including me), the stock started to climb. It reached $15 in a few weeks.

In a very childish reflex, I said to myself: "I missed it". So I waited – in vain – for the stock to fall back to $10. Expedia earned $0.89 in 2001 and around $1.80 in 2002. The stock is now at $65. Beside the client that called me that day, no one of us made money on it. It is interesting to note that I was disciplined in waiting for the company to make a profit but I should have been more perspicacious. Because if discipline is to respect one's own rules, wisdom is to know when to break them!

Gold Medal: Richelieu [T:RCH]

Five years ago, my good friend Bernard Mooney spoke to me about a company in which he had invested : Richelieu Hardware. The company is a distributor of various home products. I look at the numbers and they are impressive: Richelieu has a strong balance sheet and earns around 30% on equity. The growth rate is surprisingly high, more than 25% a year, with quite high margins for such an industry. Of course, there is always great people behind great numbers. Bernard tells me about his admiration for Richard Lord, Richelieu's CEO. Mr. Lord has a defined plan and a common sense managerial approach focused on the company's strengths. And another little thing to notice, the stock was trading at $3 (adjusted for splits) at a P/E ratio of only 9x.

It took me three years to decide to acquire some shares at the end of 2000. And I was worried that the recession that was starting out would affect the company and I decided to buy slowly, only for clients with cash in their accounts (I did want to sell some other stock). I started to buy at $5.5 but the stock climbed above $6 quickly and I did not want to pay a few points more. The stock then doubled in 2001, a down year for markets.

At the beginning of 2002, Bernard set up a meeting with Mr. Lord and us. I was very impressed by him but again I wanted to wait for a "lower" valuation before acquiring other shares. The stock has climbed another 50% since then (and 2002 was a worse year for the markets than 2001). So Richelieu's stock is now five times the level it was five years ago and almost three times the level of 2000. And I understood the company well (Bernard was an expert on the business) so there is no excuse. This mistake is gold caliber! But believe it or not, that is not all…

There are some strange coincidences in life. In 1993, I had bought my house in La Prairie. And the door lock is from Richelieu (it's even written on it). Every day for the last 9 years, the first thing I see when I get home is the name of the company! After Bernard talked to me about Richelieu, so often I said to myself I should study the company more closely. My punishment for my lack of perseverance was to see the name of the company again and again for the most part of 2002. I say "the most part" because in July, I changed my lock and this time I made sure to buy one without a name written on it!

Conclusion : « The gardener and the investor »

Last year, I described an analogy between investing and art. Three years ago, I used analogies with the psychology field. Charles Munger, Warren Buffett's wise sidekick and CEO of Wesco Financial, said many times how important it is not to see the world trough one mold but to have many different analytical models. For example, Ted Williams' analogy, is extremely pertinent.

When I named my money management firm Giverny Capital, it was in honor of Claude Monet and its creations, both his garden and his paintings. But there was also an analogy between the craft of investing and the work of building majestic gardens as the one Monet created in Giverny (France). To build such gardens, you first need a deep love for the gardening craft. You also have to really know the environment where you're setting up the garden: temperatures cycles, the sun's direction, the insects present, the soil, etc. Some plants just can't grow in Quebec. It's the same thing in investing: some sectors can't be understood by one money manager (as the aluminum and paper industry for me).

And it's a dynamic process: you always have to follow closely the flowers and trees that are cultivated in the garden. Some will blossom, some others not. Adjustments have to be made on a regular basis to maximize the space at our disposal. It's the same thing with our capital.

Peter Lynch on said that it is imperative that "*you do not remove the flowers and water the weed*". In stock language it means that we should not sell our winners to buy more of our losers. Furthermore, it is not illogical to make some experiments on a small soil surface to see what happens. A wise investor can acquire a few shares of a company to become more familiar with it.

But where the analogy is the most relevant is on the virtues of time and patience. Warren Buffett noted to Robert P. Miles (the author of the marvelous book *The Warren Buffett CEO*) that one of the main reasons that Berkshire was such a success is that he was CEO for a very long time (Mr. Buffett took control of Berkshire in 1965). Too often, a CEO is appointed late in his career and stays at the head of the business for 10 years or so, sometimes less. Frequently, great achievements are done over many decades. For example, at General Electric, the best performance was realized in the second decade that Jack Welch was CEO. That is why I like to invest with companies that exist for more than 10 years and are still managed by the founder(s) like Fastenal, Cognex, Bed Bath & Beyond, Applied Materials, Gentex, Costco, etc. A great garden needs years to become a masterpiece.

The legendary impatience of Wall-Street investors is a handicap to such blooming. Can you imagine a great gardener that would plant a tree and remove it after six months because it has not grown fast enough? Trees take time to grow; Companies are made from the same wood! Great entrepreneurs and great gardeners often have similar dreams: building a garden of tall trees that will give shades to many people for generations to come. And the gardener that genuinely love his craft, one day, realizes that his sense of purpose and happiness does not lie in the final results but in the daily journey.

Managing our portfolios give me such fulfillments.

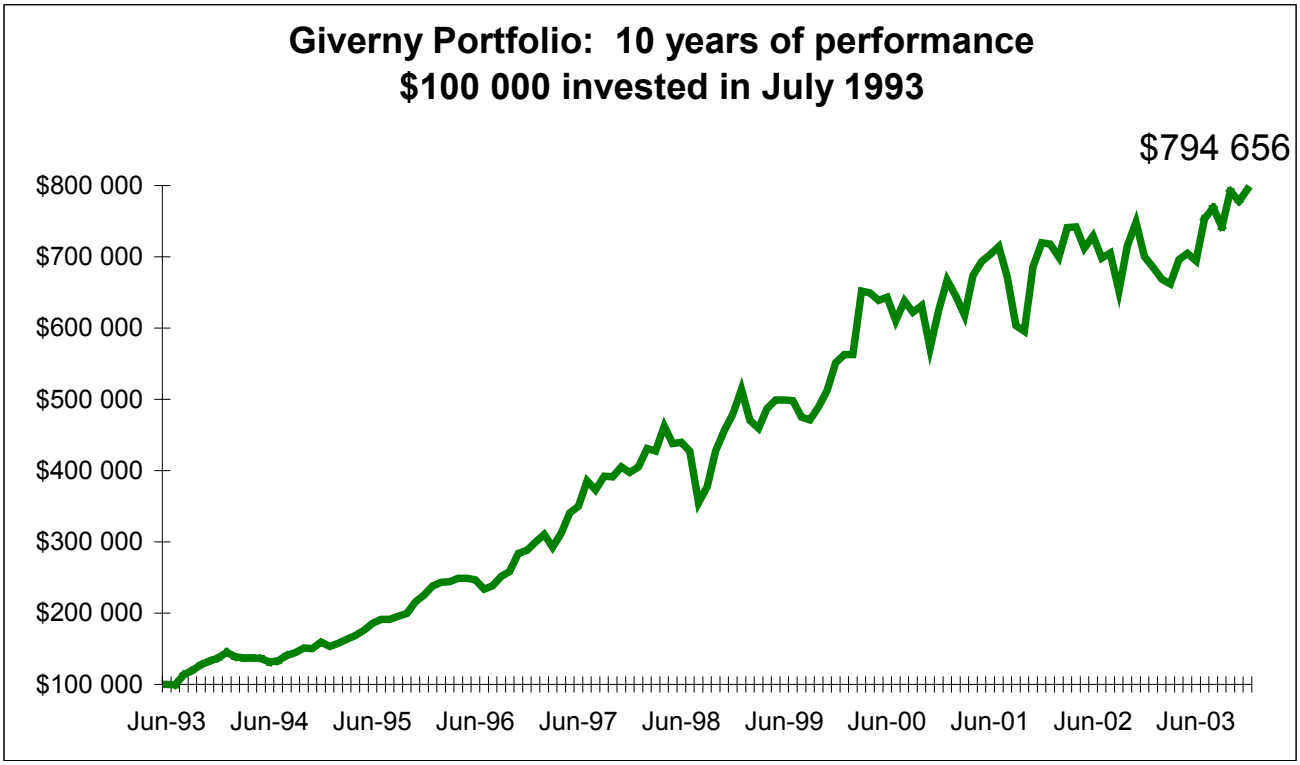
I thank you again for your trust and I wish you a great year in 2003

François Rochon
President
Giverny Capital Inc.

Giverny Capital Inc.

Annual report 2003

10th anniversary



Giverny Capital Inc.
Annual report 2003 ©

For the year ending December 31th 2003, the combined return for our global portfolio was 14% compared to 14% for our benchmark. Both results include a loss of almost 20% on the Canadian currency exchange.

Our relative return for the year was -0.4%. Compared with the S&P 500 and TSX, our relative performance was positive. But we also include in our benchmark small cap indices which have done extraordinary well in 2003.

In 2001, I underlined the fact that our results were good, but not as good as they look. This year, it's the other way around: Our results (in absolute terms) are far better than they look. Our stocks did around +34% in 2003. Since 80% or so of our portfolio is invested in the US, the spectacular rise of the Canadian dollar had a non negligible effect on our returns.

How should we react to such a matter? First, we have to recall ourselves that from 1993 to 2002, the weakness of the Canadian Dollar favored us. We easily put up with the gains at that time. But we have to be ready to accept the losses when the reverse happens. In fact, in 2003, the Canadian Dollar is simply back to where it was at my beginnings in 1993. Over the years, currency moves had a moderate effect on our results (+1% on a +694% gain).

On a more philosophical side, we have to recognize that, in life, there are elements that can have some control over or events we can predict the outcome with a reasonable level of confidence. Some others are unforeseeable and totally out of our control. For me, currency movements are of the second type.

My investment approach is to acquire outstanding businesses managed by topnotch people which stock looks to me undervalued. This approach is rational and has showed its merits, to me and to many other portfolio managers. And the United-States of America continues to be the best pond to "fish" such businesses. It is the Mecca of capitalism, where small businesses can blossom into multinationals and shareholder's capital is treated with respect (most of the time). We won't deprived us of investing in a great American company because of the Canadian currency. So our attitude will be to live with currency fluctuations not to fear them.

I'd like to add that we're not talking about investing in a country with an unstable economy and a shaky currency. The US still has – by far – the best economy in the World. The fact that much more people want to immigrate than emigrate is quite revealing. Also, when Saddam Hussein was captured in December, what was the only thing that he brought with him in hiding? Answer: American Dollars ($750 000 of them). Moreover, Mr. Hussein is not known to be pro-American. But when his life was in jeopardy, he made a economic choice over a political one.

An educational mistake

There is a lot to learn from our mistake but it is a little less painful to learn from other's mistakes. In my early years, I strongly recommended shares of Cordis Corp to a money manager. In fact, Cordis was the subject of my first detailed recommendation. Cordis was the leader in catheters, medical devises used in cardiovascular operations. I even talked to a doctor to help my research and he confirmed to me that Cordis' products were far better than the ones from its competitors.

The company was growing 25% a year and the stock was a bargain at 13 times earnings (thanks to the Clinton health reform project that scared Wall Street). So I recommended purchasing the stock at $26 a share. The money manager liked my idea but he said that it was not a good time to invest in the US because the Canadian dollar was to low (at $0.80). I did not listen to him and bought shares, for myself the first time in February 1993. And Cordis went on to be acquired by Johnson & Johnson at $109 in October 1995. An investor who would have kept his stock for 10 years (swapping them for J&J stock in 1995) would have made 10 times his money. Even if the Canadian dollar were at par with its US counterpart today, Cordis' purchase would have turn out to be quite a rational decision.

In his book « *Common stocks and Uncommon Profits* », the legendary investor Philip Fisher devoted a complete chapter on "when to buy". His conclusion was that the best time to buy a great company is when we find it (and the price makes sense). His chapter ends with this major statement: **« Be undeterred by fears or hopes based on conjectures, or conclusions based on surmises »**

Our return over the last 10 years

The published returns have been audited by PriceWaterhouse Coopers. For the period of 1993-1997, they are a little different from the ones published in the past. They now include the 5 family portfolios that I manage since 1993 and the starting date has been moved to July 1st 1993. Also, I now divide the portfolio in two parts: the RRSP portfolio and the non-RRSP portfolio (Giverny International). The Giverny portfolio is simply the combination of the two parts.

Giverny portfolio (all returns in Canadian dollars) :

Year	Giverny	Index **	+ / -	S&P 500	+ / -	$ US / Can ***
1993 (Q3-Q4) *	**37.0%**	9.5%	**27.6%**	8.4%	**28.6%**	3.3%
1994	**16.5%**	3.7%	**12.7%**	7.3%	**9.1%**	6.0%
1995	**41.2%**	24.0%	**17.2%**	32.9%	**8.3%**	-2.7%
1996	**28.0%**	22.8%	**5.2%**	22.7%	**5.4%**	0.3%
1997	**37.7%**	28.5%	**9.2%**	36.7%	**1.0%**	4.3%
1998	**20.6%**	18.8%	**1.8%**	37.7%	**-17.0%**	7.1%
1999	**15.1%**	16.3%	**-1.2%**	14.1%	**1.0%**	-5.7%
2000	**13.4%**	3.2%	**10.2%**	-4.6%	**18.0%**	3.9%
2001	**15.1%**	-0.4%	**15.5%**	-5.7%	**20.8%**	6.2%
2002	**-2.8%**	-18.3%	**15.6%**	-22.0%	**19.2%**	-0.9%
2003	**13.6%**	14.0%	**-0.4%**	5.7%	**7.9%**	-17.8%
Total	**694.8%**	**193.8%**	**501.0%**	**202.2%**	**492.6%**	**1.1%**
Annualized	**21.8%**	**10.8%**	**11.0%**	**11.1%**	**10.7%**	**0.1%**

* From July to December 1993.
** An hybrid benchmark of 5 indexes (S&P/TSX, S&P 500, Russell 2000, etc.) which reflects approximately the asset allocation.
*** The US Dollar compared with its Canadian counterpart.

Giverny International (in US dollars) :

Year	Giverny Intl.	S&P 500	+ / -
1993	32.7%	5.0%	27.7%
1994	9.1%	1.5%	7.7%
1995	54.8%	36.6%	18.6%
1996	27.0%	22.2%	5.4%
1997	32.9%	31.0%	1.7%
1998	11.0%	28.5%	-17.4%
1999	15.9%	21.0%	-4.2%
2000	11.3%	-8.2%	20.0%
2001	8.1%	-11.1%	18.7%
2002	-4.4%	-21.4%	17.4%
2003	31.6%	28.6%	3.0%
Total ($US)	637.0%	198.9%	443.8%
Annualized	21.0%	11.0%	10.2%

Giverny RRSP (in Canadian dollars):

Year	Giverny RRSP	S&P / TSX	+/-
1995	0.4%	14.3%	-13.9%
1996	29.9%	27.8%	2.2%
1997	32.3%	15.0%	17.3%
1998	29.3%	-1.2%	30.5%
1999	42.7%	31.1%	11.6%
2000	5.2%	8.2%	-3.0%
2001	16.2%	-11.5%	27.7%
2002	6.3%	-11.6%	17.8%
2003	32.4%	26.7%	5.7%
Total	447.3%	133.3%	314.0%
Annualized	20.8%	9.9%	10.9%

Since the start of managing our capital, July 1st 1993, our annualized return is more than 21% compared with 11% for our benchmark. Also, our yearly compounded return is 10% better than the S&P 500, a performance with would put us in the top 1% of money managers in North America.

These results far exceed our objectives and what can be expected in the future. Our ambitious goal is to add 5% annually to the indices. If stocks in general return on average 6 to 9% per year in the future – which seems to me realistic – we would be more than happy to earn 11 to 14% per year.

The year in review

Once again in 2003, the stock market showed its manic-depressive character. During the first months of the year, pessimism ruled the markets. The media focused only on the war in Irak. There were lots of attractive stocks. It was hard to choose which ones to buy. I acquired small stakes in many companies I knew well for some time like Factset Reseach, Expeditors International of Washington, Harley

Davidson, Walgreen, Fifth Third Bank, Resmed and First Data (a stock I owned for two years before I mistakenly sold in 1999, see the "mistake du jour" section in the 2001 annual report).

The old saying that the military are always ready to fight the previous war fits like a glove to Wall Street strategists. They forget that each crisis is different in nature: tomorrow is always an unknown land. Because it is new and unforeseen, the present crisis always looks worst than the previous ones. I keep preciously old articles from 1962, 1974, 1982, 1987 and 1990 to remind myself how gloomy the future looks in the depressive phases of the stock market.

To the general surprise ("as always", a cynic could add), the S&P 500 climbed 40% from its March low. Some of our high-tech stocks purchased in 2001-02 were even more rewarding (Applied Materials, Cognex and Intel doubled in a few months).

The biggest mistake stock investors regularly make

This brings me to a fascinating subject: Stocks are the best asset class in the long run but still most investors never really make money investing in them. Why is that?

The author André Gosselin recently wrote an article on average returns for stock investors from 1984 to 2002. In an period where the S&P 500 returned a 12% average, the mutual fund owner has averaged around 3% per year (Source Dalbar Inc.). This is 6% less than the 9% that the average mutual fund returned. The first 3% differential between the funds and the S&P 500 can be mostly explained by fees paid to the many parties involved. But the other 6% is quite surprising. It's too high a number to be explained by entry (or exit) fees.

So there can be only one explanation: the great majority of stock investors trade their shares (funds or stocks) at the wrong time. They sell when quotations are low and buy when they're high! This could apply to funds, stocks, sectors or even styles. To summarize their flaw: they frequently make purchases or sells based on extrapolating recent market quotations.

Clearly, most participants in this performance chase think they can optimize their market entries and exits better than the others. This reminds me of a Swedish car drivers poll that Charlie Munger – Warren Buffett's partner - talked about in one of his famous speeches: 90% of drivers believed they were better than the average!

The simple fact is that many investors can't stand market corrections and want to avoid them at all costs. But as the great investor Peter Lynch once said: Market corrections are part of stock investing and they are the price to pay for higher returns. So forth, he added, the most important organ in investing is not the head but the stomach.

Since no one really knows what the market will do in the short run, the best strategy, I believe, is to simply stay invested (at least as long as we find businesses that meet our criteria). And one thing that 2003 showed us again is that the first ingredient to make money in the stock market is to be *present*.

Trying to predict market quotations – for a stock, a sector or the whole market – is futile. It is astounding to see how many investment "professionals" continue to waste their time and talent on an activity that has so many times proved its uselessness. And what is most surprising is that many investors still continue to read almost religiously market forecasts. In Greek mythology, Cassandra was condemned by Apollo to know the future but to be disbelieved when she foretold it. Hence the

agony of foreknowledge combined with the impotence to do anything about it. Wall Street gurus are in the reverse situation: They don't know the future but they are often blindly believed when they foretell it.

And there is something worst: brilliant investors that wait for a *better* moment to purchase shares of companies they like and admire. Bernard Mooney and I know very well a money manager that is truly an outstanding stock picker but that has been pessimistic about the stock market for 18 years. As he invested 100% of his portfolio in his favorites stocks and just forgot about the market, he would have done more than 20% a year for more than three decades.

In this line of thinking, to be humble toward the stock market becomes the supreme advantage. An investor that decides not to try to outsmart the market (in believing that HE will know when it's the best time to invest) can in the end beat 90% of his colleagues.

How to react to market volatility

The conclusion of the preceding paragraphs is that market volatility remains the greatest concern for most participants. Fifty five years ago, Ben Graham gave us the right framework to deal with stock fluctuations by stating that market quotes are "what others think the company is worth" not its true intrinsic value (at least in the short run). If we can see beyond quotations, market volatility can become our greatest allied in our noble quest for richness.

This reminds me of a movie quote from *The Matrix*. When Neo goes to meet the Oracle, he meets a young boy bending spoons. Neo tries on its own but fails. The boy then says: "Do not try to bend the spoon. That's impossible. Instead, only try to realize the truth…. There is no spoon…. Then you'll see, that it is not the spoon that bends, it is only yourself."

A similar wisdom can be applied to market quotations. Once we understand that they can often be mirages, we can transcend them and come to see stocks simply as shares of businesses…which in the end is the one and only reality.

Picking truly great companies and to become immune to stock market fluctuations is indeed hard to develop and to fully master (we're never really arrived at destination). But it is the key to succeed in the long run. To paraphrase Jimmy Dugan in the baseball movie *A league of their own*: "The hard is what makes it great".

Macro-economic comments

I have a minimalist attitude in the area of economic analysis. As usual, I don't make any prediction concerning the economy nor the market. But in general, it is not being rash to avoid what is popular, what I label the *flavor of the day* on Wall Street (or Bay Street in Canada).

These days, what is popular – its seems to me – are gold stocks and basic materials companies (particularly in Canada). China or not, a commodity remains a commodity. Basic materials companies in their aggregate are condemned to generate modest returns on capital in the long run. And the worst time not to avoid them is when they're popular.

Investment philosophy

It's "Dejà vu" all over gain

- Yogi Berra

Note : this section is mostly a repetition from old reports intended for new clients. The older ones can skip it!

The year 2003 was not only good for the stock market but also for Giverny Capital. The number of partners (what we call a client at Giverny Capital) has tripled to reach 360. We also got our first institutional mandate: a religious foundation. With all these new comers, it is imperative that we talk again (and again) about our investment philosophy.

Let's be honest: many clients have been attracted to our firm because of the portfolio returns. It's quite legitimate and it could be said that I got what I bargained for! But what is the most important thing to consider when choosing a money manager is the investment philosophy. Returns on capital is the result of the philosophy. To fully adhere to our approach is essential. Because if not, sooner or later, you're going to be disappointed.

Here are the key points:

- In the long run, stocks are the best investments (8-10%), better than bonds, real estate, gold, stamps and treasure bills.
- It is futile to predict when it will be the best time to begin buying stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity). We focus our capital on businesses that we believe can – in the long run – earn 15% on equity annually.
- To sustain a high level of profitability, a company must have intrinsic qualities that protect its market from competitors (what Warren Buffett calls a "franchise") that is the equivalent of a moat shielding an economic castle from invaders.
- A franchise doesn't emerge from nowhere. It is built by men (or women). The essential ingredient thus is the quality of top management. Becoming shareholder is becoming partner with them.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be grossly assessed.
- The stock market is dominated by participants that perceive stocks almost as casino chips. With that knowledge, we can buy great businesses sometimes well bellow their intrinsic value.
- But there can be some time before the market recognize the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

One important point: Owning a few undervalued securities (20 or so) over many years doesn't yield linear returns. It is a certainty that in many years, our portfolio will underperform the index. The best managers usually underperform one year out of three (that is something like 10 times over 30 years). Our approach it to judge the quality of an investment over a five years period. I truly believe that such a similar horizon is necessary to judge a money manager.

So, your role as a partner is far from being negligible. The time I spend on reassuring clients and commenting on stock fluctuations is not devoted to analysis. So we have adopted a clear and specific mode of communication. I write a detailed annual report (and considered my many quite long) and three quarterly reports. If there is truly a bad news on one of our companies, we will inform you (good

news takes care of itself). If you genuinely adhere to our philosophy, you can do your share by trying not be affected by the market and by keeping your eyes on the long term.

Patience – from the money manager AND the clients – becomes the supreme quality in investing.

The example of BMTC Group

Here is a real-life example on the vital importance of patience.

I first bought shares of BMTC Group (the parent company of the furniture stores Brault & Martineau and Tanguay) on October 31st 1995, the day of the latest Quebec referendum. Quebec based companies were trading at very low valuations that day (go figure!). After our initial purchase, the stock did well, increasing by 200% in two and one half years. But after that, there was a three years period during when the stock did absolutely nothing (see the chart bellow) even though the underlying results continued to be exceptionally good. On its 2000 low, the P/E ratio was only four times, a very attractive valuation. In those days, Bay Street was only interested in tech stocks (Nortel being the all around favorite stock). A great deal of patience during those 1000 days of standstill was needed. Starting in 2001, the stock went up six folds in three years. To this day, our total return on the initial purchase is 1400%.



In the 1996 Wesco Financial's annual report, its CEO, Charlie Munger, wrote this phrase:

> *"...Being prepared, on a few occasions in a lifetime, to act promptly in scale in doing some simple and logical thing will often dramatically improve the financial results of that lifetime. A few major opportunities, clearly recognizable as such, will usually come to one who continuously searches and waits, with a curious mind, loving diagnosis involving multiple variables. And then all that is required is a willingness to bet heavily when the odds are extremely favorable, using ressources available as a result of prudence and patience in the past...."*

BMTC was such an opportunity.

Five years postmortem: 1998 in review

Last year, I started a new yearly tradition: a five-year postmortem review. The idea is to go back five years in the past on my decisions (and writings) and study what did happen afterwards.

Johnson & Johnson does such reviews five years after an acquisition. And their results have been impressive. Also, five years is our time horizon when we acquire shares of a company. It is logical that we use such a time frame for a thoroughly analysis.

In October of 1998, we did lots of buying. The market had lost 30% because of the recession in Asia (who remembers that today?). We bought five stocks during that month: JDS-Fitel, Fastenal, Bed Bath & Beyond, Catalina Marketing and Templeton Dragon Fund. It turns out that two of those buys were mistakes and three delivered outstanding results.

First, JDS-Fitel (which was renamed later JDS-Uniphase). I bought shares at $4. At that time, the company was the leader in WDM (Wave-division multiplexers). It was growing very fast and was one of the most promising Canadian companies. I also admired its CEO Jozef Strauss. The stock had lost 50 % in a few weeks and was trading bellow 20 times earnings. After our purchase, the stock starting to climb. Rapidly, it looked very pricey and we sold 90% of our shares just a year later at around 8 times our cost (see the 1999 annual report). JDS continue to climb to reach the level of $250 in the tech bubble (trading at a lofty P/E of around 300x).

Today, the stock trades at $6. The company was devastated by the recession in its market and even seems to have change many of its products. Things were so bad for a while that, for some quarters, gross margin were negative. It is far from certain at this point that the long-term perspectives are good. It seems to me now that this purchase was a mistake. It's strange that a purchase that rapidly produced an important short-term gain turned out to be a mistake. It says a lot about the validation of short-term performance, doesn't it?

Catalina Marketing was an outstanding Floridian company. Its base business seems truly marvelous. Catalina's network leverages scanned UPC codes and/or loyalty card data to analyze consumer purchase behavior and automatically respond with strategic promotional messages (mostly discount coupons). This capability allows for more effective targeting, with average coupon redemption rates ranging from 8 to 11 percent, up to ten times that of other traditional promotion methods. This was a good business for everyone: the consumer, the retailer, the producer and Catalina's shareholders.

In just a few years, the company had built leading market share but at the same time started to face saturation. Clearly, growing at 25-30% looked more difficult. It's not that bad a destiny to dominate a market to a point that saturation arises. But when diversifications and acquisitions turn sour, the great basic business does not reward shareholders anymore. It seems today, after five years of being shareholders, that Catalina Marketing was not a company for us. So I sold my shares in 2003 at about the same level as the one we had purchased in 1998.

Our purchase of Fastenal was more rewarding. I knew Fastenal for a while when finally the stock traded in October 1998 at very attractive levels. I bought shares. And I became much more acquainted with its CEO Robert Kierlin. In the past, I've said nice words about Mr. Kierlin. They are totally deserved: he is one of the best CEO in the World. In fact, he's a great human being. In the last

few years, the recession in the manufacturing sector has slowed Fastenal growth but the company did very well in these tough circumstances. And the stock has increased by 300% in five years.

We had similar results with Bed Bath & Beyond. The company has been sustaining a 25-30% growth rate since our purchase and so the stock has followed the rise in intrinsic value, climbing 300% in five years. In the 2001 annual report, I told you the story of the two founders and how well the company is managed. Bed Bath & Beyond is earning extraordinary returns on capital of more than 24% and that even though the equity is 50% invested in cash.

Finally, we did very well with our shares of the closed-end fund Templeton Dragon (TDF). During the Asian crisis, I wanted to profit from the great pessimism in that part of the World by investing in it in some way. Since, I did not know Asian companies well enough to buy them directly, I looked for an indirect way. And I found it with TDF, a fund that invested in Chinese and Hong-Kong companies.

A closed-end fund is a fund that trades on the stock market. For every buyer, there must be a seller. And the other way around is true. In time of great pessimism, it is possible to find closed-end funds that trade at discount to their net asset value (NAV). I knew about TDF because it is managed by Mark Moebius, a money manager I admire a lot. He doesn't invest in the same way I do, but what he does, he does it very well. When I first started to buy TDF, the stock was at $6. The NAV was $9. So in addition to buy depressed stocks, I could buy them at a 33% discount to the market. But that was not all. In the $9 of NAV, there was $3 of cash. So in fact, I was paying $3 for $6 of value in stocks (which were already depressed I reminded myself). Wow ! I was like a kid in a candy store.

Moreover, to reduce the market discount, the fund management decided to pay a dividend equal to 10% of the NAV. So at $6, I was receiving $0.90 in yearly dividend (a yield of 15%). For a RRSP account – where revenues are not taxed – it was an ideal vehicle. Today, TDF trades at $18. So an investor that bought at $6 in 1998 and has hold it for all that time, has made a total return of 250%, not bad for a period where the market has went nowhere.

The best time to invest in China is not when it is popular (!).

Index funds : The flavor of the day in 1998

Strangely, what was the most popular in 1998 were index funds (and indirectly large capitalization stocks). I wrote in my 1998 annual report that a wide gap was created between large cap stocks and smaller cap stocks. If a company was in the top 40 of the S&P 500, it was trading at very high ratios since many money managers – active or passive – wanted to own it. So, the top 40 stocks of the index were trading at around 33 times earnings as the other 460 (which have the same index weight as the top 40) were trading at around 18 times.

In the last three years, the gap between small cap and large cap stocks has been rectified. In fact, since 1988, the returns of the S&P 500 and the Russell 2000 (RUT) have been very similar.

The two groups of stocks (large and small) trade today at around 19 times 2004 estimated earnings. Those that bought the S&P 500 index at the end of 1998 are still waiting for a profit. But now that blue chips valuations are back to normal, it is rational to believe that their future performance will be more in line with their underlying intrinsic performance. The same will hold true for small cap stocks which are much more popular these days.

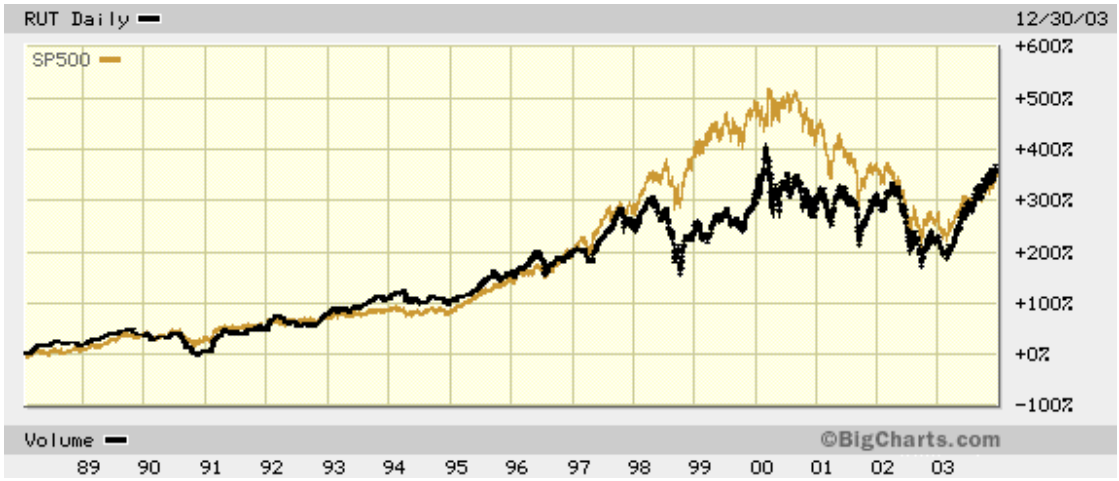


Chart of the market performance of the S&P 500 compared to the Russell 2000 (1988-2003)

Our companies

We delight in being different from the rest and in taking creative approaches to solving problems.

- Dr. Robert Shillman, CEO of Cognex

Cognex (CGNX.Q)

After two years of misery, things are starting to improve at Cognex. Revenus were up 32% in 2003 et net margin climbed to 11%. After the red ink in 2002, it is refreashing to smell the odor of black ink in the bottom line. The stock has doubled since its 2002 low. We have been shareholders for 7 years now. Although, our results are OK, they have been bellow our expectations. But I have great confidence in the company and its CEO, Robert Shillman. I hope that the best is yet to come.

M&T Bank (MTB.N)

Our Buffalo bank – under the wing of Robert Wilmers – continue to perform very well. Its most recent acquisition, Allfirst Financial, seems to be going well so far. In 2003, EPS went up 11%.

Since we also own shares of Cincinnati based Fifth Third Bank, I can now say that we own shares of two of the best banks in America. For the fourth year in a row, M&T Bank is our top holding.

BMTC Group (GBTa.T)

Our furniture stores chain, BMTC, continued to deliver impressive results. After an outstanding year in 2002, which I believed could not be equaled for some time, BMTC did even better in 2003. The balance sheet is still without debt (with $50 millions in cash) and the company continued to buy back shares. Under Yves Des Groseillers, BMTC is the best public company in Quebec to my knowledge. But the market valuation is not as exciting as a few years back, although – to me – totally warranted.

Progressive Corp (PGR.N)

In our September quarterly report, I told you about my summer trip in Ohio, during which I met with the people of Progressive (in Cleveland). Progressive Corp, a superbly run car insurance company, had another outstanding year in 2003. EPS were up 77% thanks to a 26% increase in premium and a combined ratio well bellow 90%, an incredible achievement. It is hard to believe that Progressive can maintain such profitability in this highly competitive industry (with our friendly competitor GEICO not far away!). But this company has surprised us many times in the past….

Fairfax Financials (FFH.N)

The year 2003 was shaky for Fairfax, a Canadian insurance company. We began to buy shares in November 2002 at around $120 a share. Rumors of inadequate reserves and liquidity problems brought the stock down to $57 at the beginning of 2003. Bernard and I knew Prem Watsa, Fairfax's CEO, for quite some time through his annual reports. In March, I went to Toronto to meet Mr. Watsa (thanks to an introduction by my good friend John Zemanovich) and I was satisfied with the meeting. We bought more shares. The stock rebounded a few months later and ended the year at $226.

It is of course early to conclude anything because Fairfax has still too much debt to my likings. But its combined ratio has improved and the company has restructured its holding. For example, Northbridge Financial and Odyssey Re were spun-off. We also acquired shares of Northbridge during the year.

One thing is clear though: Farfaix stock's huge ups and downs in less than one year shows how violent Mr. Market mood changes can be and how cool we have to stay in such instances.

Expeditors International of Washington (EXPD.Q)

About two years ago, my young and dynamic assistant, Jean-Philippe Bouchard, recommended to me the company Expeditors International of Washington. Expeditors is engaged in the business of providing global logistics services. I already knew about the company, having read a few annual reports and been a witness of its spectacular rise in the 1990s (only a witness unfortunately).

My worries were that the company would be sensitive to recessions. But the company did very well in the 2000-2003 period and has showed the strength of his business model. Also, reading the 8-K reports (top management answers to shareholder's questions) clearly convinced me of the great integrity and leadership of the key people. Expeditors' CEO, Peter Rose (not to be confused with the famous ball player), is the kind of businessman I like to be partner with. The long-term potential of Expeditors looks very promising thanks to the huge increase in Asian commerce. The market valuation of EXPD is not low (25 times earnings) but I've learned that outstanding companies are worth paying for.

<u>Owner's earnings</u>

We have been plagiarizing Berkshire Hathaway's way of looking at their stock portfolio performance through owner's earnings increase. In our mind, we own the companies of which we bought stocks. We focus our attention not on market increase (or decrease) but on EPS growth and their perspectives over the next five years to judge the quality of our investments.

In 2003, our stocks went up 34% (without taking into account currency changes). Our owner's earnings went up 30%. Our median ROE was 18% (21% without excess cash) which is in line with our goals.

I've compiled in the table bellow the results for the last 8 years compared with the S&P 500. I did not include the year 1995 because the year was exceptionally good (39% increase in earnings and 41% market performance) and would increase the annualized return to an unsustainable level.

	Giverny			S&P 500		
Year ***	EPS Growth *	Market **	Difference	Earnings *	Market **	Difference
1996	13%	29%	16%	11%	22%	11%
1997	16%	35%	19%	10%	31%	21%
1998	10%	12%	2%	-2%	28%	31%
1999	15%	12%	-3%	16%	20%	4%
2000	18%	10%	-8%	8%	-9%	-17%
2001	-10%	10%	20%	-20%	-11%	9%
2002	18%	-2%	-20%	9%	-22%	-31%
2003	30%	34%	4%	13%	28%	15%
Total	170%	246%	76%	46%	101%	55%
Annualized	13%	17%	4%	5%	9%	4%

* Owner's earnings growth
** Market performance including dividend
*** All results are estimated without currency effects

As you can conclude from the table, our portfolio as done 8% better than the S&P 500 (17% compared with 9%) because our companies have grown their intrinsic value at a similar rate differential. The 4% difference between market performance and intrinsic performance is linked to dividends (1-2% on average) and an important increase in P/E ratios in general during that time. The latter was direcly linked with the sharp drop in interest rates in the last 8 years.

In the long run, stock market performance will follow hand in hand the intrinsic performance of the underlying companies. But in the short term, there can be huge gaps between the two. You can notice that some years, the market performance was bellow intrinsic performance (1999, 2000 and 2002). This is 3 years out of 8 (40% of the time).

At Giverny Capital, we love such valuation gaps and try to profit from them (withing a reasonable level of trading). The more irrational the market will be, the higher will our subsequent returns be. Volatily is not synonymous of risk but – for those who truly understand it – of wealth.

Mistake *du jour*

> *Managers who avoid risk and fear failure spend their entire careers cheating themselves, their people, and their companies.*
>
> - Ken Iverson, CEO of Nucor (1965-1995)

This section of the report is a yearly tradition and a favorite of our clients (I wonder why). What is a tradition also – unfortunately – is the huge amount of mistakes I come up with each and every year. Some times, the mistake is recognized rapidly (read: we lose money). In many cases, it takes years to

realize how a buying (or a non buying) decision was costly. Time brings something that nothing else in this world can bring: perspective.

This year, we present an honorable mention to my decision not to buy shares of McDonald's (MCD.N) in early 2003. McDo is easy for me to understand. In addition of being a loyal client, I knew the history of the company and of its builder, Ray Kroc, very well. For 40 years, the company had grown at high rates. But these last few years, sales growth had slowed. Like I wrote a few pages above, domination can eventually create saturation.

At its 1999 high of $49, MCD was trading at 35 times earnings. And the stock went down to $12 withing four years. At that level, the P/E was only 9. In a short period, the P/E contraction was spectacular (but how typical of Wall Street) and reflected a profound change in market perception. As much as the stock was way to expensive in 1999, it was clearly undervalued in 2003.

And I knew it perfectly. I did not buy shares because I believed that the company could not sustain my objective of intrinsic earnings growth. As you know, I look for businesses that can grow their EPS at twice the average rate (at least 12% a year). But from time to time, it is not totally insane to buy shares of a great business that doesn't totally qualify to our criterias but that looks undervalued by a huge margin.

Bronze Medal : Stryker (SYK.N)

Our first medal of 2003 goes to my decision NOT to buy shares of Stryker in 1998. I knew the Kalamazoo (Michigan) company from for many years. I understood its business and had come to realize over the years how brilliant its CEO John Brown is. In 1998, the company made an important acquisition that added $1.5 billion of debts to the balance sheet.

I met with the top management at that time at a Baltimore conference and thought that their business plan was rational and full of potential. The stock had lost 40% of its value and it seems like an opportunity to become shareholder. But the high level of debt scared me and I decided to follow my rule of avoiding companies with too much leverage even if sometimes we do make an exception (like I did in 2001 with Level 3). Discipline is to respect one's rules, wisdom is to know when to break them!

And I definitively should have used more of that wisdom with Stryker. The company delivered on all its promises: In five years, earnings tripled, the debt was paid off and fundamentals continue to look good. The stock has increased five fold. In a bear market, that's an incredible result. And I was a front-row witness…..but a passive witness like a turtle hidden in its shell.

Silver Medal: Vitesse Semiconductor (VTSS.Q)

In my 2001 annual report, I explained in length why I acquired a small weight in a californian company called Vitesse Semiconductor. We were lucky that the weight was small, because the mistake was huge.

Vitesse was a leader in Gallium Arsenide (GaAs) based integrated circuits. This compound enabled signals to be transmitted at very high speed (Vitesse means "speed" in French). But two major problems hit Vitesse a the same time: A depression in their clients' industry (telecommunication) and a technological change that made their product line obsolete.

And I knew about those two risks (probably more the second one). In just two years, would you believe?, the GaAs business became worthless. Since the company doesn't seem to have the competitive advantages it had a few years back, it is highly unlikely that they will again earn 30% on sales (or even 20%). It was a good thing that the balance sheet was solid because the company could have gone under.

I finally sold our shares with an horrible loss of 70%. Even if it represented "only" 1% of our capital, I'm far from being proud of that purchase. What's ironic is in that same 2001 annual report, I took the time to explain the dangers of investing in the highly changing technology sector.

And what is even worse - much worse - is that I sold some BMTC shares to fund the Vitesse purchase. Since BMTC has climbed 400% since then, the economical cost (non accounting) of that mistake is terrible.

Gold Medal: eBay (EBAY.Q)

Every good capitalist dreams to be present at the birth of a business that will become huge in just a few years time. To have the vision to invest in a unknown company but that we are able to gage the full potential before the others can be very rewarding. And I had such an opportunity and I blew it!

I like to collect many items (stamps, old adds, books, antique radios, etc.). My eternal problem is to find foreign items in my neighbourhood. It is not easy to find Latvian stamps in Montreal. I discovered eBay in its early years in 1997 or so. I instantly saw a huge market without limit, a revolution in trade between consumers, eliminating distance and middlemen.

Moreover, eBay displayed in its beginning the number of items listed (the first time I visited the site, there were something like 2.5 millions items on sale). And the growth rate was around 33% *per month*. And I found it pretty handy to be able to follow the company's growth that easily. But soon, eBay put a stop to that politic and I was frustrated of it. I said to myself that perhaps growth is slowing and the company doesn't want to show it!

The company went public in 1998 at $2 a share (adjusted for stock splits). The company was then earning around $0.02 a share so the price did not look cheap. I should have been more perspicacious at first but the really gold caliber mistake came about two years later. In the tech bubble, the stock reached $58 but fell in autumn of 2000 to $35. I then wrote an article in *Les Affaires* newspaper about the company. I tried to value the stock and came out with a target of $35 in 2005. So, I concluded that the stock was still too expensive and needed to fall 50% before becoming interesting. And the stock did it! It went to $14 in just a few months. The results were still great. That was the opportunity I was waiting for.

At the end of 2002, the company had 638 millions items on sale on its web site (an increase of only 30 000% since the my first visit to its site). Results from 2000 to 2003 were incredible and the stock has increased by five fold since its 2000 low. The stock does not look cheap at today's levels but still, I should have bought it in 2000. I have no excuses. I understood the business, I came up with a reasonable valuation and I had the discipline to wait for my price. But when the price came up, I was motionless.

Even more than a Galapagos Islands' giant turtle.

********** **PUBLICITY** **********

It is with great pride that I share with you the fact that Andy Kilpatrick devoted to me a chapter in his latest edition of his book « Of Permanent Value : The story of Warren Buffett – the 04 California edition ». With his generous permission, I include a copy of that chapter with this report . Of course, you should buy the book. You'll love it. It is 1500 pages long so you'll have ample reading materials for those long and cold Quebec winter nights.

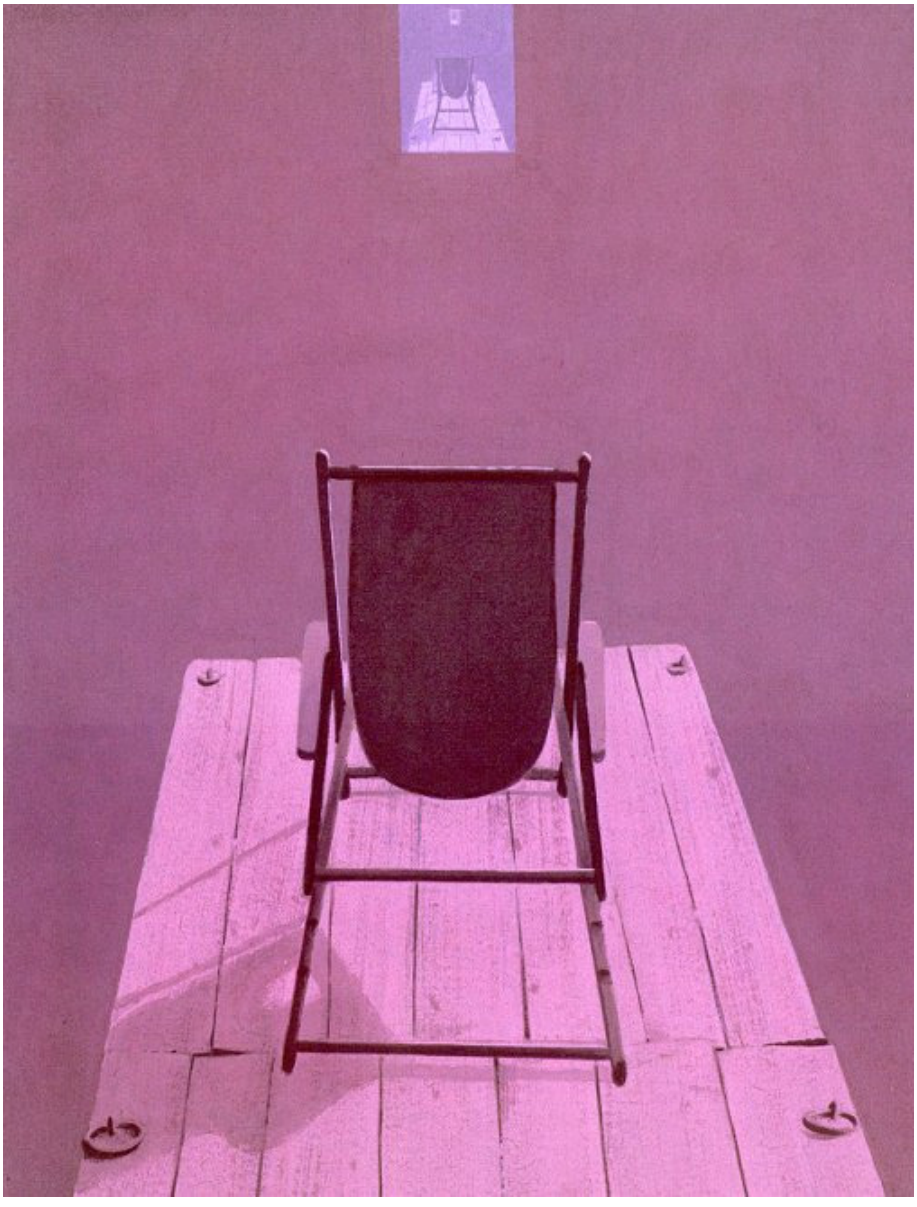
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I wish you all a great year in 2004.

François Rochon
President and portfolio manager
Giverny Capital Inc.

Giverny Capital Inc.

Annual Report 2004



Edmund Alleyn (1931-2004)
Transat pour Giacometti, 1989

Giverny Capital Inc. – Annual report 2004 ©

For the year ending December 31st 2004, the return on our Global Giverny portfolio was 1.6% in Canadian currency. The International portfolio (in US currency) achieved 9.3% for the year. Our weighted benchmark had a return of 6.1% in Canadian currency and the S&P 500 achieved 10.7% (in US dollars). It is important to underline that our US stocks (80% of the Global portfolio) were impacted again by the fall of the US currency, losing 7% to its Canadian counterpart.

Since starting the fund, July 1st 1993, our annual return has been 19.9% compared to 10.4% for our benchmark and 10.4% for the S&P 500 (all in Canadian currency).

It's hard to be happy about our returns in 2004. What's important, though, is that our businesses had a great year, as their combined earnings increased 20% for the year (we'll go through the details in the "owner's earnings" section). As for the Canadian dollar effect, we won't - of course - be influenced by it. Over many years, the effects are almost negligible. Since 1993, the US dollar has lost 6%, the effect being an annual loss of 0.6%.

In fact, our underperformance in 2004 was due mainly to our Canadian stocks. Not to the extent to what we owned but to what *we didn't own*. The year 2004 was very good for the resources stocks, a sector which we avoid. As you know, our philosophy is to own companies that have a competitive advantage. So we tend to avoid enterprises that sell a commodity-like product or service (as Warren Buffett said: no one ever asks, "I want a Coke only if it comes in an Alcoa aluminum can"). We believe that our philosophy is prudent and rational. We also believe that it should yield superior returns over the long run. We will not change it because of one or two years of underperformance.



"It's a special episode of 'Fear Factor'. They're daring the contestants to get back into the stock market!"

Our returns since 1993

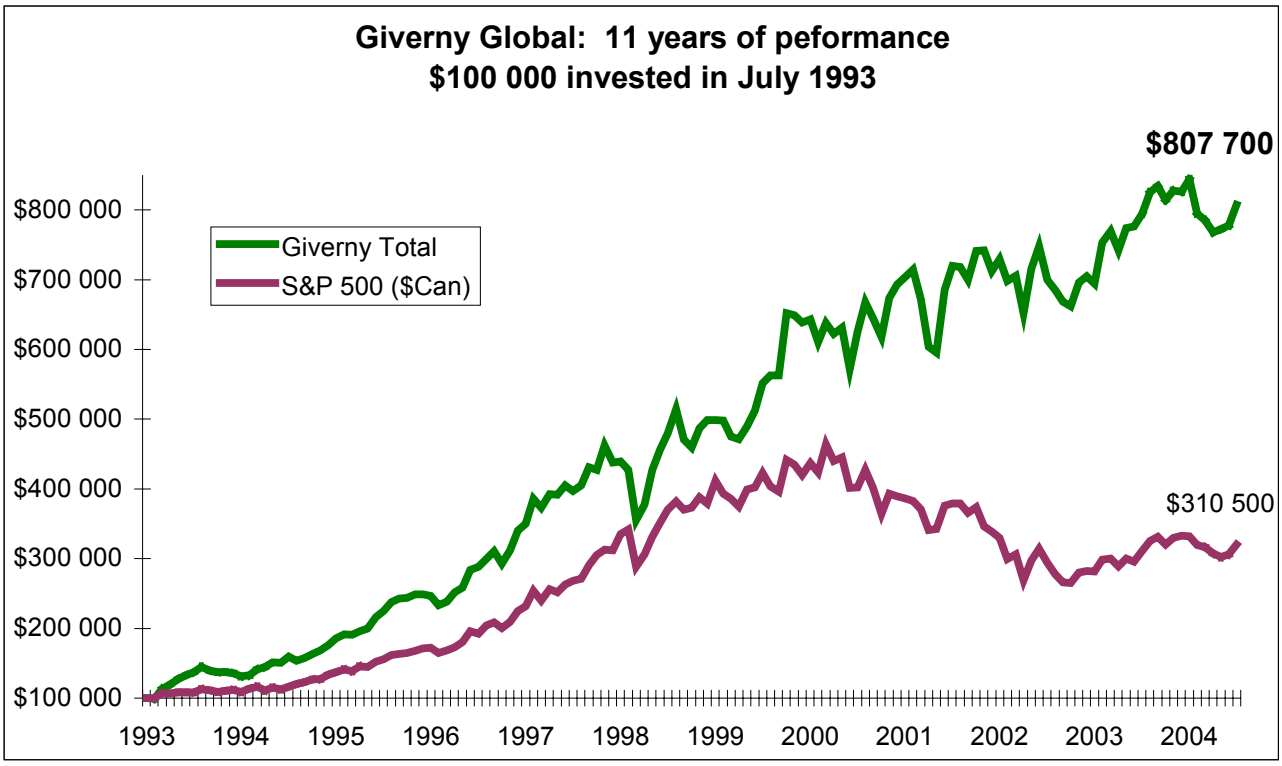
Our portfolio is « real » money. It is a family portfolio (most of the capital being my own). The portfolio is separted in two parts : Around 20% is a RRSP based part (limited to 30% in non-Canadian

content) and the other 80% is the International part (invested mostly in US stocks). Our returns have been audited by PriceWaterhouse Coopers.

Giverny portfolio (all in Canadian currency) :

Returns	Giverny	Benchmark *	+ / -	S&P 500	+ / -	$ US / Can
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	8.4%	**28.6%**	3.3%
1994	**16.5%**	3.7%	**12.7%**	7.3%	**9.1%**	6.0%
1995	**41.2%**	24.0%	**17.2%**	32.9%	**8.3%**	-2.7%
1996	**28.0%**	22.8%	**5.2%**	22.7%	**5.4%**	0.3%
1997	**37.8%**	28.5%	**9.2%**	36.7%	**1.1%**	4.3%
1998	**20.6%**	18.8%	**1.8%**	37.7%	**-17.1%**	7.1%
1999	**15.1%**	16.3%	**-1.2%**	14.1%	**1.0%**	-5.7%
2000	**13.4%**	3.2%	**10.2%**	-4.6%	**18.0%**	3.9%
2001	**15.1%**	-0.4%	**15.5%**	-5.7%	**20.8%**	6.2%
2002	**-2.8%**	-18.3%	**15.6%**	-22.0%	**19.2%**	-0.9%
2003	**13.6%**	14.0%	**-0.4%**	5.7%	**7.9%**	-17.8%
2004	**1.6%**	6.1%	**-4.5%**	2.8%	**-1.1%**	-7.3%
Total	**707.7%**	**211.9%**	**495.8%**	**210.5%**	**497.1%**	**-6.3%**
Annualized	**19.9%**	**10.4%**	**9.5%**	**10.4%**	**9.6%**	**-0.6%**

* The benchmark is made out of weighted indexes (S&P/TSX, S&P 500, Russell 2000, etc). in a way to reflect assets allocation



Giverny International portfolio (in US dollars)

Year	Giverny Intl.	S&P 500	+ / -
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	36.6%	18.2%
1996	27.0%	22.3%	4.8%
1997	32.9%	31.0%	1.9%
1998	11.0%	28.5%	-17.5%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-8.2%	19.5%
2001	8.1%	-11.2%	19.3%
2002	-4.4%	-21.4%	16.9%
2003	31.6%	28.6%	3.0%
2004	9.3%	10.7%	-1.4%
Total ($US)	711.3%	230.3%	480.9%
Annualized	20.0%	10.9%	9.0%

Period	Giverny	S&P 500
1 year	9.3%	10.7%
3 years	11.2%	3.8%
5 years	10.6%	-1.8%
10 years	18.7%	12.0%
Since start	20.0%	10.9%

Giverny RRSP porfolio (in Canadian dollars)

Our RRSP portfolio underperformed the S&P/TSX in 2004. But we have to keep in mind that 25-30% of it is invested in US stocks (which were impacted by its currency). Secondly, since we avoid resources stocks (35% of the index) and we do not own, at this time, Canadian banks (25% of the index), our correlation to the TSX is quite low. To this day, our focused approach yielded good results although some years, the discrepancy with the index can be large.

Year	Giverny RRSP	S&P / TSX	+/-
1995	0.4%	14.3%	-13.9%
1996	29.9%	27.8%	2.2%
1997	32.3%	15.0%	17.3%
1998	29.3%	-1.2%	30.5%
1999	42.7%	31.1%	11.6%
2000	5.2%	8.2%	-3.0%
2001	16.2%	-11.5%	27.7%
2002	6.3%	-11.6%	17.8%
2003	32.4%	26.7%	5.7%
2004	2.9%	14.0%	-11.1%
Total	463.1%	165.8%	297.3%
Annualized	18.9%	10.3%	8.6%

Giverny RRSP porfolio: 10 years of return

This was our 10th year for the Giverny RRSP portfolio. Over 10 years, our return as 18.9%, an annualized added value of 8.6%. Also, we had no negative year (knock on wood)

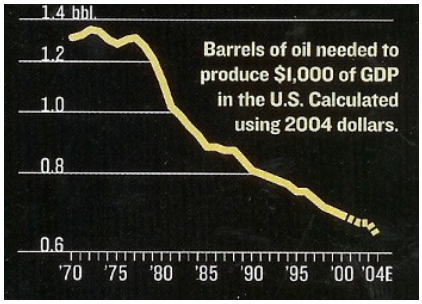
Période	Giverny RRSP	S&P / TSX	+/-
1 year	2.9%	14.0%	-11.1%
3 years	13.1%	8.5%	4.6%
5 years	12.1%	4.1%	8.0%
10 years	18.9%	10.3%	8.6%

Long term objectives

Our results since 1993 have been way better than anticipated and what can be expected in the future. Our ambitious objective is to sustain yearly returns of 5% better than the indexes. If stocks in general return something like 5 to 9% over the next decade – to me, a realistic assessment – we would be quite pleased to return 10 to 14% on our capital. We try to select companies that we believe should permit us to attain such goals, in other words that grow their intrinsic value at twice the average.

Review of the year 2004

In the US, corporate earnings were up on average an impressive 19%. Including the dividend, the S&P 500 returned around 11%. The increase in earnings was clouded by a sharp rise in basic material prices. On the other hand, we have to realize that basic material prices are not as important to the economy as it used to be. For example, recent studies have shown that over the last 34 years, oil needs in the US have gone down 50% : In 1970, the economy needed 1.31 barrel of oil to produce $1000 of GDP (in 2004 dollars). This ratio was down to 0.64 barrel in 2004[1].



Source : Forbes

Low dependency on resources is important to me. I try to choose businesses to which "knowledge" and "brand" are the most important assets (both intangible). Companies like Astral Media, Johnson & Johnson, Cognex or Resmed do not see their costs go up in a significant way when oil or steel rises.

Cyclical stocks

In the long run, investing in cyclical stocks can yield – at best – modest returns. In my early days, I invested in many cyclical companies (that looked "cheap"). I've own, for example, shares of

[1] Source : Forbes Sept 2004. Calculations by Joel Darmstadter and Ian Parry, « Ressources for the Future».

Goodfellow, Héroux, Czar Ressources, Franco-Nevada, Pan-American Silver, Chrysler, Idéal Métal, Amisk, CCL Industries and Slater Industries. I've been there and I did not like the experience.

The most important investment I made in a cyclical stock was Nucor in 1997. Nucor is a steel producer whose costs are way lower than those of its competitors. Under Ken Inverson, the company increased its value by 20% annually for almost 30 years (the stock was up 250 fold). I also admired its successor John Correnti. But when Mr. Correnti left the company in 1999, I decided to sell our shares. But I was an owner for long enough to realize how much the company was struggling with cheap steel imports (from Russia at that time). So even if the company had the lowest cost in its industry, it was not good enough. And such parameters are beyond the control of any company, even the best managed ones. I've come to appreciate businesses where profit margins are not too dependant on external factors. The intelligence without the control to apply it is futile.

Nucor's EPS went nowhere for 10 years: They were $1.57 in 1995 and $0.40 in 2003. In fact, in 2003, the stock was at the same price as in 1993. But, in 2004, EPS exploded to more than $7 a share and the stock more than doubled. But 10 years is quite a long time to reap the reward of an investment. And many industry participants did not survive long enough (at least the stockholder's equity) to get their share of the reward: Bethlehem Steel, Birmingham Steel, Slater and Ivaco had to resort to Chapter 11 at some point in the last decade.

A luxury we can afford

The beauty of the stock market is that it gives us the luxury to avoid sectors and/or businesses that are outside our circle of understanding.

Since the start, I knew there were going to be ups and downs in the economy, corporate profits, interest rates and inflation level. That is why I choose companies that I believe can sail through the occasional storms that hit our "econo-system". We don't try to predict the sequence of those storms but rather select companies that we believe are so strong that we have the luxury to focus on the long term.

And at Giverny Capital, I have given myself means to afford such a luxury. When I worked for others, I had a pressure to beat the S&P 500 every quarter (every months if marketing had its way). Moreover, many clients expect their manager to be invested in every sector (particularly those which are doing well in the market) and that the biggest weights in the index (like GE for example) be an integral part of their portfolios (particularly in times – you've guessed it! – when the stock is going up).

We have no constraints or pressure of that manner. It could not be more simple: I buy for Giverny's partners the same stocks as for my own portfolio. And for me, I have the luxury to buy what I like, when I like and with the time horizon that I believe is sensible. In the end, such a managing style is more than a luxury, it becomes a competitive advantage. It's the equivalent – in baseball terms – of being at bat in front of the stock market pitcher and have no strike being called on us: We can choose the balls we'll swing at! Managers whose returns are scrutinize by clients and their consultants (sometime the brother in law) don't have my luck!

The flavor of the day 2004

It is usually common wisdom to avoid what's popular in the market. So we try to avoid what's the flavor of the day in Wall-Street (or Bay Street in Canada). It's hard not to be skeptical of the huge popularity (particularly in Canada) of the basic materials sectors. Not being objective in this manner

(since we do not own any of such securities), I will just share a little paragraph in Business Week magazine's edition of January 31st 2005:

> *In 2003, a seat on the Chicago Board of Trade sold for just $338,000 compared with 2 millions for one on the New York Stock Exchange. But in early January of 2005, a seat on the Chicago futures exchange changed hands for $1.25 million – just off a November high of $1.4 million. Meanwhile, the price of a seat at the NYSE has eroded to a nine-year low of $975,000, thanks in part to uncertainty over plans to automate more trading. It's the first time in roughly 20 years that a CBOT membership is priced higher than that of the NYSE.*

Investment philosophy

Note : this section is a repetition or old annual reports for the sake of the new clients.

The year 2004 was good for Giverny Capital. The number of partners (the term we use for a client at Giverny) has climbed to 525. With all these new comers, it is imperative that we talk again (and again) about our investment philosophy.

What is the most important thing to consider when choosing a money manager is the investment philosophy. Returns on capital is the result of the philosophy. To fully adhere to our approach is essential. Because if not, sooner or later, you're going to be disappointed.

Here the key points:

- It is futile to predict when it will be the best time to begin buying (or selling) stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity).
- We choose companies that have (sustainable) high margins and high returns on equity, good long term prospects and that are managed by brilliant and devoted people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be grossly assessed.
- The stock market is dominated by participants that perceive stocks almost as casino chips. With that knowledge, we can then buy great businesses sometimes well bellow their intrinsic value.
- There can be quite some time before the market recognizes the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

This discrepancy between the market quotes of a business and its underlying intrinsic value and the high volatility of the securities market are perceived by many participants as disadvantages. It's the other way around: market imbalances and fluctuations are our *allied* in our noble quest for wealth. In fact, the more irrational the stock market, the higher our chances are to attain our financial objectives.

But there is one important point: Owning a few undervalued securities (around 20) over many years doesn't yield linear returns. To stare at a freshly planted tree does not make it grow faster. Our approach is to judge the quality of an investment over a five years period. I truly believe that at least such a similar horizon is necessary to judge a money manager.

So patience – ours AND those of the partners – becomes the key ingredient for success. Real patience is neither easy nor that common. That is why many investors pray in those words: "Dear God, could you gratify me with patience? And if it is at all possible, RIGHT NOW"

The Rule of Three

In conjunction with our investment philosophy, I've added a market rule that I called : The Rule of Three. This rule comes from historical observations: it is not a scientific process that has come to its enunciation but an empirical one.

- One year out of three, the stock market will go down at least 10%.
- One stock out of three that we buy will be a disappointment.
- At least one year out of three, we will underperform the index.

What are the consequences of these rules? First, it is quite obvious that in the next 10 years, the market will go down 10% at least three times. It is important to be mentally ready for such corrections (those who panic can't be helped by even the best money manager). Secondly, out of 20 stocks or so that we buy, around 7 of them will yield deceiving results. So we should not judge the result of one investment but the whole portfolio. Thirdly, over a 10 years period, it would be a normal occurrence that our performance be lower than the index around three times.

The judgment that you – as partners – pose on my work should be in line with these parameters.

Creativity according to Erich Fromm

Beyond a sound investment philosophy, there is one element necessary to any art: creativity.

It is true that principles by definition do not change…because they're would not be principles! Paradoxically, a philosophy that seeks to echo human thinking must be in constant evolution. If not, it will rapidly not be able to depict adequately the world it wishes to reflect. In that sense, creativity, the capacity to build something "new" from the established, becomes the catalyst in any evolution process.

And some conditions are necessary for creativity to blossom. The great German philosopher Erich Fromm stated that theses conditions are at the opposite of what we instinctively cherish. By our nature, we hate insecurity and cherish what is familiar. The genuine creativity needs the courage to let go of some certainties to attain a constant state of mind opening.

Experience teaches us that investment success goes way beyond finance and numbers (otherwise all CFAs would be multimillionaires). It blossoms out of rationality and judgment but also in combination with the capacity of thinking independently, which needs more often than not creativity. And this, in light of the fundamental needs of security entrenched in those who have cumulated capital over the years. I know what I'm talking about!

Post Mortem 1999

For a third year in a row, we do a postmortem on my decisions (and writing) of five years ago. Since, five years is our general time horizon., it is fitting to do such yearly reviews.

The year 1999 is now known as the culminating moment of the high tech bubble (in fact the peak was reached in March of 2000). In my 1999 annual report, I had highlighted the fact that I believed that many investors not familiar with some notions of economic valuations were numerous in the stock market. And that I did not intended to participate in their "funfair". Unfortunately, the fair ended badly for many of them. And my decisions to sell most of our shares of Cisco Systems, JDS-Uniphase and Intel in 1999-2000 were appropriate.

Purchases : the class of 1999

In 1999, I wrote about three important purchases: Masco, Promatek and Progressive Corp. After our purchase, Masco acquired a few companies (mostly with debt) and it seemed to me that their growth plan was too aggressive. I've learned over the years that companies that seek a high growth rate – although a noble cause – are entitled to making huge mistakes. I believed that Masco was taking on too much debt and I decided to sell (at a small loss).

I sold Promatek – with a small gain – in 2000. You can read about this sale in the annual report of that year. I wrote then that I believed that the company had modest growth prospects and even though the stock was quite undervalued, our capital would be more wisely invested in other securities. In the end, shareholders were well enriched (with capital gains and huge dividends). It validated at least my belief that the stock was cheap. But, I must add that the stock is very illiquid and it would be have been impossible to buy this stock for more that 40 or 50 clients.

Progressive

My purchase of Progressive Corp of Ohio was a homerun! The story of this purchase is interesting, even instructive. We have to go back to 1993. When I read all I could find on the life and career of Warren Buffett, I've learned all about the history of GEICO, a car insurance company which was a major investment for Mr. Buffett.

In 1993, the *Wall Street Journal* published an interview with Philip Carret, a famous money manager who had a tremendous 65 years track record of returning 14% to its investors. Warren Buffett said of him that he was the "Lou Gehrig of investment" [2].

In the interview, Mr. Carret recommends a few stocks including Progressive which he labeled the "next GEICO". I immediately wrote to the company to get its annual reports. And in the six years subsequent, I followed the company closely and watch it climb in the market by 400%. I was biting my fingers so much that my friends taught that my girlfriend was cannibal.

In 1999, I finally got my chance: the stock went down 67% from a high of $58 to $25. Progressive was getting aggressively on the Internet as it decided to become the leader. At the same time, there was some underwriting margin pressure in the industry. So for a few quarters, EPS were down. I believed that these were temporary problems and decided to acquire shares. My purchase was not instantly rewarding as the stock went down to $16 just a few weeks afterward (a drop of 35%).

[2] Lou Gehrig was a baseball player who from 1925 to 1938 played in 2130 consecutive games. His record, for a long time believed to be unbreakable, was surpassed by Cal Ripken Jr. in 1995.

But five years latter, all that is forgotten. The combined ratio of Progressive has never been better and the company earned $7.40 per share in 2004, an incredible performance. It is now a clear leader in the car insurance sell through the Internet. And the stock has reached more than $85.

There are two important conclusions. First, the fact that PGR went down 35% just after I bought it ("the Rochon effect") shows us – once more – that the stock market can be irrational in the short term. And this fall was happening during a huge bull market as many young companies with no revenues were reaching many billions in market cap.

The other conclusion is equally important. We did not make money out of Masco and Prematek but the gains realized with Progressive more than compensated this. Judging a portfolio in its whole and over many years is wise. In fact, the combination of two mistakes and one success can be enough to earn decent returns (as this illustrates). In this line of thinking, selling quickly our losers and holding on to our winners is a constructive way to manage portfolios. Doing the other way around is the equivalent – to use Peter Lynch's words – of removing the flowers and watering the weeds.

Philip Fisher (1907-2004)

The legendary investor Philip Fisher passed away in 2004. I had the chance to talk to him two times on the telephone and to meet him briefly in San Francisco, many years ago. Over our conversations, I asked him many questions and at some point, he summarized his approach in these words : "*You know, Wall Street focuses on lots of unimportant things. But the quality of the management makes up 90 to 120% of the success of a business. Investors think with a such a short term horizon but in the end, management is the key factor*". I never forgot this advice.

I've read all of Mr. Fisher's books. There is a chapter in "Path to wealth through common stocks" that I want to recommend because few investors have heard about it ("How the greatest rise in stock prices comes about"). This book – I believed – has never been republished since its first edition in 1960; it is almost a historical treasure. And you would not believe how long I searched for it. Even Mr. Fisher could not help me find a copy.

Finally, I did find it at the central library in New York city. I could not take the book out but I did make photocopies (it's hard to invest $20 more wisely). The other three books of Mr. Fisher have been republished in a single book lately but "Path" is still a hidden gem.

I owe a lot to Mr. Fisher. He wrote books out of pure altruism (he was already wealthy at that time) to simply share his experience with us. I thanked him then and I thank him again. Giverny Capital owes a part of its existence to him.

A new purchase : Knight Transportation

In 1994, I bought shares of a small trucking company in St-Hyacinthe (Quebec) called Groupe Goyette (one of the first company I visited). Since then, I've been following the trucking industry closely. In the last two years, I purchase shares of Knight Transport, a Phoenix (AZ) company.

I discovered Knight in 1998 when I studied competitors of Heartland Express (which I owned at that time). Like Heartland, Knight is a small company that does well in this hyper competitive industry characterized by low margins and modest ROEs.

Let's first look at the numbers of a few players :

Companies	Margins	ROE *	EPS CAGR **
Arkansas Best	3%	11%	7%
CNF Inc.	2%	8%	8%
Heartland Express (HTLD)	13%	16%	15%
J.B. Hunt	4%	9%	9%
Knight Transportation (KNX)	11%	16%	26%
Ryder	3%	10%	3%
Swift Transport	3%	9%	16%
USF	2%	6%	1%
Werner Enterprises	5%	10%	8%
Yellow Roadway	2%	12%	12%
Average (without HTLD and KNX)	**3%**	**9%**	**8%**

* Return on equity

** Annual growth in EPS, last 10 years

Clearly, two companies stand out from the group : Heartland Express and Knight Transport. Both have cost structures well bellow the average (their cost ratio being 82% compared with 95% for the industry). But I think that Knight has a little intangible something better than Heartland.

The main difference lies in their business plan for growth. Heartland mostly grows through acquisitions. The negative side of that plan is that candidates are not always available at good prices but also – sometime – "surprises" can lie in the acquired business (and rarely are surprises positive).

Knight grows organically. It opens offices in new areas. Initially based in Phoenix , the company has opened 8 new operational centers in the last 10 years (not counting the new Knight Refrigerated division started this year). I believe this path should lead to a more stable and durable growth. Another important point for us: Knight is managed by four members of the same family (two pairs of brothers, cousins to each other). The four have a similar salary of $265 000 per year and are owners of 9% of the stock. Their interests are in line with ours.

We paid around $17 for our shares or a P/E ratio of around 20 times. It's not cheap but I believe it's warranted. Few companies – all sector included – has such a track record (10 years of 26% CAGR in EPS). And its balance sheet has stayed solid over the years.

Our businesses

Once again, I've made only minor changes in our portfolios this year. Our core holdings are the same as last year. We own shares of some of the best businesses in the World. Our attitude is that of a museum director: We only want to own masterpieces.

M&T Bank

Our Buffalo bank continues to reward its shareholders like a metronome. The acquisition of Allfirst Financial in 2003 has yielded good results. EPS went up 14% in 2004. We have been owners of M&T since 1998. In that timeframe, EPS have doubled from $3.08 to $6.38, a 13% annual growth rate (if

we use the same accounting in 1998 than in 2004, mostly expensing stock options, EPS would have grown at around 15% a year). The stock has followed EPS growth increasing from $45 to $107.

As it is so often the case, this investment was also not rewarded instantly. In fact, 18 months after our first purchase, the stock was at $36 (a drop of 20%). At that time, March 2000, only tech stocks were viewed as good long term investments (the "new economy" was the expression used). What an opportunity for true investors that acquire shares of such a great company at a price well bellow intrinsic value. And we bought more with enthusiasm. Can you imagine the consequences if we had let the market quotations undermine our judgment?

Groupe BMTC

2004 was the 10th year we where shareholders of BMTC Group, the leading furniture retailer in Québec. After a year 2003 where margins reached unbelievable level, it was realistic to lower our expectations. Moreover a 3 weeks strike hurt the company this summer as the arrival of a new competitor – The Brick – put some additional margin pressure. But even those events did not alter BMTC's strong business model (to this day at least). ESP were up 30% (5% if we take into account special charges in 2003) and prospects for 2005 are very positive.

BMTC is a much stronger company than The Brick. Its revenues per store are three times higher, their stock rotation is 12 times compared with 7 times for Brick and – most important of all – the ROE at BMTC is way higher than 20% compared with less than 10% for The Brick.

Cognex

Cognex had a very good year 2004 although the first 3 quarters were better than the last. I've been owning Cognex since 1996. I have to admit it's been a so-so investment. Our first purchase was made at $15. Since the stock trades at $27, we earned around 8% per year on this purchase, a similar return than the S&P 500 for the period.

We have to accept that Cognex revenues can be cyclical. On the other hand, the company has virtually a monopole in its industry (and in good years, earns 30% on sales). And Cognex has an outstanding balance sheet: It has $8 in cash, the sum of all its earnings since its foundation. I believe that Cognex has transformed itself in the last years and should be less sensitive to the semi-conductor industry in the future. And – as you know by now – I truly admire Bob Shillman, its CEO. So I do think that our patience will be rewarded in the next years.

Walgreens

It was another great year for our favorite drug store chains : EPS were up 19% and same store growth was around 9%. In fact, it was the 17th consecutive year of 10% or more EPS improvement. The company is the biggest player in its industry and has the best balance sheet. With only 12% of the prescriptions market, the growth potential still remains high.

Expeditors International of Washington

Our logistic Seattle company had a very good year : EPS were up 26%. The sharp rise in energy costs had a slight negative impact but overall, it was a banner year. This investment has proved very rewarding so far: the stock has doubled in less than 3 years. The P/E ratio is not low (around 30 times

2005 estimates). Using the word "overvaluation" would be simplistic but the margin of safety is not as high as I would hope for. But CEOs like Peter Rose are scarce. We are happy to be partner with him.

W.P. Stewart & Co.

Two years ago, I began acquiring shares of a money managing firm: W.P. Stewart (WPS). I've met with Mr. Stewart and I've known about his investment philosophy for many years. It is similar to ours. He had the courage and foresight to start his firm at the bottom of the 1973-74 bear market and has maintained great returns since then (for the 1993-2004 period, their results are not as good as ours, I must add!). In 2002, the stock was trading at $18. With a dividend of $1.20, the stock's yield was 6% which was quite attractive. I know most of the stock that make up their portfolios and I believe that in the next years, they should earn decent returns, probably better than the S&P 500.

In 2004, the company beat the market by a wide margin. Most important, over 5 years, it has overperformed the S&P 500 by 2% annually. This is impressive in the light that the company manages $9 billions in assets and does not have the flexibility of a smaller firm. EPS were up 41% in 2004 and the stock has done well, climbing to $24. The year 2005 looks promising.

Owner's earnings

At Giverny Capital, we do not judge the quality of an investment by its short term market performance. It our minds, we OWN the companies in which we acquire shares. So we focus on the growth in intrinsic value (mostly EPS growth) of our businesses and on their long term prospects. In 2004, our stocks were up 8% (in constant currencies). But the growth in our intrinsic earnings was 20%. These are satisfy results and they are similar to those of the S&P 500 in 2004.

Last year, I presented to you a table I consider almost as important as the ones of the yearly returns: the yearly growth in our owner's earnings. We compare those with the market performance of our portfolio and with the same numbers for the S&P 500.

	Giverny			S&P 500		
Year	Growth *	Market **	Difference	Growth *	Market **	Difference
1996	13%	29%	16%	11%	22%	11%
1997	16%	35%	19%	10%	31%	21%
1998	10%	12%	2%	-2%	28%	31%
1999	15%	12%	-3%	16%	20%	4%
2000	18%	10%	-8%	8%	-9%	-17%
2001	-10%	10%	20%	-20%	-11%	9%
2002	18%	-2%	-20%	9%	-22%	-31%
2003	30%	34%	4%	13%	28%	15%
2004	20%	8%	-12%	19%	11%	-8%
Total	224%	274%	50%	74%	123%	49%
Annualized	14%	16%	2%	6%	9%	3%

* Earnings growth (note : it is an approximation)
** Merket performance, dividend included (without currency effects)

The annual 2-3% difference between market performance and earnings growth is mostly due to dividends (the average P/E in 2004 is slightly higher than in 1996). As you may notice, we've done better than the S&P 500 for one reason only: our businesses intrinsically did better. In fact, since 1996,

our companies have grown their earnings at a rate of 8% better than the S&P 500. Our portfolio overperformed the index by a similar rate.

We aim at finding companies that grow their underlying value at around 12-14% per year, twice the market average. So far, we have been able to find such enterprises and usually at prices we felt comfortable with. Over many years, market performance will walk hands in hands with earnings growth. So focusing on our owner's earnings should lead to satisfying results. But in the short run, there can be wide gaps between market performance and EPS growth. You can see that in the 1996-2004 period, our portfolio underperformed the underlying businesses four years (1999, 2000, 2002 and 2004). We have to be able to be patient sometimes to reap the reward of good business selection.

Mistakes *du jour*

"*Experience is simply the name we give our mistakes*" - Oscar Wilde

Once again, candidates were numerous for our three mistake medals for the year.

Let's start with an honorable mention: Krispy Kreme. I took a starting position (around 1%) in this company in the spring of this year. Their donuts are divine but the stock was nothing like it in the year just passed. The company encountered serious problems and we decided to sell our shares at a 70% loss. My mistake was – with some hindsights – that I did not realize that their business model was so dependant on new stores openings. Peter Lynch once said "More companies die of indigestion than starvation". This was the case here (without any play on words intended).

You could conclude that an investment that turned out to be a 70% loss should at least qualify for a medal. Not necessarily: Losing 70% on a 1.5% investment represent a 1% loss of capital. I've done much worst in "omission" mistakes. For example, *not* investing our typical 4% weight of our portfolio in a stock that latter has increased by 200% has a cost to us of 8%. You don't see it in our reports but such opportunity costs are real.

For our first two medals, here are two great examples of such mistakes:

Bronze Medal : NVR Inc.

In 2000-01, I got interested in a home construction company based in Virginia: NVR. The company earns incredible returns on capital (in the 80%) and has increased their EPS from $1 in 1995 to $63 in 2004 (a 5000% increase in 9 years). Half of that growth was fueled by a major stock buyback plan (I usually prefer such a plan to an "acquisition" plan).

I thought about acquiring shares of NVR when the stock was $150, four years ago. Its P/E was 7 times. I had two main worries: a high level of stock options (which costs were inflated by the huge reduction in shares outstanding) and the cyclical nature of the construction market.

It was a mistake because I should have use more judgment. First, because even with the expense of stock options included, the valuation was still compelling. And when I find an outstanding business, well managed and with good long term prospects (even with some ups and downs), I should purchase it without worrying about short term events.

Since 2001, the results have continued to be outstanding and the stock is now $770.

Silver Medal: Pixar

In 1995, a new company, specializing in 3D animation movies, came public : Pixar. The new issue was in big demand (thanks to the huge success of “Toy Story”) and climbed to $40 the first few days of trading. This was more than 75 times estimated earnings for 1996 (which turned out to be $0.56), a level that had a very thin margin of safety.

In spite of this, I continued to follow the company closely. In 1996, we owned shares of Disney and I knew their history very well. So I did realize that Disney was losing some of its leadership in the animation industry but also that they had the foresight of making a distribution deal with Pixar. In 1998, “A bug’s life” was another hit. With “Toy Story 2”, this helped Pixar more than double their earnings in 2000 to $1.56 a share. Pixar released a movie every two years and the consequence was that the profits were not linear which clouded the earning power valuation (and so the intrinsic value).

In 2001, Pixar relased the marvelous movie : "Monsters Inc.". When I saw it, I knew instantly that this was the best animated movie of all time and that Pixar was not a fade. So I took a closer look at the stock. It was then trading at $30 (50% lower than its 1998 high). The company had $5 in cash so we were really paying $25 for the movie business which was the equivalent of 16 times 2000 earnings and 15 times those estimated for 2002 (2001 EPS were depressed, remember earnings were not linear!).

But I decided not to invest for two reasons: first because of my fear of profit instability but also because of its dependency on the Disney partnership.

Since then, Pixar has increased the number of movie releases: "Finding Nemo" in 2003, "The Incredibles" in 2004 and "Cars" in 2005. This has helped to stabilize profits. But I also realized that it was not Pixar who was dependant on Disney but the other way around. So in 2006, when Disney’s partnership will end, Pixar will be able to negotiate better profit sharing contracts and revenues per movie will probably be higher in the future. Clearly, I should have been more perspicacious and use better thinking about the long term economics of the business.

This year, "The Incredibles" was another great success (revenues of $340 millions, even more than "Finding Nemo"). The stock climbed almost 200% in the last three years to end the year at $85. I have no excuses: I knew the animation industry’s history in length and I understood Pixar’s strengths.



Gold medal: Yahoo !

The company Yahoo! as a unique privilege in my business career: it has been awarded two golden medals of "mistake *du jour*" in four years.

Let's go back four years in the past. In 2000, I bought shares of Yahoo! at $12. In the year's annual report, I underlined the fact that I made a huge mistake not to buy it way sooner (and so it got a gold medal mistake). In the quarters that followed, the company had disappointing results. And down the stock went, to a low of $4 in 2002. That price was the total value of their shares in Yahoo! Japan and the cash on hand. All the rest, the market gave it to you for free! What a bargain!!

But instead of buying aggressively more shares, without being disturbed by the general pessimism toward the Internet industry, I stayed still. I was disappointed by the departure of its CEO and by the 35% drop in revenues for the 2001 fiscal year. At the end of 2002, the stock rebounded to $8 and I decided to sell to buy more shares of Cognex (see the 2002 annual report). Since Cognex has almost doubled in the last two years, it was not a bad purchase. But Yahoo! did way better.

The new management team did a fabulous job. In only two years, revenues have tripled and EPS quadrupled. The stock is now $38, three times my initial purchase price and four times the level I sold it at. The stock trades at a very high P/E, it's true, but only time will time if it's warranted or not. For example, I expected in 2000 that at some point in the future Yahoo! would be able to charge its users fees that would translate their huge customer base in lots of revenues. In 2004, the number of paying users was 7.4 million, 80% more than in 2003 alone.

My mistake, of golden calibre, was simple : I was not patient enough!

That's why I use the expression "long term" so many times in this report!

I wish you all a great year 2005.

François Rochon
CEO and portfolio manager
Giverny Capital Inc.

Giverny Capital Inc.

Annual Report 2005



Pierre Dorion
Figure assise, 1993
Giverny Capital Inc. Collection

For the year ending December 31st 2005, the return on the Giverny Global portfolio was 11.5% in Canadian currency compared with 3.6% for our weighted benchmark. The Giverny US portfolio (in US currency) achieved 12.5% for the year compared with 4.9% for the S&P 500.

Since the start of our portfolio, July 1st 1993, our annual return has been 19.2% compared to 9.8% for our benchmark and 9.6% for the S&P 500 (all in Canadian currency). Our ambitious objective is to maintain an annual return 5% better than the indexes over any five years period. I believe that stocks in general (as measured by the S&P 500) will return 6 to 9% per year in the future. So our annualized target should be in the 11-14% area.

I am satisfied of our results in 2005. First, our stocks did better than our benchmark. Also, we made some changes in our portfolio that I believe will produce better returns in the future. What is still the most important factor is that our businesses continued to obtain outstanding intrinsic performances. This was reflected by a 13% increase in their combined earnings, a performance mostly in line with our 2005 market performance and also with our long term results. I'll come back with more details in the "Owner's earnings" section.

The Federal Budget of February 23rd 2005

Without any doubt, the last Federal Budget was the key event for us in 2005. By eliminating the foreign content limit for registered accounts, our "pound" where we can fish outstanding businesses has been extended to all the accounts we manage. Historically, RRSP portfolios made up 25% of the Giverny Global portfolio and so the Canadian securities content was around 20%. We reduced that weight during the year to around 10%. As you know, we don't have any country asset mix policy. We focused our energy in finding 20 or so outstanding companies, whatever their nationality. In the past, the country asset mix changed depending on the opportunities available. In 1995-97, we had more than 40% of the portfolio in Canadian Stocks. In 1998, we invested in Asia to profit from the high level of pessimism in that part of the World (who remembers the Asian crisis?). Recently, we acquired an Australian company.

Our approach is similar to the one of a hockey team General manager: Our goal is to win the Stanley Cup by selecting 20 all-star players to put on the ice. Their origin, whether it is Canadian, Russian, American, Swedish, Finish or Slovak, is not a criteria. We simply want the best players. And in the stock market, we have this incredible luxury to choose whoever fits in our team.

Consequences for our portfolios:

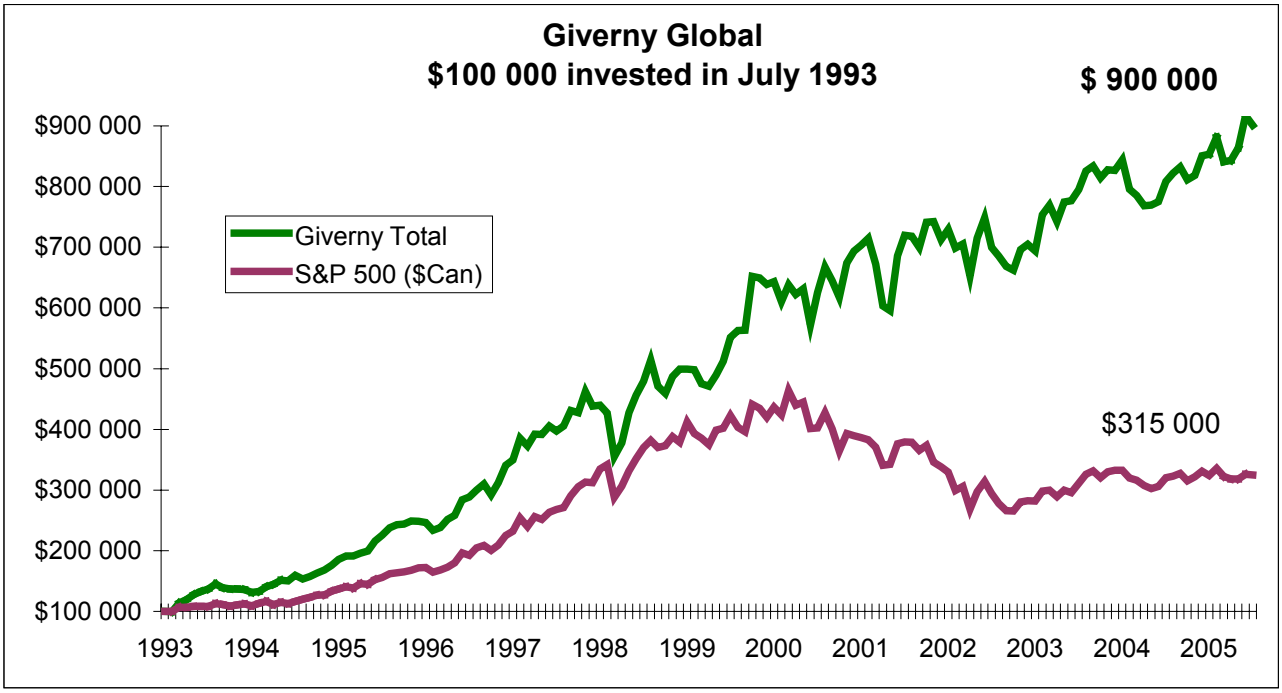
- Since our RRSP portfolio won't be materially different from the non-RRSP portfolio, we decided to stop differentiate it from the Global portfolio.
- Since we have many US mandate, we will continue to measure the Giverny US portfolio (which is mostly the US part of the Global Giverny portfolio).
- So, we will have two portfolios measured in our reports: The US Giverny portfolio and the Global Giverny portfolio. The later is the one started in 1993 and that regroups all my money. As always, we're in the same boat at Giverny: I have all my money in the same stocks as you!

Our Yearly Returns since 1993 [1]

Giverny Global Portfolio (in Canadian dollars):

Returns *	Giverny	Benchmark **	+ / -	S&P 500	+ / -	$ US / Can ***
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	8.4%	**28.6%**	3.3%
1994	**16.5%**	3.7%	**12.7%**	7.3%	**9.1%**	6.0%
1995	**41.2%**	24.0%	**17.2%**	32.9%	**8.3%**	-2.7%
1996	**28.0%**	22.8%	**5.2%**	22.7%	**5.4%**	0.3%
1997	**37.8%**	28.6%	**9.2%**	36.7%	**1.1%**	4.3%
1998	**20.6%**	18.8%	**1.8%**	37.7%	**-17.1%**	7.1%
1999	**15.1%**	16.3%	**-1.2%**	14.1%	**1.0%**	-5.7%
2000	**13.4%**	3.2%	**10.2%**	-4.6%	**18.0%**	3.9%
2001	**15.1%**	-0.4%	**15.5%**	-5.7%	**20.8%**	6.2%
2002	**-2.8%**	-18.3%	**15.6%**	-22.0%	**19.2%**	-0.9%
2003	**13.6%**	14.0%	**-0.4%**	5.7%	**7.9%**	-17.8%
2004	**1.6%**	6.2%	**-4.5%**	2.8%	**-1.1%**	-7.3%
2005	**11.5%**	3.6%	**7.9%**	1.5%	**10.0%**	-3.3%
Total	**800.3%**	**223.1%**	**577.2%**	**215.2%**	**585.1%**	**-9.4%**
Annualized	**19.2%**	**9.8%**	**9.4%**	**9.6%**	**9.6%**	**-0.8%**

* All return adjusted in Canadian currency
** The Benchmark is a group of indexes (S&P/TSX, S&P 500, Russell 2000, etc.) that reflects the asset mix of the portfolio.
*** Variation of the US currency compared with its Canadian counterpart.



[1] All the returns have been audited by the accounting firm PriceWaterhouse Coopers.

Giverny US Portfolio (in US dollars):

Our US portfolio returned 12.5% in 2005, around 8% better than the S&P 500. Since 1993, our US portfolio had a 813% total return or 19.4% on an annualized basis. This compares to 247% and 10.5% for the S&P 500. Our annualized added value was 9%.

Year	Giverny US	S&P 500	+ / -
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	36.6%	18.2%
1996	27.0%	22.3%	4.8%
1997	32.9%	31.0%	1.9%
1998	11.0%	28.5%	-17.5%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-8.2%	19.5%
2001	8.1%	-11.2%	19.3%
2002	-4.4%	-21.4%	16.9%
2003	31.6%	28.6%	3.0%
2004	9.3%	10.7%	-1.4%
2005	12.5%	4.9%	7.6%
Total	812.9%	246.5%	566.5%
Annualized	19.4%	10.5%	8.9%

Period	Giverny	S&P 500	+/-
1 year	12.5%	4.9%	7.6%
3 years	17.4%	14.3%	3.1%
5 years	10.8%	0.9%	10.0%
10 years	15.0%	9.1%	5.9%
Since the start	19.4%	10.5%	8.9%

We can observe in the second table that the last 5 years (from 2001 to 2005) were our worst absolute return but our best relative return since we did 10% better than the S&P 500. In the last 10 years, our yearly added value was 6%, in line with our long term objectives.

Currency fluctuations

These last few years, the impressive rise in the Canadian currency has been at the center of many debates in the financial industry as to the relevance of investing in foreign securities (even if foreign markets is the equivalent of 97% of the economic world). Those who focus on short term results tend to forget that in the long run the US/Canadian rate changes tend to normalize and is an insignificant parameter. At the same time, I can empathize with the partners that joined us three years ago and had to live through a 26% loss of the US currency.

It is important to have some perspective. In the following table, I have separated the Giverny portfolio returns in Canadian dollars and without currency effects. **We can see that the longer the time period, the less important is the currency effect.** Over 5 years, our 12% annual return was reduced to 8% in Canadian dollars. It is a major effect but still this 8% return is better than any indexes (including the TSX). Over 10 years, our 16% annual return was reduced to 15% in Canadian, a modest effect.

	In Canadian currency			Without currency effect		$ US / CAN	
Period	Giverny	Benchmark	+/-	Giverny	Benchmark	Total	Annualized
1 year	12%	4%	8%	15%	7%	-3%	-3%
3 years	9%	8%	1%	18%	17%	-26%	-10%
5 years	8%	0%	7%	12%	5%	-22%	-5%
10 years	15%	9%	6%	16%	10%	-15%	-2%
Total	19%	10%	9%	20%	11%	-9%	-1%

Should we hedge our portfolios against the US currency ?

Since 1993, the yearly effect of the Canadian dollar was a 1% loss. If I decided to hedge our portfolios against the US currency in 1993, our total returns would have been much lower. To hedge is costly. It varies depending on the size of the account but the yearly cost can easily reach 4%. So instead of having a 19% return since 1993, it would have been 16% (20% - 4%). In the last 10 years, it would have been 12% instead of 15%. And it would be irrational to hedge when the Canadian dollar is as high as it is now.

In fact, even if the Canadian currency would go at par with the US dollar in the next decade (which seems to me quite improbable), the yearly cost would be 1% from today's level. If we achieve our objective of yearly returns of 11-14% on our portfolios, this rise would reduce our returns to 10-13% per year. I can live with such a "risk".

The year 2005

Last year was marked by an important rise in oil prices. For a third consecutive year, the Canadian stock market did very well, mostly because of energy related securities. Energy stocks returned 63% in 2005 after returning 30% in 2004 and 25% in 2003. In three years, the energy weight in the TSX Index has climbed from 15% to 30%. In fact, more than 40% of the TSX is comprised of resources related stocks. These companies have experienced a huge profit rise in the last two years. These are cyclical businesses and it is wise to remind ourselves that their recent growth rate are not sustainable (and for the TSX by ricochet). By definition, cyclical businesses have ups and downs.

The TSX trades at around 17 times earnings. Considering the large weight of cyclical and bank stocks in the index – which usually trades at discount P/Es – the Canadian stock market in general looks pricey. There are some interesting securities, as always, but they're not in large numbers.

Our own Canadian securities have done extraordinary well lately and we reduced the ones that we believed were too richly valued. In contrast to some of our co-investors, patriotism is NOT a fundamental parameter in our analyses. In general, emotions should be left out of the investment process.

Since I started managing money, I used a "value" approach that gets me far away from stock market fads. It is quite amazing to hear today the same arguments for investing in oil that we heard about technology stocks only six years ago. It's the same song, the same jingle but with different couplets

South of our borders

American stocks look more undervalued than their Canadian counterparts. The S&P 500 trades at around 16 times earnings, a level that I would qualified as reasonable. In fact, the S&P 500 is at the same level it was 7 years ago although earnings are up almost 50% since then.

The key factor

Faithful to our investment philosophy, we look at our investments as part ownership of businesses. We own some of the best businesses in the World and they were selected knowing we will navigate through some good times and also through some storms. Tough periods have two good side effects. First, weaker competitors tend to fold during recessions or at least lose market share (usually to better managed companies like the ones we own). Second, a temporary stock market decline creates the opportunity to acquire more shares of the company we own at better prices. For example, in September, Knight Transport retracted to $15 for a week days. We took the opportunity to buy more shares. The stock rebounded to end the year at $20.

On the other hand, we don't have fresh money to invest all the time (we're not Berkshire Hathaway!). In such instances, the best thing to do is to be indifferent to market fluctuations and simply stay put. Going to the movies is often less dangerous than to read alarming headlines on the Internet or in the newspaper.

Wall-Street's forecasters

> *When it comes to predicting the market, the important skill is not listening, but snoring. The trick is not to learn to trust your gut feelings, but rather to discipline yourself to ignore them.*
>
> - Peter Lynch

Both Warren Buffett and Peter Lynch often said that disregarding headlines and market/economic forecasts is a wise thing. In spite of that, the favorite game in Wall-Street is to predict the short term future; I use the word "game" because obviously no one knows the future. Trying to foresee interest rates, currency fluctuations, market levels, commodity prices and economic cycles is futile. But still, there's no shortage of it on Wall-Street (and on Bay Street in Toronto). The reason is simple : "This is what the client asks for". It is not totally untrue: since the beginning of time, men have wanted to know their future. Forecasters and other fortune-tellers exist since then to reveal *it* to them !

To me it is so obvious that if someone could really predict the future of securities markets, he would become rapidly a billionaire. The fact that a forecaster still sells his "services" (especially after many years of "experience") seems to tell a lot about his real forecasting talent.

The Fog of the economy

The economy can't be predicted because there are to much parameters to account for (not counting the unknowable ones). The best analogy I heard about this came from a movie called "The Fog of War" which is an interview with Robert S. McNamara, who was the US Secretary of Defense from 1961 to

1968. If some comments are literally astonishing – the World came so close to a nuclear war in 1962 – it is the conclusion of Mr. McNamara, now 85 years old, that is of a grand wisdom:

> *"…There's a wonderful phrase: 'the fog of war.' What the fog of war means is: war is so complex it's beyond the ability of the human mind to comprehend all the variables. Our judgment, our understanding, are not adequate."*

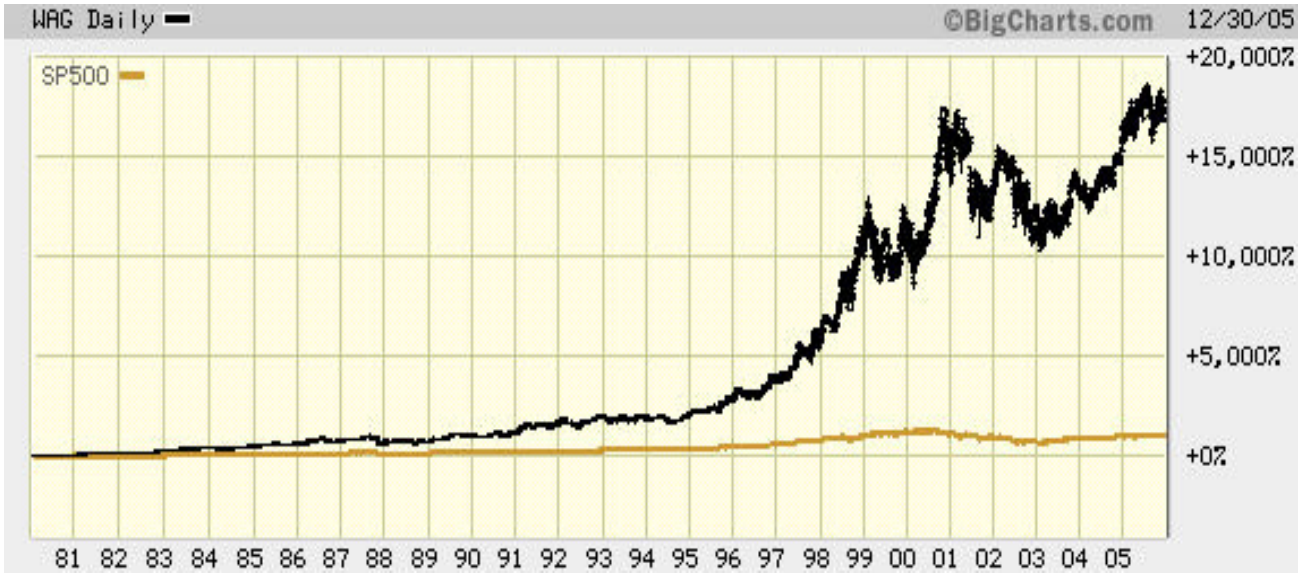
Fortunately, the consequences of the fog of the economy are less tragic than those of war. But still, too many investors bet their financial future on parameters that are both unpredictable and uncontrollable.

The Good news !

Beyond economic hazes and misty predictions, we can focus on what investing really is. In one sentence: Investing is acquiring a participation in a business. If the business does well over many years, all fog tend to disappear and the stock market reflects in all its brightness the true intrinsic performance of the underlying enterprise. Without exception!

For example, let's look at the performance of Walgreen's over one generation (25 years). Since 1980, short term interest rates have fluctuated between 2% and 20%. We went through tree recessions in North America and numerous wars. In 1980, we were deep into the second oil choc and gold reached $850 an onze. The budget deficit reached new highs as a percentage of GDP in 1982. In the 25 years that followed, the stock market went up 1000% (10% a year) including 8 market corrections (a fall of 10% or more) and two great market drops (40% in 1987 and 50% in 2000-2002). The saying that "The market climbs a wall of worries" could not be more true.

During those 25 years, Walgreen's stock climbed 18 000%, a 23% annual rate. A $10 000 amount invested in 1980 would be worth close to $2 millions today, 20 times the level a same amount invested in the S&P 500 would have yielded. In 1996, the legendary investor Philip Fisher, then aged 89 years old, said in a Forbes interview: **« If you are in the right companies, the potential rise can be so enormous that everything else is secondary ».**



Walgreen's performance over 25 years (Source : BigCharts.com)

Five years Postmortem : The year 2000

Since five years is our time horizon, it is fitting and consequential that we go through a yearly quinquennial postmortem.

In March 2000, I made some important changes in the portfolio. I reduced some of our stocks that I felt were way too pricey to buy more shares of three of our stocks that I believed were undervalued: Berkshire Hathaway, M&T Bank and Lincare Holdings.

		Buys		Sells	
Stocks	**Today**	**Price**	**Difference**	**Price**	**Difference**
Berkshire Hathaway B	2 936$	1 367$	115%		
IMS Health	25$			21$	19%
Cisco Systems	17$			68$	-75%
Disney	24$			37$	-35%
Hewlett Packard	22$			73$	-70%
Intel	25$			60$	-58%
Lincare Holdings	42$	23$	80%		
JDS Uniphase	3$			137$	-98%
M&T Bank	109$	38$	189%		
Average			**128%**		**-53%**

Since then, stocks that were sold have yielded, on average, a market return of -53% and those bought +128%. Those results don't take into account portfolio weights (JDS Uniphase and Hewlett-Packard were then small weight). Also, I sold Lincare in 2004 at around $31 so I did not fully profit from this investment. In spite of that, these changes prove to be quite positive.

And these purchases and sales definitively went against the crowd in March 2000, which proved to be the top of the technology craze. At the time we purchased more shares of Berkshire at $1367, many believed that Warren Buffett, its CEO, had lost his magic touch and was out of date with the new way of investing. Like Berkshire, M&T Bank and Lincare were considered "old economy" stocks and were trading at very low P/Es. We don't hear that financial term anymore but it was used daily in those years.

Perhaps again today, the neglected stocks we're buying (Wal-Mart, Disney, HMA and Berkshire again) could turn out to be tomorrow's winners. We will see in 2010...

<u>Our businesses</u>

Although it's easy to forget sometimes, a share of a stock is not a lottery ticket. It's part ownership of a business.

- Peter Lynch

Disney

We bought shares of Disney in 1996 at around $20 a few months after its merger with Capital Cities ABC. We sold them in 2000 at around $37. I then believed that the company was diversifying too much (*Disney stores* for example). Moreover, they neglected their animation movie division. Michael Eisner seemed to lack some leadership qualities. Even though the stock had doubled in four years, EPS

had not grown accordingly. So the stock traded at more than 33 times earnings, a level I believed to be too high. Since then, EPS have increased 30% but the stock is 28% lower. Disney's market valuation is thereby much more attractive today.

It is not for that reason that I decided to repurchase shares lately. It is because of the new CEO: Mr. Eisner left in September and was succeeded by Mr. Robert Iger. I knew Mr. Iger at the time he worked at ABC under Mr. Tom Murphy, one of the best managers of all time. After reading a few interviews with Mr. Iger late in 2005, I decided that he would be the man to put Disney back on the right track. Already, the company had sold its stores to The Children's Place. Mr. Iger then worked on the number one priority: a deal with Pixar. A merger was announced in January 2006. Disney also recently spinned off its radio division by merging it with Citadel Broadcasting. In light of the radio satellite networks (XM and Sirius), it is hard to foresee how this industry will evolve in the next few years.

Disney, at its end of year price of $24, trades at 15 times 2006 EPS estimates. It has an excellent CEO. And it seems to focus on the right things to improve its growth prospects. On the other hand, Wall-Street seems to have thrown the towel (the stock is at the same price as in 1997). Ironically, the situation looks to be the reverse of the one that prevailed in 2000.

BMTC Group

Our Quebec based company BMTC Group (the furniture stores Brault & Martineau and Tanguay) had another good year. Earnings were not materially different but the good news come from competitors. Many had to close down. The Brick, their biggest competitor, had an so-so year and its stock is down this year. In fact, since its Quebec arrival in August 2004, The Brick's stock is down 12% and BMTC Group's stock is up 50%.

Sadly, BMTC's stock is not liquid and it has become difficult for us – with $115 millions under management – to buy large quantities of shares. Furthermore, the company is not making our life easier by buying back its stock aggressively. But we're not complaining….

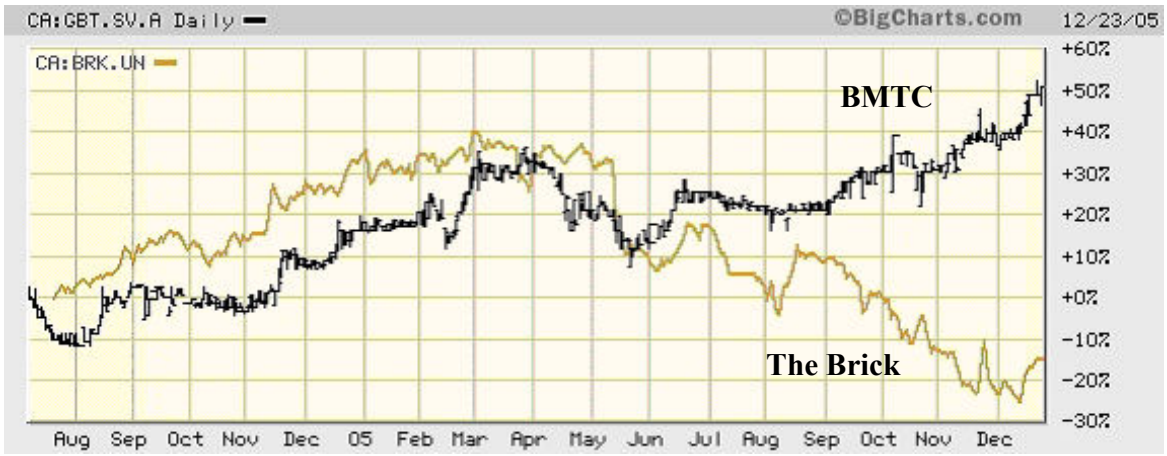


Chart of BMTC's stock performance compared to The Brick over 15 months (Source BigCharts.com)

Walgreen's

The best drugstore chain in the World had another great year: EPS were up 14% in 2005. Besides CVS, many competitors had a tough year. Walgreen's has increased its same store sales by 9% in 2005

(on the pharmacy side) compared with 4% for the industry. Pharmacy sales make up 64% of revenues. With 5000 stores, the company now owns 15% of the US market for retail prescription.

Walgreen's can use its clean balance sheet (no debt and $1.4 billion in cash) to continue its expansion. In 2005, the company opened 435 stores which is more than one a day. The company believe it can reach the level of 10 000 stores by 2015. It is therefore realistic to think that the company can maintain a good growth rate (12% or more) for many years to come.

Knight Transporation

Our Phoenix trucking company had another outstanding year. Revenues and EPS were up more than 28%. The company was wise to have a fuel surcharge clause in their client's contracts. Knight is now one of our top holdings. It is still a small company so we hope the best is yet to come.

Bed Bath & Beyond

Bed Bath &Beyond had a good year in 2005 but it's the destiny of any fast growing company to experience a growth rate slow down at some point. When we became owner of BB&B in 1998, the company was growing at 30% a year. In the last quarters of 2005, it was 11%.

It's still a very good performance and the company treats its shareholders in a perfect manner. The stock is up more than three fold since our first purchase but future returns looks more modest. We could decide to replace this investment in the months to come.

Pason Systems

Our Calgary company is doing very well these days. Pason Systems Inc. provides design, manufacturing and rental of specialized drilling instrumentation systems for use on land-based drilling rigs. Pason's products and services include data acquisition, wellsite reporting software, remote communications and Internet information management tools. Contrary to oil producers, Pason doesn't sell a commodity like product. In Canada, it has a 90% market share. Its net margins stand at 25% and its return on equity reaches 30%. In 2005, revenues and EPS were up 45%.

Although these growth rates are not sustainable, Pason's long term perspective still look impressive. In just five years, the company has increased its market share in the US from 10% to 37%. Pason also has entered Argentina, Australia and Mexico. I would add that Jim Hill, Pason's CEO, is our kind of manager (see later in the report our definition of a "good" manager).

ResMed

ResMed, the Sydney (Australia) company had another outstanding year. Revenues were up 33% and EPS 26% (stock options expenses decreased margins). ResMed is a leading respiratory medical device manufacturer, specializing in products for the diagnosis and treatment of sleep disordered breathing (SDB). It is not (yet) the biggest player in the industry - which is the American company Respironics - but it is the fastest growing.

When ResMed was formed in 1989, its primary purpose was to commercialize a device for treating obstructive sleep apnea (OSA), a major subset of SDB. OSA affects millions of people worldwide (approximately 20 million in the United States alone), its prevalence being comparable to that of asthma or diabetes. However, awareness is low with only around 5% of sufferers being

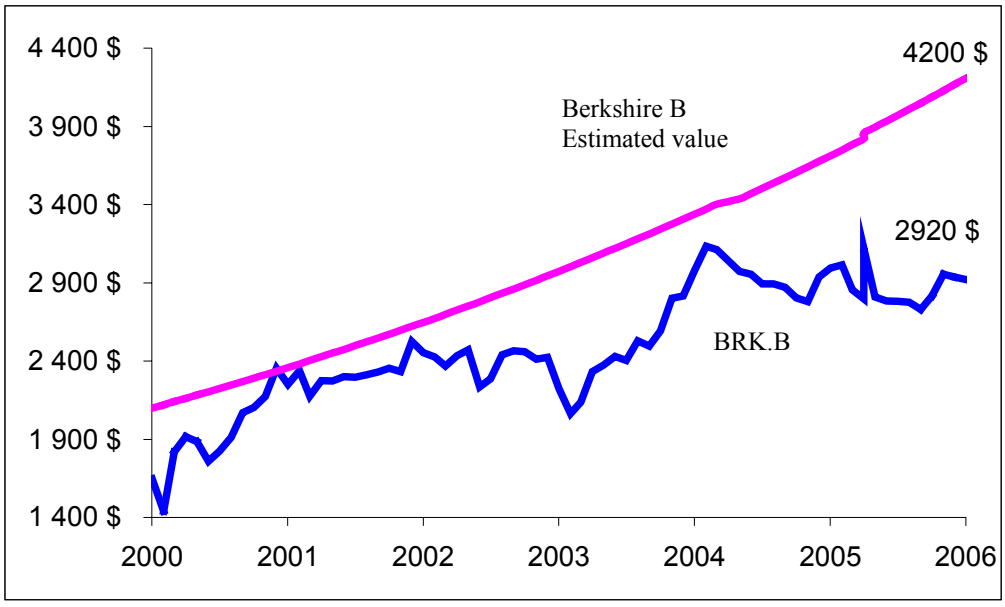
diagnosed and treated. Along with an increasing understanding of the morbidity and mortality caused by SDB, this discrepancy has created one of the fastest growing segments of the respiratory industry. There is also now a recognized association between SDB and common diseases such as chronic obstructive pulmonary disease, stroke, and cardiovascular disease.

The stock is not cheap (trading usually in the 30 times range) but the long term fundamentals are impressive. So far, it has done very well since we first purchased shares two years ago.

Berkshire Hathaway

Berkshire Hathaway, the company managed by the great Warren Buffett, has seen its stock move sideways for two years now. I believed that the company can grow its intrinsic value by around 12% a year. In other words, its value doubles every six years.

When I purchased more shares of Berkshire B in 2000 at $1400 (half today's level), I believed that it was worth 50% more or around $2100. Therefore, I believe that Berkshire B is worth $4200 today. The market discount seems to be similar to the one that existed in March 2000. Once again, Warren Buffett is not in fashion these days but if Berkshire Hathaway continues to increase its value by 12% a year, eventually its stock will follow. We just don't know when!



Berkshire Hathaway B: Stock prices compared with estimated intrinsic value over last 6 years

Wal-Mart

We acquired shares of Wal-Mart this summer. If sometimes we buy shares of some unknown company, the retail giant is more than well known. I started to follow the company in 1993. I have always admired their discipline to maintain a cost structure unequaled by any, its policy of "always low prices" and its devotion to long-term shareholders value. At the beginning of the 1990's, the company started to expand outside the US. I was sceptical that the company could succeed in other countries. To this day, it was a vast success in most of the region in which it expanded. The potential of growth in China is quite impressive and so far their store have been well received (although there are some tough competitors like "Wu-Mart").

On the other hand, the Bentonville (Arkansas) company is facing lots of critics. Even some of our partners raised questions about rumors and hearsays on Wal-Mart. Why is Wal-Mart so profitable? Well it is not *that* profitable since net margins are at around 3%. The return on equity is impressive at 20% but it is not that spectacular. They do have lower gross margins than competitors but in terms of salaries they are in the same ballpark Employees are not less paid than those of Target for example. On average, Wal-Mart associates are paid $10 an hour. On the benefits side, in Fiscal year 2006, Wal-Mart is projected to spend roughly $4.7 billion on associate benefits including, for example, contributions to health and dental plans, 401(K)/profit-sharing plans and associate discount cards. Wal-Mart offers health coverage to both full and part-time associates. Only 23% of all US employers offer coverage to their part-time employees.

Where Wal-Mart is king is on efficiency. Its offices are lean and mean and they have a thrift philosophy on everything. Even the CEO has a similar office than other directors. And in business trip, he shares his room ! Computer systems is where the company spend lots of money ! If the computer system detects a weather forecasts that will influence sales, automatically actions are taken. For example, if an hurricane is schedule to pass through a region in Florida, the computer sends instantly an order of "Poptarts" to Kellogg's for the targeted store (the computer made a link between hurricanes and sales of that item).

There were lots of bad press when Wal-Mart Canada closed its Jonquiere store because of unionization. The company is demonized by many way beyond reality. On the other hand, Wal-Mart Canada was named – again – on the list of "Canada's 50 best employers" published in the magazine "Report on Business" and "La Presse" newspaper. In fact, it was the fourth time in five years that Wal-Mart Canada was on the list. It is the number one retailer and it is even in higher ranks than companies like Pfizer, Glaxo, Wyeth and Abott Canada. Moreover, Wal-Mart Canada is on the 6th place for career opportunities and on the 5th place on work/personal life balance.

I certainly don't want to start a debate on the benefits of unions. But to have a different point of view doesn't hurt: with 1.5 million employees (1.3 million in America), Wal-Mart is a target of choice for unions. At $600 of annual fees per employee, this is a $1 billion "market" for them.

The company is growing at around 12% per year but its P/E ratio is only 15x . Pessimism that surrounds the company is – in my opinion – a good opportunity to become shareholders at a good price.

Owner's earnings

At Giverny Capital, we do not judge the quality of an investment by its short term market performance. In our mind, we OWN the companies in which we acquire shares. So we focus on the intrinsic value increase of our businesses (reflected by EPS growth) and on their long-term prospects. We also take into account market valuation in our decisions of buying or selling, although it is not our first criteria.

In 2005, our stocks were up 15% (without currency effects). Our owner's earnings were up 13%. So, including the dividend, our market performance was in line with our EPS growth.

Each year, I presente you a table I consider almost as important as the ones of the yearly returns: the yearly growth in our owner's earnings. We compare those with the market performance of our portfolio and with the same numbers for the S&P 500.

	Giverny			S&P 500		
Year	Growth *	Market **	+/-	Growth *	Market **	+/-
1996	13%	29%	16%	11%	22%	11%
1997	16%	35%	19%	10%	31%	21%
1998	10%	12%	2%	-2%	28%	31%
1999	15%	12%	-3%	16%	20%	4%
2000	18%	10%	-8%	8%	-9%	-17%
2001	-10%	10%	20%	-20%	-11%	9%
2002	18%	-2%	-20%	9%	-22%	-31%
2003	30%	34%	4%	13%	28%	15%
2004	20%	8%	-12%	19%	11%	-8%
2005	13%	15%	2%	11%	5%	-6%
Total	266%	328%	62%	92%	134%	42%
Annualized	14%	16%	2%	7%	9%	2%

* Earnings per share growth for the entire portfolio (note : it is an approximation)
** Market performance, dividend included (without currency effects)

The annual 2% difference between market performance and earnings growth (both for us and the S&P 500) is mostly due to dividends.

Many investors don't understand why the S&P 500 index has yielded almost no returns for the last 5 years even though we write that stock's intrinsic value has increased by a fair amount since then. This second table gives a better perspective to understand this phenomenon.

Annual basis	Giverny			S&P 500		
Year	Growth	Market	+/-	Growth	Market	+/-
1996-2000	14%	19%	5%	8%	18%	9%
2001-2005	13%	12%	-1%	5%	1%	-4%
1996-2005	14%	16%	2%	7%	9%	2%

As you can see, from 1996 to 2000, earnings for the S&P 500 companies grew by 8% a year but the market performance was 18% a year. This was due to a large (and exaggerated) increase in P/E ratios, mostly for the larger cap names. The market came back to reality in the five years that followed. In the end, over 10 years, the companies making up the S&P 500 increased their earnings by 7% a year, paid on average 2% in dividends. And the annual market performance was 9%. The first conclusion is no news: The stock market always ends up reflecting the intrinsic performance of businesses.

The second conclusion is more relevant: our portfolio did better than the S&P 500 because our companies did better. Since 1996, our companies increased their earnings by 14% a year, twice the level of S&P 500 companies. And in the 2001-05 period, we did way better than the S&P 500 because not only did our companies continue do perform outstandingly but the general P/E compression was not as severe for our stocks. The "value" dimension of our approach played a vital role.

The third conclusion is more empirical. If in the long run, market performance follows unrelentingly the performance of underlying businesses, in the short term, there can be large disparities between the two. The 1997 and 2002 results are good examples (20% difference).

We love such market disparities and we try to profit from them, within the limits of a reasonable level of transactions.

A « good » manager

Over the years, I insisted on the importance of choosing good managers for the business in which we invest. Of course, when we read hundreds of annual report, all top managers are "good" (particularly when their stock go up!). We have to use a little more sapience to adequately judge managers.

I've learned from experience – sometimes through pain – but also from writings by Warren Buffett (and by Robert P. Miles' great book "*The Warren Buffett CEO*"). Investing is becoming partners with top managers. We have to select people that share our values. Obviously, intelligence and competence are important but usually, once they have reached the high spheres of corporate management, all directors have those qualities. And their integrity must be without stain.

We look for deeper qualities. Warren Buffett often mentioned that in the end he asks himself this vital question: "Is this person loves more the business than money?". He adds : "There is nothing wrong in loving money but we want managers that like business better".

Business managers have lots of responsibilities, toward clients, employees, suppliers and shareholders. They must be able to conciliate appropriately the diverse interest of everyone involved. In a few words: <u>They must treat those who put their trust into them, the same way they would want to be treated if the roles were reversed</u>.

This is a philosophy I always keep in mind with those that trusted Giverny Capital with their capital.

Mistake *du jour*

Once again, here are our three mistake medals for the year. As it is so often the case, it is omission mistakes rather than commission ones that had the most tremendous consequences for our portfolio (even though they leave no clear trace).

Bronze medal : Gillette

I've bought some shares of Gillette in 1998. Some of the problems that then existed – mostly linked to acquisitions – continued and I decided to sell in 2000. In 2003, the situation looked better. James Kilt was just named CEO and I believed (after reading a *Fortune* article) that he was the right person to put Gillette back on the right track. Financial results were improving and I decided to buy a few shares at $32. But the stock started to climb and I decided to wait for a correction before continuing my purchases. And in 2005, the company was purchased by Procter & Gamble at around $52 a share.

I knew the company well. I had adequately judged Mr. Kilt qualities. And the market valuation was reasonable. I have no excuses: this 60% gain in two years should have been realized. Even without the P&G buyout, the stock would have done very well since results improved dramatically and long-term prospects are still very good. We bought shares of Gillette after the announcement since it was a way to acquire P&G at a small discount. But it would have been way more rewarding to buy earlier…

***** PUBLICITY ***** Fellow men: Have you tried the new Gillette *Fusion* razor ?

Silver Medal: Panera Bread

I have this long term friend, Caroline Banville, that I know has excellent business senses. She moved in the United States eight years ago. So, each time I see her, my second question (after I have inquired about the wellbeing of her family) is "Did you notice in your neighborhood a company that looks to be doing very well?".

Two years ago, she responded: "There is this nice sandwich shop that I like: *Panera Bread*". I instantly went on the Internet to get Panera's annual reports. I realized that Panera is a rebirth of the merger between *St-Louis Bread* and *Au Bon Pain*, a company I followed for a while a dozen years ago. Au Bon Pain was a good company that in 1993 got into too much debt and into a merger that did not work out. I decided to stop following the company.

A new managing team was brought in a few years later and did quite a turnaround. Au Bon Pain was sold in 1999 and the company was renamed Panera Bread. They also cleaned up the balance sheet. Since 2000, revenues went from $150 million to $640 million this year, a 33% annual growth rate. Net margins were increased to 8% and return on equity reached 18% (without leverage), an exceptional performance in such a competitive industry.

When Caroline talked about Panera, the stock was trading at around $35 which was 34 times earnings. EPS have just doubled and it seems to me that the company could not continue at such a rate. I decided to wait for a better price. Now, it seems the company will earn in 2006 twice what they earned in 2003. And guess what? The stock has doubled since then and I did not buy a single share.

I even had done my field research. When I was in Tampa (where we have a small office) in December of 2003, I visited a Panera Bread. I enjoyed my experience a lot. To a point where I returned twice during my trip (culinary diversification is not in my blood).



Gold Medal: Starbucks (1994-)

Our gold medal this year is a lifetime achievement award. I've erred for 12 years in a row about the investment merits of the company Starbucks Coffee.

Since 1994, I have followed with admiration the destiny of Starbucks. I have been a close witness of the 1800% rise in the stock market – 30% a year – without buying a single share. You surely know about this marvelous coffee chain (that started to "invade" Montreal this year).

When I started to invest in stocks in 1992, I went in the US in December and I noticed that there were less coffee shops than in Montreal. Howard Schultz changed that dramatically!

Starbucks was founded in 1971. The three founders opened the first coffee shop in Pikes Place in Seattle. In 1982, they hired Howard Schultz. He's the one that saw the real long term potential. Five years later, he bought the company with the help of a few local investors. In 1992, the company came public. And the stock is up 5000% since then.



The first Starbucks Coffee in Seattle's Pike Place Market

My good friend Bernard Mooney (another coffee lover) and I were in the front row. We both started to follow the company in 1994. Bernard bought the first book written on the company ten years ago and talked about it in length and with enthusiasm. But we never bought shares because of the high P/E (in the 40s) at which the stock has always traded. As good "value" investors, we decided to wait for a more modest valuation.

But as I always say : "Discipline is to respect one owns rules. Wisdom is to know when to break them". In the case of Starbucks, I've been lacking wisdom for 12 years. And each year, I say to myself that perhaps the stock will go down so I can buy shares.

In vain.

I wish you all a great year 2006.

Francois Rochon
President
Giverny Capital Inc.

APPENDIX

Investment philosophy

In 2005, we saw a large increase in the number of Giverny Capital partners (the term we use for a client). We are now more than 600 partners. With all these new comers, it is imperative that we write again (and again) about our investment philosophy.

Here the key points:

- We believe that over the long run, stocks are the best class of investments.
- It is futile to predict when it will be the best time to begin buying (or selling) stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity).
- We choose companies that have (sustainable) high margins and high returns on equity, good long term prospects and that are managed by brilliant, honest, dedicated and altruist people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be grossly assessed.
- The stock market is dominated by participants that perceive stocks as casino chips. With that knowledge, we can then buy great businesses sometimes well bellow their intrinsic value.
- There can be quite some time before the market recognizes the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

This discrepancy between the market quotes of a business and its underlying intrinsic value and the high volatility of the securities market are perceived by many participants as disadvantages. It's the other way around: market imbalances and fluctuations are our allies in our noble quest for wealth. In fact, the more irrational the stock market, the higher our chances are to attain our financial objectives.

But there is one important point: Owning a few undervalued securities (around 20) over many years doesn't yield linear returns. To stare at a freshly planted tree does not make it grow faster. Our approach is to judge the quality of an investment over a **five years period.** I truly believe that at least such a similar horizon is necessary to judge a money manager.

So patience – ours AND those of the partners – becomes the key ingredient for success.

Real patience is neither easy nor that common. That is why many investors pray in those words: "Dear God, could you gratify me with patience? And if it is at all possible, RIGHT NOW"

The Rule of Three

In conjunction with our investment philosophy, I've added a stock market rule that I called : The Rule of Three. This three parts rule comes from historical observations: it is not a scientific process that has come to its enunciation but an empirical one.

- One year out of three, the stock market will go down at least 10%.
- One stock out of three that we buy will be a disappointment.
- One year out of three, we will underperform the index.

The judgment that you – as partners – pose on our work should be in line with these parameters.

Giverny Capital Inc.

Annual Report 2006



Marc Séguin
Autoportrait en dénie, 2002
Giverny Capital Inc. Collection

For the year ending December 31st 2006, the return of the Giverny Global portfolio was 3.5% in Canadian currency compared with 17.0% for our weighted benchmark. The Giverny US portfolio (in US currency) achieved 3.3% for the year compared with 15.4% for the S&P 500.

Since July 1st 1993, the start of our Global portfolio, our annual return has been 18.0% compared to 10.4% for our benchmark and 10.1% for the S&P 500 (all in Canadian currency).

Our ambitious objective is to maintain an annual return of 5% superior to the indexes over a long term period. We believe that stocks in general (as measured by the S&P 500) will return 7 to 9% per year in the future. In consequence, our long term annualized target should be in the 12-14% area.

We use the term "ambitious" with some insight since we know that less than 1% of managers succeed in achieving such a goal over a 10 years period.

A difficult year

If we are in the right path, the only thing left to do is to keep walking.

- Buddhist Wisdom

We obviously did not achieve our long-term goal in 2006. However, the intrinsic growth per share of our companies was good, an increase of approximately 13% compared to 2005 (14% including the dividends). We will discuss this further in the section "owner's earnings". Thus, contrary to the indexes, our companies' stocks under performed their intrinsic gains. On one hand, our US large-cap stocks group return was similar to the S&P 500. On the other hand, our US small-cap stocks have under-performed the Russell 2000.

Our investment philosophy is to consider ourselves as owners of the companies in which we have bought shares in. (We invite you to re-read the appendix on our investment philosophy at the end of this annual report). The consequence of this philosophy is that we shouldn't be affected by the stock quotes in the short term.

Warren Buffett said these words often: *"The stock market is not there to guide you but to serve you. The key to success is to have a good temperament in regards to its quotations. Sometimes they can be right but often, in the short run, they can be far from the economic reality"*.

Everyone embrace these noble words when the results are good. It is in difficult times – like today – that our commitment to this healthy philosophy is truly tested. It is during such times, that having the right temperament of which so often speaks Warren Buffett is absolutely necessary.

Any wise investor (or at the very least in a quest for wisdom) must at the same time be able to step back and analyze if it is the market that is wrong or if it's him that is blind to reality. One should never underestimate the power of denial. The art work on the cover of our annual report this year, created by the brilliant artist Marc Séguin, is entitled "Self-portrait in denial". In addition to being a masterpiece, it reminds us how important it is to always keep our eyes opened and to not fall into the many holes of denial that the human spirit digs, often unconsciously.

On several occasions this year, we re-examined all the stocks we own with a different perspective. As you know, we do not like to sell. If we look at our most important positions, we have owned them on average four and a half years. Six stocks for more than eight years. On the other hand, it is important to be rational - emotions and stocks don't mix well. We try, at least once a year, to revaluate the quality of all our investments. Because there is a difference between being patient and being stubborn.

Our Yearly Returns since 1993 [1]

Giverny Global Portfolio (in Canadian dollars):

Returns *	Giverny	Benchmark **	+ / -	$ US/Can ***	S&P 500	+ / -
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	3.3%	8.4%	**28.6%**
1994	**16.5%**	3.7%	**12.7%**	6.0%	7.3%	**9.2%**
1995	**41.2%**	24.0%	**17.2%**	-2.7%	32.9%	**8.3%**
1996	**28.0%**	22.8%	**5.2%**	0.3%	22.7%	**5.3%**
1997	**37.8%**	28.6%	**9.2%**	4.3%	36.7%	**1.0%**
1998	**20.6%**	18.8%	**1.8%**	7.1%	37.7%	**-17.0%**
1999	**15.1%**	16.3%	**-1.2%**	-5.7%	14.1%	**1.0%**
2000	**13.4%**	3.2%	**10.2%**	3.9%	-4.6%	**18.0%**
2001	**15.1%**	-0.4%	**15.5%**	6.2%	-5.7%	**20.8%**
2002	**-2.8%**	-18.3%	**15.6%**	-0.8%	-22.0%	**19.3%**
2003	**13.6%**	14.0%	**-0.4%**	-17.7%	5.7%	**7.9%**
2004	**1.6%**	6.2%	**-4.5%**	-7.3%	2.8%	**-1.1%**
2005	**11.5%**	3.6%	**7.9%**	-3.2%	1.5%	**10.0%**
2006	**3.5%**	17.0%	**-13.5%**	0.2%	15.7%	**-12.1%**
Total	**831.9%**	**278.0%**	**533.9%**	**-8.8%**	**264.5%**	**567.4%**
Annualized	**18.0%**	**10.4%**	**7.6%**	**-0.7%**	**10.1%**	**7.9%**

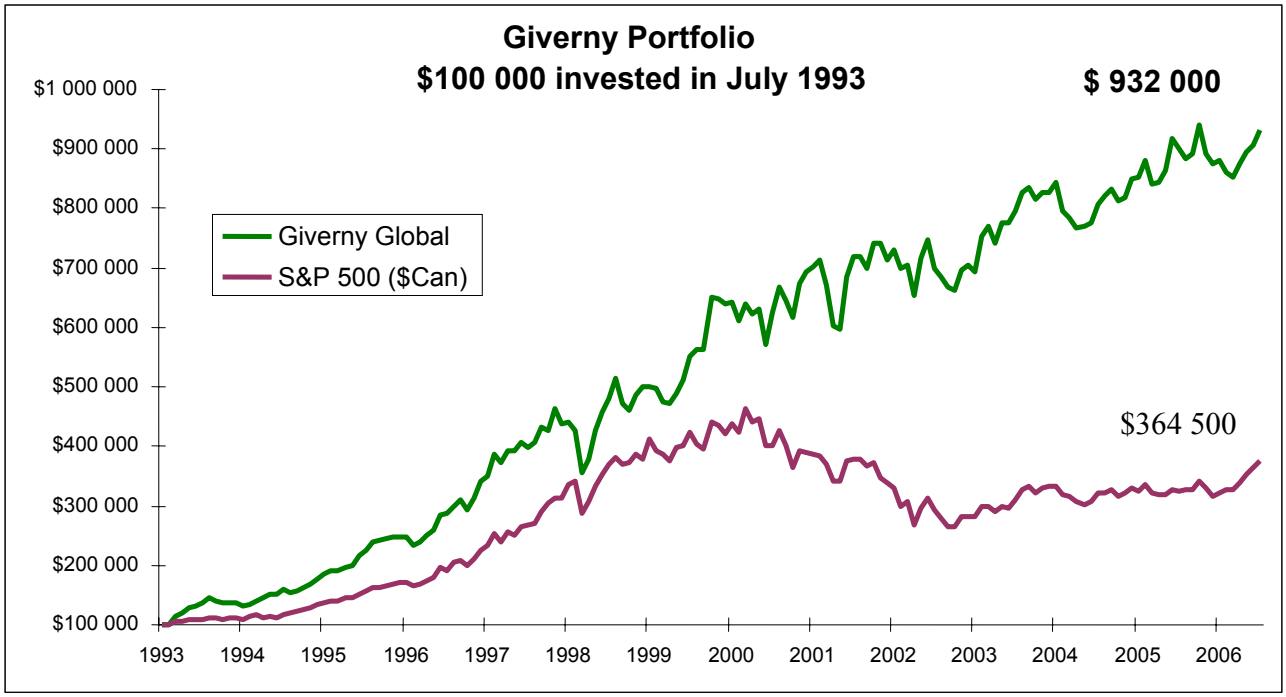
* All return adjusted in Canadian currency
** The Benchmark is a group of indexes (S&P/TSX, S&P 500, Russell 2000, etc.) that reflects the asset mix of the portfolio.
*** Variation of the US currency compared with its Canadian counterpart.

Over the last three years, two years were disappointing. We do not want to blur you with excuses. The losers find excuses, winners find ways! We'd rather go with some explanations:

- First of all, the rise in the Canadian currency erased part of our returns. Since 2003, the return of our stocks was 71% (14% annually) but once brought back in Canadian dollars, it drops to 33% (7% annually). Historically, the effect of the currency fluctuation between the US and the Canadian dollar tends to become insignificant. It is thus necessary to keep things in perspective. Since the beginning of the Giverny Capital portfolio in 1993, the Canadian dollar only reduced our annual returns by 0.7%, nothing really significant.
- Since 2004, our companies' intrinsic value increased by approximately 57% (16% annually) whereas their stocks only climbed 28% (8% annually). These differences are explained by a contraction of their P/E ratios. Our portfolio valuation is at a 10 year low. So we consider several of our stocks undervalued.

[1] All the returns have been audited by the accounting firm PriceWaterhouse Coopers.

- Finally, on a relative basis, the sectors which did best in the last 3 years are those related to the natural resources, industries which we tend to avoid in general.



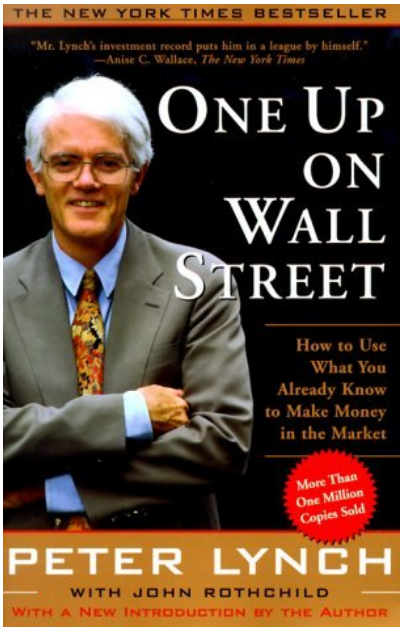
Giverny US Portfolio (in US dollars):

Our US portfolio returned 3.3% in 2006, 12% less than the S&P 500. Since 1993, our US portfolio had a 843% total return or 18.1% on an annualized basis. This compares to 300% and 10.8% for the S&P 500. Our annualized added value was 7.3%. Here are the details since 1993:

Year	Giverny US	S&P 500	+ / -
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	36.6%	18.2%
1996	27.0%	22.3%	4.8%
1997	32.9%	31.0%	1.9%
1998	11.0%	28.5%	-17.5%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-8.2%	19.5%
2001	8.1%	-11.2%	19.3%
2002	-4.4%	-21.4%	16.9%
2003	31.6%	28.6%	3.0%
2004	9.3%	10.7%	-1.4%
2005	12.5%	4.9%	7.6%
2006	3.3%	15.4%	-12.1%
Total	843.3%	299.9%	543.3%
Annualized	18.1%	10.8%	7.3%

A memorable night 15 years ago!

In 1992, I bought the book "One Up one Wall Street" by Peter Lynch. I read it in a few hours and it was an unforgettable night. With "The intelligent investor", by Benjamin Graham, this book is likely one of the best written on investment. I discovered in it a passion for the stock market which has never left me since.



Peter Lynch particularly insisted in this book on the volatile nature of the stock market and that the only way to succeed was to have a long-term horizon. Here are some key points from the book.

- Sometime in the next month, year, or three years, the market will decline sharply.
- Trying to predict the direction of the market over one year, or even two years, is impossible.
- Trying to predict the economy is futile.
- Invest in companies not in the market.
- Forget about market fluctuations in short terms.
- Stock prices often move in opposite directions of the fundamentals but in the long term, the direction of profits per share will prevail.
- Just because the price of a stock goes up doesn't mean you're right.
- Just because the price of a stock goes down doesn't mean you' re wrong.
- There is always something to worry about.

Since reading this book 15 years ago, nothing has changed in the fundamental nature of the stock market (and in the human nature). Also, I quickly understood then that there would be ups and downs in a life dedicated to portfolio management.

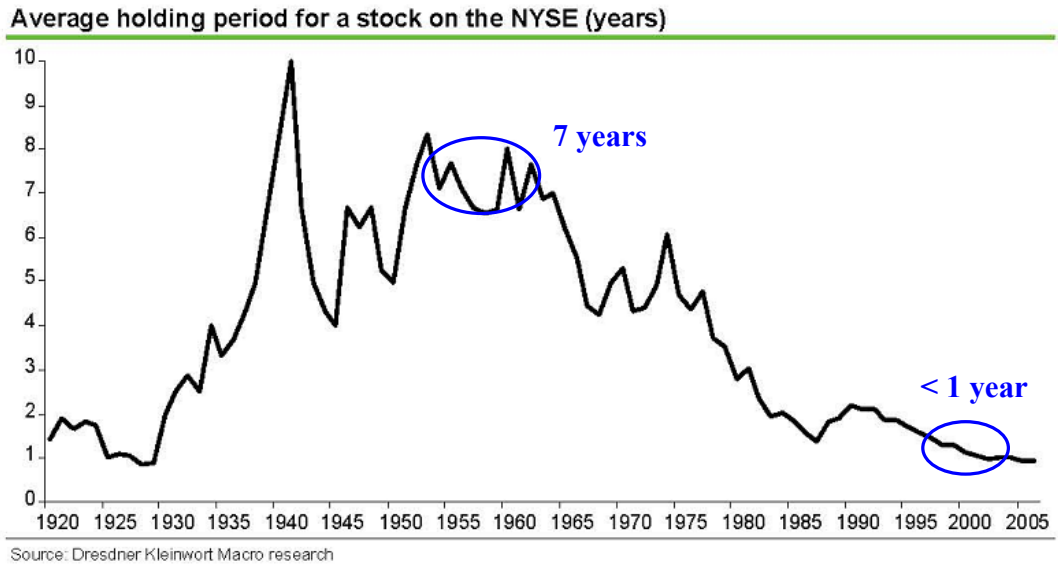
To quote my favourite philosopher Erich Fromm: "The goal in life is not to overcome the inherent insecurity of existing; the goal is to learn to live with it".

The investors returns according to Dalbar (follow up from 2003)

Three years ago, we presented the results of a fascinating analysis by the firm Dalbar Inc. This firm specialized in studying behavioural patterns of market investors. The study showed huge differences between the returns of the S&P 500, of mutual funds in general and especially holders of these mutual funds. Here are the figures for the 20 years period ending in 2005.

Annual return of the S&P 500	12%
Average return of the stock mutual funds	9%
Average return of the holders of these funds	4%

How can such results be explained? The only possible answer is that investors collectively buy and sell their mutual funds (stocks, bonds, etc) at a bad time. They buy what has "worked" in the last few years and sell what hasn't. They have no trouble finding reasons to justify these moves (usually some kind of trend or fad). If they would base their decisions on intrinsic value analysis and not on the stock market quotations in the short run, they would most likely act differently. But that doesn't seem to be in the nature of the "human stock investor". In fact, the behaviour of extreme trading continues to degenerate instead of improving. The holding period of a stock on the New York stock exchange in the 1950s and 1960s was on average seven years. The holding period is now less then 7 months. In less than half a century, the average holding period of stocks by "investors" fell more than 90%.



Resisting the mermaids' enchanting songs

Although stocks in general are the best asset class on the long run, most investors earn low return when they invest in them. It is mostly linked to their behaviour: Switching from one fund to the other or from one asset class (cash) to the other (stocks) at the wrong time is a capital destructive activity. It would be useful to remember the classic adventures of the Greek-roman mythology hero Ulysse. After the Trojan wars, Ulysse wandered through the sea. He crossed the path of singing mermaids that tried to wreck

passing ships with their enchanting melody. Warned in advance, Ulysse ordered the crew to block their ears with wax and attached himself to the boat's mast.

Equity investors must also learn to resist the temping and enchanting songs from the "mermaids of short term returns". If not, the reefs of the Dalbar study could await many of them….

Our companies

Behind every stock, there is a company.

- Peter Lynch

Walgreen's

Walgreens had an excellent year in 2006. For the fiscal year ending in August, net income climbed 12%, same store sales 8% and earnings per share (EPS) 13%. The return on equity was 18%. The company still has no debt and $1.5 billion in cash. Few companies succeed in maintaining such a growth rate as long as Walgreen' s. (We invite you to read the chapter devoted to the company in the book "Good to Great"). We bought shares of Walgreen's four years ago at approximately $30. The stock ended the year 2006 at $45. Up to now, it has been a profitable investment (12% per year including the dividend).

This market return is however slightly lower than the intrinsic performance of the company. The stock dropped last fall following the announcement by Wal-Mart of offering generic drugs at $4. Also, the merger of Caremarx and CVS, the prime competitor of Walgreen's, worries many investors. I still believe that Walgreen's has the best game plan and remains the most solid company in its industry.

The first quarter of 2007 was extremely positive; sales climbed 17%, same store sales 10% and EPS 25%. The company also repurchased $343 million of its stock. Walgreen's also announced a new buyback program of $1 billion.

Disney

Disney had an outstanding year. Profits climbed more than 31%. These results are no accident: Robert Iger continues to do a fantastic job as the CEO. The stock has done well since our purchase in September 2005. It climbed from $24 to $35. The market valuation is a little higher than at the time we made our first purchase, but we are still very enthusiastic about the long-term prospects of the company.

Fastenal

Fastenal, of Winova, Minnesota, continues to reward us with impressive results. In 2006 revenues and net profits climbed more around 20%. Fastenal is part of our portfolio since 1998 (the stock climbed 500% in 8 years). We know the company very well and it fits perfectly with our philosophy: a company in a dull sector (nuts and bolts), with an excellent balance sheet, extremely profitable and with an outstanding management team.

Except for October 1998, when we first became shareholders, Fastenal's stock never traded bellow 20 times earnings. The high valuation of the stock, which seems to us justified, makes the stock volatile.

Thus, in spite of an excellent intrinsic performance, the stock dropped by 8% this year. We took advantage of this correction to increase our investment

Bank of the Ozarks

Last fall, we spent a day with the management team of our small bank from Little Rock (Arkansas). The company is in the process of completing an important expansion plan which was started at the beginning of 2006. The timing could have been better: The increase in expenses due to the opening of new branches was combined with pressures on the bank deposit interest rates and a decrease in interest margins (related to the flat yield curve).

Thus, in 2006, EPS slightly improved compared to 2005, in spite of an increase of 20% assets. The first two quarters of 2007 should be similar. In the long term, growth prospects seem to us excellent.

W.P. Stewart

The stock of the portfolio management firm *W.P. Stewart* was our most disappointing investment this year. After two difficult quarters at the beginning of the year, W.P. Stewart obtained adequate returns for the portfolios under management in the last two quarters of 2006. For the year 2006, the accounts returns were 7%, which is lower than the S&P 500. The company thus continues to lose assets.

By looking at the stocks held in the portfolio, we remain confident that the company will be able to beat the indexes in the long run. In the mean time, the dividend of $0.92 gives us a 7% yield.

Microsoft

The top software company in the world had a good year in 2006. EPS roughly increased by 10% and the stock increased by 14%. Profitability is finally in sight for the video game division. The X-Box 360 is without a doubt a great success. And I did my part by purchasing an X-Box system at Christmas.

Microsoft's stock was volatile this year. It went from $29 to $22 this summer when the company announced additional R&D expenses of $2 billion ($0.20 per action) to improve its competitive position against Google. We took advantage to buy more shares. The stock finished the year at $31.

The 2007-08 prospects are excellent with the near release of the Vista operating system. Microsoft is an extraordinarily profitable company. However, we believe that Google is an exceptional company too and it could become a tough competitor in certain market segments. We're following the story closely.

Wells-Fargo

This large San Francisco based bank had another excellent year in 2006. EPS climbed 11% in spite of the difficult flat yield curve (to our knowledge it is the bank that best managed the effect of the flat curve on its loan portfolio). After having been shareholders in the nineties, we repurchased shares in 2005 and continued to increase our position last year.

Wal-Mart

Wal-Mart had a more difficult year. EPS climbed only 9%, under our target of 12%. The weakness in retail sales (in part because of the rise in the price of gas) affected the company. The competition is

intense in the United States (Target is a solid competitor), in Great Britain (Tesco PLC) and in Germany (Metro AG).

On the other hand, the company is doing very well in Mexico and in Canada. In India, the company is about to sign an important partnership agreement with Bharti to develop stores in this country.

Wal-Mart also announced many environmental initiatives and an increase in benefit packages granted to employees. Even if the results are slightly weaker than anticipated, the stock seems undervalued: It trades at only 15 times the estimated profits for 2007.

Resmed

Once again, Resmed was our fastest growing company in 2006. Revenues climbed 32% and EPS 27% (including the stock options expenses). The stock did well in 2006: it climbed 28%. Since our purchase in 2004, the stock of this wonderful Australian company has doubled. It is not a cheap stock (trading at 30 times estimated EPS), but we believe that the long-term prospects are excellent.

Brown & Brown

Our Daytona Beach (Florida) insurance broker continues to carry out its ambitious objective to grow profits by 15% per year (over 5 years and 10 years, its annual growth rate exceeds 20%). We bought Brown and Brown shares in 2004 when the leader of the industry, Marsh & McLennan, found itself in a turmoil. At that time, the stock of BRO dropped by 20% in sympathy with M&M.

Since then, Brown & Brown EPS and its stock climbed 40%. As it is the case often, this raise was not linear. In 2006, for example, the stock went down by 8%. That is a 23% lower return than the increase in its intrinsic value. This had contributed to our underperformance to the Russell 2000. We believe that nothing has changed in this exceptional company.

Mohawk Industries

In Peter Lynch's second book "Beating the Street", written in 1992, he talks about *Shaw Industries*. It was one of the first companies which I studied in detail. In 1999, I even wrote an article in the newspaper "Les Affaires", about to the excellent prospects for the company. We did not buy any shares at the time (God knows why!). A few weeks later, Warren Buffett's company, Berkshire Hathaway, acquired Shaw.

When I studied Shaw, Mohawk Industries was its closest competitor. Over the years, Mohawk became as a dominant company as Shaw. Its diversity in the hard surface floors (hard wood, floating and ceramics floors) was very beneficial. Moreover, the company is very well managed.

The stock went from $90 at the beginning of 2006 to $75 this fall because of uncertainties regarding the slowdown in the US residential housing market. However, only 15% of the revenues are related to the new housing market. It was the opportunity we were waiting for to buy shares.

Owner's earnings

Each year, we present a table as important as the one of the returns: the growth of our owner's earnings. This year, we will go through the usual table. But we will also add another one that will detail the performance of our companies in 2006 compared to the growth in their respective owner's earnings.

	Giverny			S&P 500		
Year ***	Growth *	Market **	Difference	Growth *	Market **	Difference
1996	14%	29%	15%	13%	22%	9%
1997	17%	35%	18%	11%	31%	20%
1998	11%	12%	1%	-1%	28%	29%
1999	16%	12%	-4%	17%	20%	3%
2000	19%	10%	-9%	9%	-9%	-18%
2001	-9%	10%	19%	-18%	-11%	7%
2002	19%	-2%	-21%	11%	-22%	-33%
2003	31%	34%	3%	15%	28%	13%
2004	21%	8%	-12%	21%	11%	-8%
2005	14%	15%	0%	13%	5%	-8%
2006	14%	3%	-11%	15%	16%	1%
Total	356%	342%	-14%	161%	170%	10%
Annualized	15%	14%	0%	9%	9%	0%

* Earnings per share growth for the entire portfolio (note : it is an approximation) with dividend
** Market performance, dividend included (without currency effects)
*** All the results are estimated without the currency variations

There are two extremely different periods in the last 11 years: the five years period from 1996 to 2000 and the six following ones from 2001 to 2006.

	Giverny			S&P 500		
Year	Growth	Market	+/-	Growth	Market	+/-
1996-2000	15%	19%	4%	10%	18%	8%
2001-2006	14%	11%	-4%	9%	3%	-6%
1996-2006	15%	14%	0%	9%	9%	0%

During those two periods, the growth in intrinsic value was similar (ours like the one of the S&P 500). But the first period was characterized by an expansion of the price-to-earning ratios whereas it was the reverse during the second period.

Over the 11 years period, the stock market performance followed, as it rightfully should, the underlying intrinsic performance of companies. Both for our holdings and the ones of the S&P 500.

Market and intrinsic performance in 2006 details

This year, their has been enormous differences between the intrinsic performance (growth in EPS) of our businesses and their market performance. Here are the details for our top holdings:

Stock	2006 stock market	EPS 06/05 Est.	Difference
Berkshire Hathaway B	25%	21%	4%
Walgreen	4%	17%	-13%
O'Reilly Automotive	0%	11%	-11%
Knight Transportation	-18%	20%	-37%
ResMed Inc.	28%	27%	2%
Fastenal	-8%	21%	-29%
Brown & Brown	-8%	15%	-23%
Microsoft	14%	10%	5%
Disney	43%	31%	12%
M&T Bank	12%	10%	2%
American Express	18%	18%	0%
Pason Systems	-8%	38%	-46%
Wells-Fargo	13%	11%	2%
Progressive Corp	-17%	23%	-40%
W.P. Stewart & Co	-33%	-35%	2%
Wal-Mart	-1%	9%	-10%
Bank of the Ozarks	-10%	4%	-14%
Expeditors Intl.	20%	24%	-4%
Average	**4%**	**15%**	**-11%**

For these 18 stocks, they realized on average a 15 % growth in their EPS in 2006. This compares to a performance of only 4% in the stock market. We have discussed at several times this year, the special case of W.P. Stewart. Except for W.P.S., all our companies had a record year in profitability.

How should we react when facing such disparities? It isn't constructive to react with frustration. It is better to verify that the fundamental of our companies remain solid and then accept that certain factors in business are out of our control. Market quotations in the short run belong to that group.

This acceptance is not passive. In fact, it is the opposite. We make a constant effort to better understand the nature of our companies and of the stock market. The reality is that several of our stocks are simply not "in fashion" in spite of their excellent intrinsic qualities. The only sensible thing to do is to wait until the stock market reflects them.

Flavour of the day

We are often asked what is the most dangerous thing on the stock market (the "Flavour of the day"). A few years ago in Canada, Nortel and the other techno superstars were highly popular. Whereas today, nothing seems to us more popular than the Canadian banks. Ironically, at the time where Nortel was king of the Canadian market, we bought shares of two banks: the Scotia Bank and the Bank of Montreal, two stocks that were unpopular at the time.

We sold our shares approximately two years later at a price 60% higher but we would have done way better if we had kept them longer in the portfolio (it is easier said *afterwards*). On a comparative basis, here is a table which shows the fundamental differences between the situation in 2000 and in 2006.

Bank of Montreal	2000	2006		Scotia Bank	2000	2006
Return on assets	0.72%	0.82%		Return on assets	0.76%	0.95%
Reserves / net profits	21.4%	6.7%		Reserves / net profits	39.7%	6.0%
Tax rate	36.5%	23.1%		Tax rate	33.2%	19.2%
P/E ratio	8x	14x		P/E ratio	8x	14x

We can see that in six years, the level of profitability has strongly improved. It is in part linked to a decrease in the allowance for credit losses. In the case of the Scotia Bank, the rate went from 40% of net profits to 6%, a drop of 85% (in fact, in 2006, Scotia took reserves of only 0.1% of loans). Moreover, the tax rate was lowered by more than 1400 basis points which also contributed to improve the level of profitability, partly helped by an international diversification. Without a doubt, it will be impossible for the next years to reduce the rate of bad loans (it would become "gains for bad loans") nor to continue to reduce the tax rate in a substantial way.

How did the stock investors react to these gains realized in an ideal (and probably not sustainable) environment? The price-to-earning ratio climbed 75% passing from 8 times in 2000 to 14 times in 2006. In the long run, in a Canadian economy which grows at 5% per year, it seems to be unrealistic to believe that all the players of the banking industry will be able to do much better than this growth rate.

Five years Postmortem : the year 2001

Each year, we undergo a post-mortem of our decisions from five years ago (since it's our time horizon in general). In 2001, we were in the middle of the Enron scandal and the market crash of technology stocks. In the fall, the attacks of September 11 took place. Here is a graph of the S&P 500 since:



As you see in the graphics above, when the Stock Exchange reopened, a few days following September 11, it dropped 6% in one day. Unfortunately for those who sold at this moment, the S&P 500 is 40% higher today. To sell in a panic is not a winning strategy.

We had decided to make some purchases following this correction. We bought shares of American Express (it slipped from $50 to $25 in a few months) following 911. It was the stock that I recommended during an interview on the radio station Webfin following the attacks. As Amex is now at $58 (without counting the bonus "spin off" of Ameriprise), one can come to a conclusion, five years later, that it was a good purchase.

We had also bought shares from the Canadian company Wesjet Airlines after 9-11. Stocks of airline companies collapsed everywhere in the world at the end of 2001. Westjet was at the time a profitable company with a beautiful balance sheet. We sold our shares a few years later, doubling our money.

The Canadian Stock Market 2001-2006

Today, after the Canadian index TSX has doubled during the last five years (thanks to the bull market in the resource industries), several people want to invest in the Canadian market. All the risks they saw into 2001-2002 have disappeared like magic. Paradoxically, it is exactly then, when investors don't see any risk in a market that it becomes the riskiest. But this is usually realized later…

Mistake of the day

All men make mistakes. But only wise men do learn from their mistakes.

– Winston Churchill

Bronze medal: Cognex

We had own Cognex for 10 years. We bought and sold the stock at different prices, but I would say that on average our annual returns was around 4% per year, which is extremely disappointing. In this case, our patience was not rewarded. As you know, I always admired this beautiful Boston based company and its founder, Robert Shillman.

I hesitated a long time before classifying this investment in the error box. I knew the company well and had evaluated the potential and the risks. But I finally realized that Cognex was missing an important element. The managers at Cognex treat their employees extraordinarily well (what I had always admired). The "stock options" program is very generous. When the company had a growth of 25% per year, giving approximately 3% of the company to the employees each year didn't have a huge impact. But, when the growth rate slowed and the company did not reward its shareholders for several years, it seems to me that an important reduction in the option program to the employees would have been appropriate.

I always said that we look for managers who have reached a balance in treating fairly the customers, the suppliers, the employees and the shareholders. We have to admit that the last category did not receive the same degree of fairness as the others. For example, Cognex had $6 in cash per share on its balance sheet. Giving a special dividend or repurchasing its stocks (instead of giving away some) would have been rewarding for the shareholders.

When we started to realize that while reading the 2005 annual report, we reduced our position; Without selling it completely. Then we finally sold the remaining shares in the fall. It was a mistake because the stock slipped 20% between the two moments.

Silver medal: Ominicom

Omnicom is the second largest publicity agency in the World. Warren Buffett made great purchases in the 1970s with his investments in Interpublic Group of Cies (IPG) and Ogilvy & Mather, a company acquired by WPP some 20 years ago. I've always kept a close look at this industry.

At the beginning of the years 2000, IPG made some bad acquisitions and Omnicom became, in my opinion, the best company in the industry. In 2002, IPG had a rough year. At the same time Omnicom was at the center of an accounting controversy, which I considered minor.

But Omnicom's stock dropped from $97 to $37 in a few weeks (the market was very nervous at that time). At this price, Omnicom was trading at only 11 times earnings. It is not every day that we can purchase shares of such a solid multinational enterprise at such ratios. I studied the company's financial statements and everything seemed in order.

But in spite of this, I didn't buy any stock. Why? I believe I didn't want to take the chance that the company would be at the center of a scandal. Our partners were very worried about the quality of the financial statements of our companies (as Enron and Worldcom made the headlines daily).

It was an error because the probabilities were largely in our favour. I should have bought shares in spite of the alarmist headlines and worries of our clients. It is my responsibility to evaluate the risk/return ratio. When it seems to favour us by a wide margin, we must go forward. The stock today is $106. We could have had a return of nearly 200% in 4 years.

Gold medal: Children's Place

Two years ago, Disney decided to sell its Disney stores to Children' s Place. I had been following Disney for many years: I knew that the store chain would be more profitable if it would be run by a specialized retailer. This acquisition was important for Children' s Place: it increased by almost 50% its revenues. Moreover, the price paid was very reasonable.

I studied this company which I knew only by name. Children's Place had approximately 700 stores specialized in children's wears. Children's Place had had its shares of problems in 2002: margins went down and EPS had fallen drastically. But in 2004, the company had solved its margin problems and generated good return on equity. Its balance sheet was debt free and the company had a very good outlook. I believed that the combination with the Disney stores was particularly suitable.

The stock quickly climbed from $20 to $30 following the acquisition announcement. I thought - as an amateur - that I had missed the stock. In the last two years, EPS went from $1.67 to $3.15. The stock today trades at $57.

Conclusion

The next years are promising. Our companies are leaders in their respective industry, have excellent growth prospects and theirs stocks are reasonably valued in the market. We have all the reasons to be optimistic toward the future.

We want to thank you again for your trust.

We wish a great year 2007 to all our partners.



François Rochon and the Giverny Capital team.

APPENDIX

Investment philosophy

In 2006, we saw a large increase in the number of Giverny Capital partners (the term we use for a client). With all these new comers, it is imperative that we write again (and again) about our investment philosophy.

Here the key points:

- We believe that over the long run, stocks are the best class of investments.
- It is futile to predict when it will be the best time to begin buying (or selling) stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity).
- We choose companies that have (sustainable) high margins and high returns on equity, good long term prospects and that are managed by brilliant, honest, dedicated and altruist people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be grossly assessed.
- The stock market is dominated by participants that perceive stocks as casino chips. With that knowledge, we can then buy great businesses sometimes well bellow their intrinsic value.
- There can be quite some time before the market recognizes the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

This discrepancy between the market quotes of a business and its underlying intrinsic value and the high volatility of the securities market are perceived by many participants as disadvantages. It's the other way around: market imbalances and fluctuations are our allies in our noble quest for wealth. In fact, the more irrational the stock market, the higher our chances are to attain our financial objectives.

But there is one important point: Owning a few undervalued securities (around 20) over many years doesn't yield linear returns. To stare at a freshly planted tree does not make it grow faster. Our approach is to judge the quality of an investment over a **five years period.** I truly believe that at least such a similar horizon is necessary to judge a money manager.

So patience – ours AND those of the partners – becomes the key ingredient for success.

Real patience is neither easy nor that common. That is why many investors pray in those words: "Dear God, could you gratify me with patience? And if it is at all possible, RIGHT NOW"

The Rule of Three

In conjunction with our investment philosophy, I've added a stock market rule that I called : The Rule of Three. This three parts rule comes from historical observations: it is not a scientific process that has come to its enunciation but an empirical one.

- One year out of three, the stock market will go down at least 10%.
- One stock out of three that we buy will be a disappointment.
- One year out of three, we will underperform the index.

The judgment that you – as partners – pose on our work should be in line with these parameters.

Giverny Capital Inc.

2007 Annual Report



Pascal Grandmaison
Glass #7, 2004
Giverny Capital Collection

For the year ending December 31st 2007, the return of our portfolio was -14.4% compared to approximately -12.0% for our weighted benchmark. It is an added value of -2.4%. These returns both include a loss of 14.1% related to the fluctuation of the Canadian currency. Without the effect of the currency, our return was approximately -0.3% in 2007.

Since our beginning on July 1st1993, our annual compounded return is 15.4% compared to 8.6% for our comparative index group. If we exclude the increase of the Canadian currency, our portfolio would have generated an annual return of 17.4% compared to 10.5% for the indexes. Our long-term (and ambitious) goal is to maintain an annual return of 5% higher than the indexes. If stocks in general achieve an annual return of 7 to 9% in the future, our long term objective would be to maintain an annual return of 12 to 14%.

We are going through a rough phase. We want with this report to explain the causes of the disappointing results of the last two years. We will take the time to provide all the necessary information to understand these results, the measures taken to improve them, and mostly the potential of the coming years for our investments. The theme of our annual report will be "transparency", a quality we have always valued since the beginning of our business. Therefore, this year we have chosen to illustrate the cover page of our report with a artwork named "Glass" by Pascal Grandmaison, a Montreal artist.

The Giverny portfolio (in Canadian currency): Our returns since July 1st 1993.

Returns *	Giverny	Indexes **	+ / -	$US/Can	S&P 500	+ / -	Giverny ***	Indexes ***	+/-
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	3.3%	8.4%	**28.6%**	**34.4%**	7.4%	**27.0%**
1994	**16.5%**	3.7%	**12.7%**	6.0%	7.3%	**9.2%**	**12.0%**	-0.3%	**12.3%**
1995	**41.2%**	24.0%	**17.2%**	-2.7%	32.9%	**8.3%**	**43.8%**	26.3%	**17.5%**
1996	**28.0%**	22.8%	**5.2%**	0.3%	22.7%	**5.3%**	**27.7%**	22.5%	**5.2%**
1997	**37.7%**	28.6%	**9.2%**	4.3%	36.7%	**1.0%**	**33.4%**	24.5%	**8.9%**
1998	**20.6%**	18.8%	**1.8%**	7.1%	37.7%	**-17.0%**	**14.5%**	12.8%	**1.7%**
1999	**15.1%**	16.3%	**-1.2%**	-5.7%	14.1%	**1.0%**	**20.6%**	21.9%	**-1.3%**
2000	**13.4%**	3.2%	**10.2%**	3.9%	-4.6%	**18.0%**	**9.7%**	-0.2%	**9.9%**
2001	**15.1%**	-0.4%	**15.5%**	6.2%	-5.7%	**20.8%**	**9.4%**	-5.3%	**14.7%**
2002	**-2.7%**	-18.3%	**15.6%**	-0.8%	-22.0%	**19.3%**	**-2.0%**	-17.7%	**15.7%**
2003	**13.6%**	14.0%	**-0.4%**	-17.7%	5.7%	**7.9%**	**33.7%**	34.1%	**-0.5%**
2004	**1.6%**	6.2%	**-4.5%**	-7.3%	2.8%	**-1.1%**	**8.3%**	13.1%	**-4.8%**
2005	**11.5%**	3.6%	**7.9%**	-3.2%	1.5%	**10.0%**	**14.5%**	6.7%	**7.8%**
2006	**3.5%**	17.0%	**-13.5%**	0.2%	15.7%	**-12.3%**	**3.3%**	16.8%	**-13.5%**
2007	**-14.4%**	-12.0%	**-2.4%**	-14.9%	-10.0%	**-4.4%**	**-0.3%**	2.4%	**-2.7%**
Total	**698.7%**	**234.7%**	**464.0%**	**-22.4%**	**228.3%**	**470.4%**	**922.1%**	**326.5%**	**595.5%**
Annualized	**15.4%**	**8.6%**	**6.8%**	**-1.7%**	**8.5%**	**6.9%**	**17.4%**	**10.5%**	**6.9%**

* Green section: All the returns are adjusted in Canadian dollars
** Indexes are a hybrid index (S&P/TSX, S&P 500, Russel 2000) which reflects the asset class weight
*** Estimated without the effect of the currency.

Note: the returns in Canadian dollars were audited by Price Waterhouse Coopers.

The US Giverny portfolio

Since 2003, we also publish the Giverny portfolio returns in US dollars. It mostly corresponds to the American part of the Giverny portfolio. In 2007, the US Giverny portfolio returned -1.7% compared to 5.5% for the S&P 500. Since the beginning of the portfolio, our return is 827.3% which is 16.6% annualized. During the same period, S&P 500 returned 321.9%, which is 10.4% annualized. Our annual added value is therefore 6.2%.

Year	Giverny US	S&P 500	+ / -
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	36.6%	18.2%
1996	27.0%	22.3%	4.8%
1997	32.9%	31.0%	1.9%
1998	11.0%	28.5%	-17.5%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-8.2%	19.5%
2001	8.1%	-11.2%	19.3%
2002	-4.4%	-21.4%	16.9%
2003	31.6%	28.6%	3.0%
2004	9.3%	10.7%	-1.4%
2005	12.5%	4.9%	7.6%
2006	3.3%	15.4%	-12.1%
2007	-1.7%	5.5%	-7.2%
Total ($US)	827.3%	321.9%	505.4%
Annualized	16.6%	10.4%	6.2%

Note: these returns were audited by Price Waterhouse Coopers.

Long term returns of equities

The S&P 500 return of 10.4% since our beginnings in 1993 is very much in line with the long term historical return of US equities. It is the average annual return of the last forty (40) years but also it is the same level than the longer term average. Indeed, since 1900, the annual return of American equities is 9.8%. No class of assets produced a return even close to this return over such a long period. In fact - adjusted for inflation – the real return of US equities is 6.6% since 1900, which is an incredible creation of wealth.

It is interesting to note that the real return of equities in different countries does not vary much over a long period of time. Since 1900, equities in countries other than United States generated an average real return of 5.3% per year. During the same period of time, bonds generated an average real return of 1.1% (and gold approximately 0%).

Country	Real return	Country	Real return	Country	Real return
United States	6.6%	Holland	5.4%	Japan *	4.5%
Great-Britain	5.6%	Spain	4.0%	Switzerland	4.6%
Canada	6.3%	France	3.7%	**World exc-US**	**5.3%**

Source: ABN AMRO

*including -96% in 1939-48

The year 2007

Even if we did not reach our return objective in 2007, the earnings growth of our businesses (see definition below) was quite good: a growth of approximately 9% compared to 2006. Adding an average dividend of 1%, we come up to a 10% increase of the intrinsic value of our businesses. Considering that companies making up the S&P 500 saw their earnings decrease by 3% this year, (intrinsic return of -1% if we include the dividend) our companies did better than the average.

2007 was characterized by a financial crisis created first by a drop in residential construction in the United States and then, by rebound, huge losses related to loans usually called "sub-prime". Also, the breathtaking raise of the price of oil affected even more the consumer already pressured by the real estate slowdown. As I am writing these lines, it is possible that the actual slowdown will develop into a recession. The forecasts of economic growth for the United States, Europe and Canada are reviewed downward. In the middle of January 2008, stock markets around the World went down on average 20% (the definition of "bear market"). Even if we do not own any residential construction businesses and that both our banks took low reserves, a lot of our businesses saw their stock market quotes suffer from this crisis.

We've been there before! We survived through the crisis of 2000-2002. Also, in the fall of 1998, the stock market took a plunge of over 20% during the Asian crisis (time passes by, so do crisis). There was lots of bargains then. We made investments which turned out to be excellent such as JDS Fitel (sold in 1999 with a large profit), Templeton Dragon Fund, Bed Bath & Beyond as well as Fastenal. Fastenal was the big winner: the stock went up 700% in nine years.

I wrote the following lines in the 1998 annual report :

> *…Such situations of crisis and panic that regularly affect the investors are our <u>partners</u> in the quest of our long term objectives…*
>
> *…To have good opportunities of enrichment, we therefore need a climate of pessimism that brings good businesses to prices well bellow their intrinsic value. The higher the pessimism and related market fluctuations better are the opportunities to enrich ourselves. So the next time someone asks you "does the stock correction affects you?" you can answer: "Certainly, it improves my chances of getting richer".*

I wrote these lines when we were eight partners at Giverny Capital. We are over 600 partners nine years later. Many of our new partners don't enjoy corrections to the same degree I did in 1998, when I wrote those lines.

But like it or not, we must all accept that market corrections are part of the life of an equity investor. The good temperament towards market quotations that Warren Buffett frequently talks about makes the difference in the end between those who get richer with equities and those who throw in the towel during crisis.

We don't belong in that last category.

Owner's earnings

It is not easy to have the right temperament toward market quotes. The vast majority of investors perceive the daily market quotes as an ultimate judge of value. At Giverny Capital, we do not

evaluate the quality of an investment this way. In our mind, we are owners of the businesses we invest in. Consequently, we study the growth in underlying earnings of our companies and their long-term perspectives. Every year, we submit a table showing the growth of the intrinsic value of our businesses that we measure using the term invented by Warren Buffett: owner's earnings.

We therefore come to an estimate of the intrinsic value increase of our portfolio by adding to the growth in owner's earnings, our average dividend rate (which is around 1% presently).

	Giverny			S&P 500		
Year ***	Intrisic Value *	Market **	+ / -	Intrinsic Value *	Market **	+ / -
1996	14%	29%	15%	13%	22%	9%
1997	17%	35%	18%	11%	31%	20%
1998	11%	12%	1%	-1%	28%	29%
1999	16%	12%	-4%	17%	20%	3%
2000	19%	10%	-9%	9%	-9%	-18%
2001	-9%	10%	19%	-18%	-11%	7%
2002	19%	-2%	-21%	11%	-22%	-33%
2003	31%	34%	3%	15%	28%	13%
2004	21%	8%	-12%	21%	11%	-8%
2005	14%	15%	0%	13%	5%	-8%
2006	14%	3%	-11%	15%	16%	1%
2007	10%	0%	-10%	-1%	6%	6%
Total	401%	342%	-60%	158%	184%	26%
Annualized	14%	13%	-1%	8%	9%	1%

* Owner's earnings growth (approximately) plus dividends
** Stock Market performance, including dividends
*** All the results are estimated without currency fluctuations

We can observe major differences between the growth in intrinsic value and the market performance over a short period of time. But after twelve years, the market performance – both for our securities and for the S&P 500 - has followed the intrinsic performance of the businesses.

Post-mortem: 2002

Every year, we go back five years in the past and do a post-mortem. During the period of 2000 to 2002, we had what we consider our best period (yet). We then beat the S&P 500 by 60% over those three years.

At the end of 2002, I then set forth a new rule that was labelled "the rule of three":

1. One of three years, the market will drop at least 10%
2. One of three securities bought will be disappointing
3. One of three years, our performance will be inferior to the indexes

I also added: "The rule of three is not linear. We can experience three good years in a row (as was our performance of the last three years) and afterwards have two, even four bad years in a row". It turned out that we underperformed the indexes for three of the last five years. Yet, we

are using the same approach we did at the beginning of the millennium. I also believe we improved the art of selecting market securities.

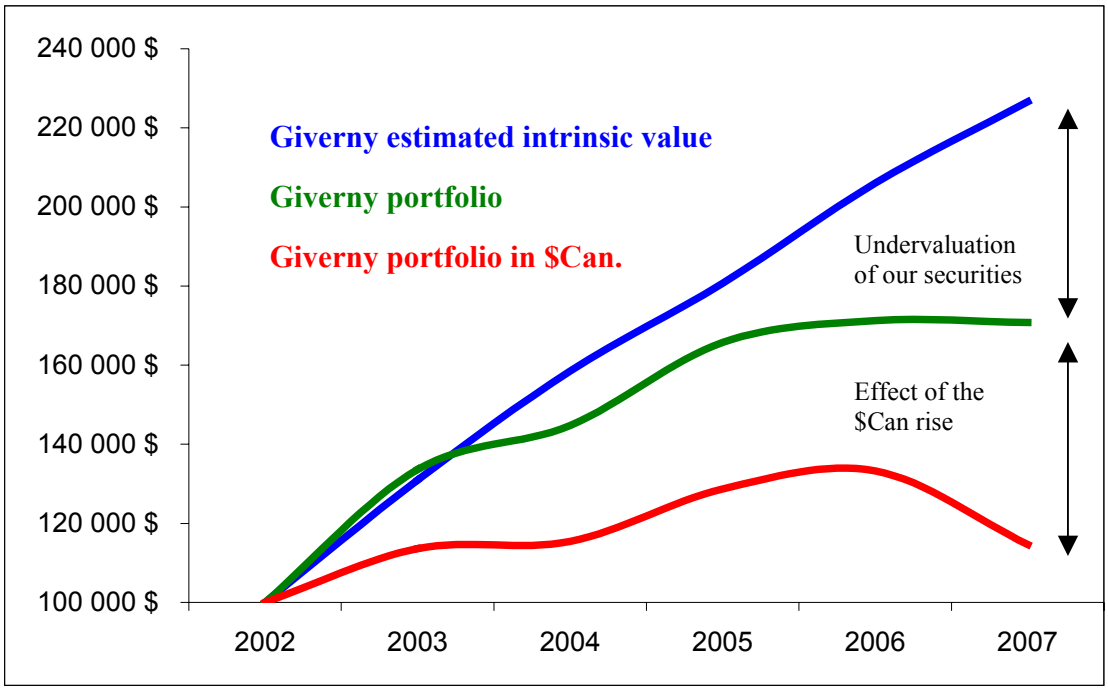
To understand our underperformance, there is no need to dig very far. The most recent bull-market was centered around the different sectors of natural resources, sectors in which we historically had very little participation. From 2003 to 2007, the S&P 500 achieved a return of +70% (84% including dividends) but the energy sub-index realized a return of +250%. In 2007, the energy and material sectors realized +26% and +20% respectively against -23% and -21% for the financial and retail industry, two sectors in which we have several investments.

In addition, our returns were distorted by the incredible rise of the Canadian currency which went from $0.65 US at the beginning of 2003 to $1.00 US at the end of 2007, an increase of more than 53%. Since approximately 90% of our assets are invested outside Canada, this last aspect affected our returns significantly.

Therefore, for the last five years, we come to this summary:

- Our businesses increased their intrinsic value by 128% (18% annually)
- Our portfolio market return was 71% (11% annually)
- In Canadian currency, our return decreased to 15% (3% annually)

Here is a diagram showing a theoretical amount of $100,000 invested with us at the end of 2002:



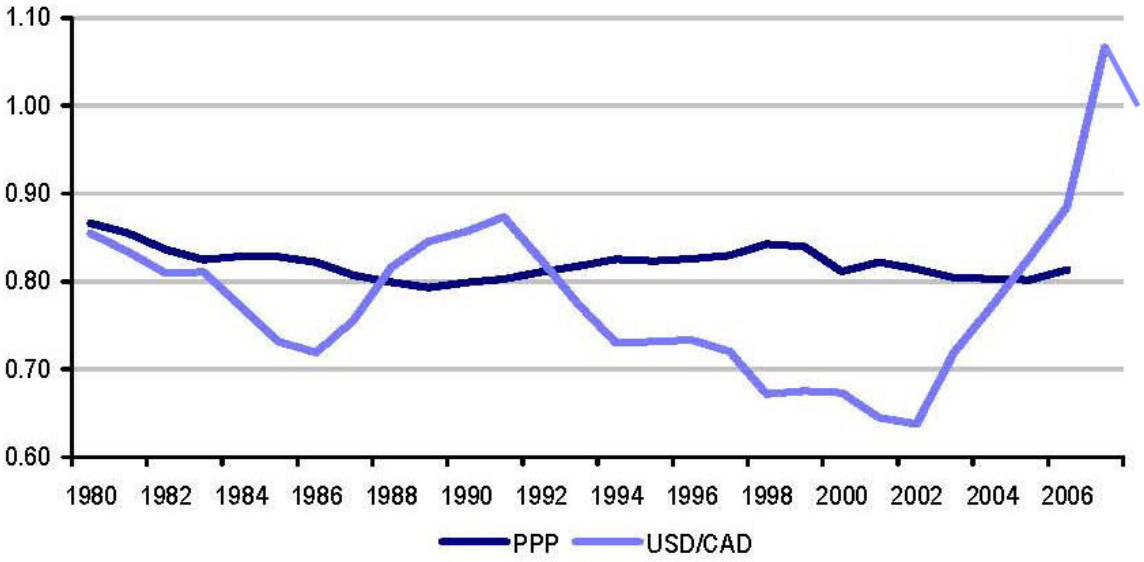
Our securities are presently traded at their lowest level since 1994 in terms of market valuations: the median P/E of our stocks stands at around 15x. But there is a great difference with 1994: at the time long-term interest rates were at 7% whereas today they are at around 4.67%. We believe our securities should be trading at around 20 times earnings, therefore approximately 30% more than their actual level.

The Canadian currency

The other element that affected us was the rise of the Canadian dollar which is no stranger to the bull-market of natural resources. We never believed that we could predict the fluctuation of currencies in general. In Canada, we believe that eventually it is an element that in the long run will have little effect. Over a long period of time the Canadian currency tends to stabilize compared to its American counterpart.

At the request of several partners, we took the time to make a study of the intrinsic value of the Canadian currency. An impartial international organization is taking care of this: The OECD (Organization for Economic Co-operation and Development). This organization reaches a PPP value (Purchasing Power Parities) of .81¢ US - .82¢ US. Another field study reaches a similar valuation: The Journal de Montréal made two identical purchases in Montreal and Plattsburgh and ended up with a shopping cart at 25% cheaper in the United States with the currency at par.

We don't pretend to be currency specialists or strategists, but it is thinkable that the Canadian currency may stabilize at approximately around its PPP at some point in the future.



Source: Bank of Canada, OECD, UBS

Five years prospects for our portfolios

In this section, we will not try to predict the future but to give you an approximate outlook of the future potential return of our securities. As detailed above, there are mostly three factors to consider. The most important one is the long-term growth in the intrinsic value of our businesses. The second is the market valuations (P/E) of our securities. And the third is the Canadian currency level (for our Canadian partners).

In the following chart, we laid out three scenarios. The most cautious of the three anticipates that the actual situation will last: a smaller growth rate of increase in the intrinsic value of our businesses, a small P/E (compared to interest rates) and a Canadian currency remaining at par.

2007-2012 Scenario Annual return	Intrinsic value growth	Increase in the price-earnings ratio	Canadian dollar effect	Annual returns combined
1st scenario	10%	@ 16x (0%)	1,00$ (0%)	10%
2nd scenario	12%	@ 18x (3%)	0,90$ (2%)	17%
3rd scenario	14%	@ 20x (5%)	0,82$ (5%)	24%

The most optimistic scenario – which would provide an annual return of 24% - includes the historical intrinsic growth of our businesses in estimates, a historical average P/E for our securities and a Canadian currency level which would be back in line with its PPP. Therefore, without making any prediction what so ever, we believe that it is realistic to conclude that our securities can provide an annual return 17% per year by 2012.

Measures to improve the returns

The art of investing wisely in the stock market is complex and always in progress. At the last meeting of Berkshire Hathaway, Charlie Munger was saying that the greatest quality of Warren Buffett was his ability to always keep learning. We are therefore constantly working to improve our approach. During the next few years, this progress will be made by opening onto several other stock markets around the world. Also, we will try to discover new business candidates for our portfolios in different – sometimes new – industries. All this will be done within the boundaries of our expertise. And most important, we will continue to search for businesses with a competitive advantage, which remains the cornerstone of our investing philosophy.

Opening up to the World

We learned over the last few years that our portfolio was dependent of the US market (and the US currency). Although we always refused to see ourselves as "US specialists" only, it remains that the best businesses were found in the United States most of the time. Also, the US market has the most rigorous compliance rules and regulations in the world. Presently, we have 10% of the portfolio invested in Canada and approximately 10% in international businesses. We have to underline the fact that in our US securities, several businesses such as Johnson & Johnson, American Express and Procter and Gamble, have an important part of their revenues coming from outside the US. These businesses take great advantage of the weakness of the US dollar.

Canada corresponds to only 3% of the world capitalization: it is normal to find fewer opportunities than in the United States, a reservoir of businesses almost fifteen times greater. Still, we acquired three new businesses from the Quebec province this year.

We are resolutely turning towards the future: there are more and more investment opportunities everywhere on the globe. The Internet and the broaden use of the English language made access to information much easier. We also have access to more research from foreign brokerage firms than previously. In 1998, we invested in Hong-Kong during the Asian crisis. In 2004, we acquired shares from an Australian business and this year, shares from a Japanese company (see below). We are also looking at the Irish stock market which has the lowest price-earning ratio of the Occidental stock markets.

We will continue our selection of the best businesses in the World and it will be done in an expanding pond.

Railroad companies, aggregate quarries and solar energy

We took the time to analyze a sector that we always perceived as capital intensive (fixed and workforce based): the railroad sector. The incredible success of Canadian National Railway in the last ten years has opened our eyes on the fact that this industry has changed significantly. Warren Buffett recently mentioned their structural changes: operating costs were reduced, the utilization of double wagons and software allowed more optimized railroad networks and the increase in fuel prices affected the rails three times less than the motorized vehicles. Railroad is in many instances an alternative much more profitable than trucking. Therefore, we are looking at investment opportunities in this sector.

By ricochet to aggregate quarries, the increasing cost of freight charges makes the geographical location an important competitive advantage. Companies such as Martin Marietta and Vulcan Materials are therefore able to increase their price-per-ton by a large amount over the last few years. Growth prospects for the residential construction sector are not positive these days but the highway infrastructures investment scheduled (and necessary) for the next few years should over-compensate. Many years ago, we invested in Simard Beaudry. Consequently, it is an area we are familiar with.

Finally, solar energy seems destined to a promising future. The recent energy crisis is different than the one in the seventies. Even if the oil needed to produce $1000 of GDP were cut in half over the last 35 years, the fact remains that humanity will eventually have to find other sources of energy. Furthermore, the awakening of our civilization to environmental consequences (an awakening not evenly shared among all the citizens of the planet) leads towards solutions where GES (Greenhouse Effect Gas) will be lower compared to traditional ways of producing energy.

Solar energy is an obvious alternative (the sun should exist for another billion years). The problem is that solar panels made of silicon produce energy at a much higher cost than conventional methods. The American company First Solar, on the other hand, proposes a different solution: it manufactures thin-film photovoltaic solar modules. These modules allow the production of energy at a lesser cost than other solar procedures.

The problem with investing in this industry is similar to the Internet industry ten years ago: it is hard to predict which company will come out a winner and market valuations are very high. On the other hand, it is possible to find businesses that will benefit indirectly from this industry.

Oil sands in Alberta

We had quite a few “recommendations” from our partners to invest in the petroleum sector, more specifically the oils sands industry of Alberta. Even if we avoided the oil business historically, we are closely observing what is going on in this sector. With our investments in businesses servicing energy companies, such as Pason Systems, we are aware of the actual evolution of this industry in Western Canada. It is clear that oil sands in Alberta represent a source of fabulous wealth. The reserves are astronomical and everything seems to be in place for a profitable exploitation (after several years of difficulties). This industry could become the most important source of economic growth in Canada for the next decade.

But this exploitation is not as simple as conventional fuel: besides requiring a large quantity of capitals and a complex procedure, the transformation of oil sands into synthetic petroleum

requires a very polluting procedure. GES are produced in large quantities. Also, the disposal of wastewater could become a major environmental problem. Indeed, to produce a barrel of petroleum from oil sands requires two to four water barrels, and the waste must be stored somewhere (there are two gigantic lakes of wastewater existing already).

At the end of 2007, the American government passed the «Energy independence and Security Act». It stipulates that federal agencies cannot initial fuel procurement contracts anymore that are more polluting than conventional sources of oil. Experts estimate that GES emissions related to oil sands are approximately 20 to 25% higher than conventional petroleum sources. This political element is added to the increase of royalties ordered by the government of Alberta last fall. The growth prospects of this region are impressive but there are numerous possible unexpected circumstances (including huge reliance to the price of crude oil). We are monitoring the major players of this industry, but for now, we just remain curious spectators.

Our businesses



The best time to plant a tree was 20 years ago.
The second best time is today.

- Chinese proverb

Walgreen's

Walgreen's, the largest drugstore chain in the world, has experienced highs and lows in 2007. The business had a bad quarter (the one ending in August) with earnings slightly lower than the previous year. The company miscalculated the reimbursements of an important generic drug and gross earnings were under their forecasts. Things were stabilized the next quarter and the earnings increased by approximately 8% for the year. But the stock was punished by Wall Street and it dropped from a high of $50 to $37.

The good news is that Walgreen's increased the number of drugstores as planned to about 6000 (a 10% increase). It also succeeded in increasing its same stores sales by approximately 6%. In the actual environment of retail sales downturn, it demonstrates the strength of its business model. This organic growth was higher than its closest competitor, CVS Caremark. Its prescription revenues continue to be the highest in the industry (see below). Also, the sales of non-pharmaceutical products (front end) jumped to $282 per square foot, approximately 30% more than its competitors.

Revenues per drugstore

Walgreen's	5 600 000 $
Longs Drug	5 100 000 $
CVS	5 000 000 $
Rite-Aid	3 500 000 $
Duane Reade	3 000 000 $

Source: MVI, UBS

We believe that Walgreen's is a solid business and in a growing market sector for many years to come. Competition is fierce and the political part of medication reimbursements has an unpredictable side. Still, we believe that Walgreen's should continue to increase its long-term earnings by 12 to 14% every year.

American Express

AMEX is the oldest security in the portfolio. We own shares since 1995. We reduced our participation occasionally when the stock got a little pricey. And we bought some stock back after September 11th 2001 and finally a third time in the summer of 2005 after the company won its battle against VISA and Mastercard.



American Express owns probably the best brand of the financial industry in the world. Its international growth is very high and the long-term prospects, quite solid.

From 2004 to 2006, earnings per share increased 18% per year. In 2007, the growth went down to 13% because of the economic slowdown in the United States. AMEX should also experience a tougher year in 2008. Its clientele has a credit score higher than average: the company should then be less affected than its competitors as to potential payment defauls. But it is not immune from charges for bad loans during an economic slowdown. Wall Street, having its typical short-term vision, has severely punished the stock these last few months. On a longer term, the company continues to maintain a growth forecast of 12 to 15% per year.

Historically, the stock has traded at P/E ratios of about 18-20x, which makes sense for such a quality business. At the present time, the P/E is 13x, a level that we consider to be much lower than its intrinsic value.

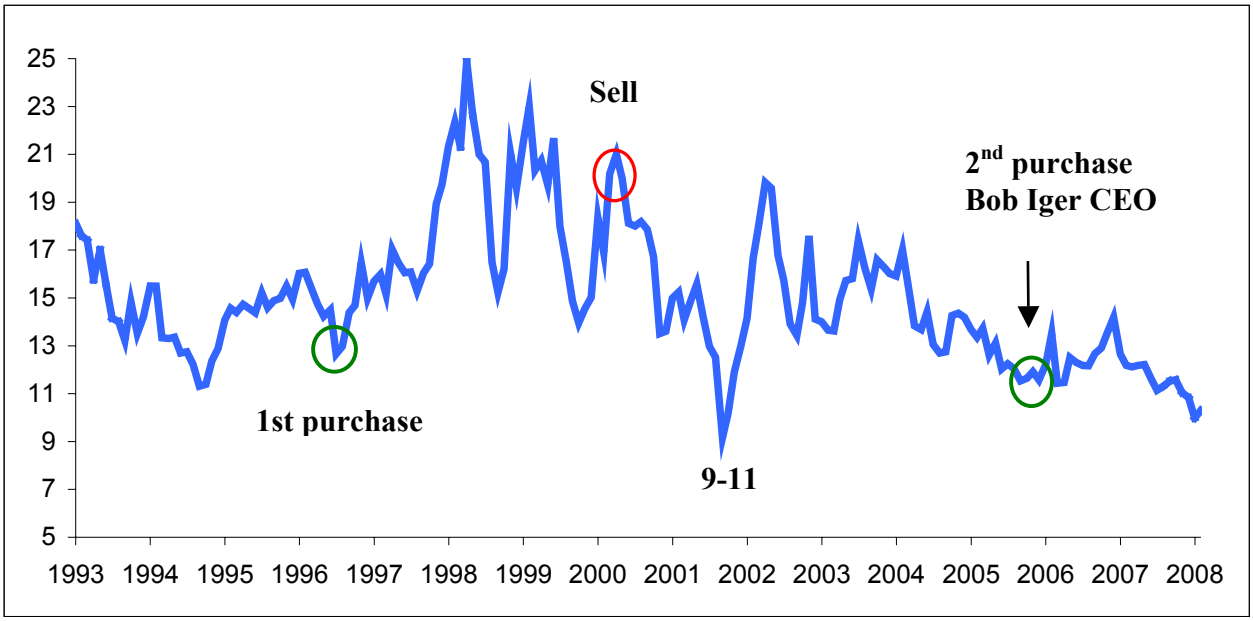
Disney

Our history with Disney goes back to 1996. Following the acquisition of Capital Cities ABC, we decided to buy some stock. At the beginning of 2000, we sold for two reasons: first, the market valuations looked too high and we were also getting less comfortable with the top executives.

Five years later when Bob Iger became President of Disney, we bought shares again. We knew Bob Iger formerly from Capital Cities ABC: he was the choice of Thomas Murphy to replace him, the then CEO (Mr. Murphy was refered to as the best manager in the world by Warren Buffett). Since our acquisition at $24 in September 2005, earnings per action have increased by 50% but the stock is up only 25%.

On the graphic below, we can see that the price to cash-flow is at a low in the last fifteen years. In fact, at the present level, Disney is traded at 10 times cash-flow and 14 times earnings, a level quite inferior to its intrinsic value. Disney has everything to be an excellent investment: a magnificent business, an exceptional CEO and an attractive valuation.

Disney (DIS) valuations over 15 years: price to cash-flow



O'Reilly Automotive

Our auto parts retailer saw its revenues and earnings increase by 11% and 9% respectively in 2007. We believe that O'Reilly is the best business in this sector. We admire its leadership team and their discipline in the execution of their development plan. In spite of the retail sale slowdown in the US, O'Reilly continues to invest in new stores (200 are anticipated for 2008), in advertising and most importantly in customer service.

O'Reilly is a good example of what has happened to our portfolio in the last few years. We bought the first shares in August 2004 at $20. The company increased its earnings per shares from $0.92 in 2003 to $1.67 in 2007 for a total growth of 82% (16% annualized). The stock is trading at $28 today, only 40% higher. The average P/E was 21x for the last four years but is at 17x today (15x 2008 estimated earnings).



We believe O'Reilly's stock is undervalued. We don't know when it will go up but we think the company can double its intrinsic value in the next five to six years. The stock should at least follow. Should it return to its historical P/E of 21x, the total return would be 140% for that period. We are therefore quite optimistic.

Brown & Brown

Our insurance brokerage business has experienced a more difficult year in 2007. Earnings went up by 10%. Not bad, but it is far from the 25% annual rate of the five previous years (2001 to 2006). The problem was insurance premiums in Florida. A few years ago, the state government set up a company, Citizens Insurance, in order to offer property insurance to Floridians without insurance. The problem is the insurance was sold at a discount price (sort of disguised subvention). After the hurricanes of 2005, Citizens increased its volume at the expense of traditional competitors. As Brown & Brown receives a share of premiums from different players, if these amounts are decreasing, generally, the revenues of B&B are decreasing. This situation is probably temporary (Citizens will not be able to operate at a loss for very long) but this situation has affected the organic growth of B&B downward.

The company continues to grow by acquisition but this year it was not sufficient to prevent a drop in earnings during the 4th quarter and a small growth for the year. The stock went down. We still believe that B&B is the best business in the sector: its margins highly exceed its competitors. We also believe the possibilities to consolidate this huge fragmented market are excellent over the coming years.

MTY Food Inc.

For many years, I stipulated that the best public company in Quebec was BMTC Group. I still have BMTC – and the CEO Yves Desgroseillers – in high esteem. But I also became a great admirer of Stanley Ma, the President of MTY Food.

The company is a leader franchisor of restaurant chains (mainly located in shopping malls). The network consists of 809 restaurants through nineteen banners such as La Crémière, Thaï Express, Croissant Plus, Tiki Ming and Sushi Shop. MTY is very profitable and growing fast (approximately 30% per year). Mr. Ma takes a reasonable salary and owns an important part of the company shares (26%).

Bank of the Ozarks

Our bank from Arkansas had a good year in spite of the difficult environment. As anticipated, earnings per share were stable in 2007 because during most of the year the bank had to deal with a flattened yield curve. The good news is that recently the curve changed drastically (Fed lowered its short-term interest rate by 2%). We are expecting a more profitable year in 2008. Another good news is that the bank took no sub-prime reserve in 2007. This is no coincidence: we favoured this bank for its loan conservatism. The CEO, George Gleason, owns 23% of the shares. Therefore, it is in his best interest to nurture a culture based on cautiousness.

In spite of this, to this date, our investment in Bank of the Ozarks has been disappointing. The P/E we paid was a little higher than usual for a bank. On the other hand, we invested a weight of only 2% of the portfolios (approximately half of a typical weight) being aware of this valuation slightly higher. Our experience tells us that refusing to invest in an exceptional business because the price seems a little too high is often a mistake. On the other hand, when the growth scenario takes longer than expected to materialize, the security can be punished by Wall Street (not reputed for its patience). We believe that Bank of the Ozarks is an excellent bank and we are keeping our shares.

Knight Transport

Our trucking company in Phoenix (Arizona) has experienced a difficult year. Earnings per share went down 12%. The problems are not specific to Knight: the trucking industry in general had a difficult year. We believe Knight is an exceptionally well managed business in a difficult sector (an "oasis in the desert") and we think we will be rewarded when the cycle comes up again. Knight has a good balance sheet and could take advantage of the present downturn to make acquisitions at decent prices. We should also keep in mind that Knight's top management own a third of the shares. We're in the same vehicle as them !

Microsoft

Microsoft had a remarkable year. The release of Vista is a huge success. Earnings per share were 33% higher than in 2006. Also, the stock jumped 20% in the market during 2007.

In February 2008, MSFT dropped to $28 following the news of an unfriendly offer to acquire Yahoo!, an offer that was refused. Even if the conclusion of the saga is unpredictable, it does not change the fact that Microsoft (with or without Yahoo!) is probably worth $40 a share, according to us. Its P/E of 14x looks quite low to us.

Nitori

Nitori Co. is a Japanese retailer with 160 stores offering articles for the home (furniture and accessories). Their stores are similar to IKEA (which tried to challenge Nitori with little success so far). At a time when retail sales seem to have stagnated in Japan for several years, Nitori sustained an impressive growth. Its net income increases 18% per year and the return of equity stoods at 17%.

Unlike other Japanese exporters (vehicles and technology), Nitori takes advantage of the raise of the yen since their furniture are bought in China and sold in the domestic market. The company was founded in 1972 by Akio Nitori who was only 28 years old at the time. He is still the CEO and manages the company brilliantly (and he owns 12% of the shares).

During the last month, in spite of a difficult retail environment everywhere in the world, same store sales grew 6%. The company intends to continue opening twenty stores per year in Japan. We believe the company can increase its EPS by 15 to 20% per year in the future.

Johnson & Johnson

J&J had an excellent year in 2007. Revenues jumped 15% thanks to the acquisition of Pfizer's consumer product division, among other things. The weakness of the US currency also contributed to the growth of revenues. Earnings per share increased 10%. At the end of 2007, the company lost the exclusivity of the important drug Risperdal (approximately 6.5% of revenues). We expect a slower growth rate in 2008, which should be in the order of 7%.

J&J is one of the best health care companies in the world (and is almost immunized to economic cycles). Its market valuation is 14x and seems much lower than its intrinsic value and its P/E average of the last ten years (25x).

Morningstar

We acquired shares from Morningstar last spring. We mentioned it in the second quarter of this year (in reply to a question from a partner). For many years, we used the financial information services of Morningstar. We like the long-term vision they demonstrate in their research, a rare commodity at Wall Street. We are ready to pay for their different services, particularly their analysis of competitive advantages of the businesses they are appraising.

Reading the first annual report of Morningstar, we became great admirers of the CEO and founder Joe Mansueto. He takes an annual salary of $100,000 with no bonus and no options. He owns 68% of the Morningstar shares (you are beginning to see a common point in our company choices?). In 2007, Morningstar revenues increased by 37% and EPS by 40%. It is certainly one of our most profitable businesses we own and we hope to be partners with Mr. Mansueto for years to come.

Fastenal

We rarely keep an investment for ten years in our portfolio. But next October, it will be a decade since we became shareholders of this fabulous business in Minnesota. In 2007, the company ignored the economic slowdown and increased its profits by 17%. Since our acquisition, EPS

went from $0.35 to $1.55 (18% per year). The stock followed the profit growth and increased by 700% as indicated above.

But we had to be patient to get this huge reward. Earnings stagnated from 2000 to 2003 and the stock did nothing for three years. Recently, in spite of excellent results, the stock is at the same point it was two years ago.

We believe our patience should be – once again – rewarded in the future.

Mistake "du jour"

Success seems to be linked to action. Successful people keep moving.
They make mistakes, but they don't quit.

- Conrad Hilton

Keeping up with Giverny's tradition, here are our three annual medals for the "best" mistakes of 2007. As always, it is with a constructive attitude – hoping to always become better investors – that we make detailed analysis of these mistakes.

Bronze medal: Garmin

As often the case, the worst mistakes are not the securities we bought but the securities we did not buy. In 2004, we looked at Garmin, a leading company in the growing world of GPS (Global Positioning System). GPS are ever present in our life and Garmin seemed to be the best positioned player in the industry.

We had an apprehension that the high margins of the company could not be maintained in the long term. The anticipated volume increase of units sold could increase the risk of commoditization that would follow. From 2003 to 2007, operating margins did bend indeed from 43% to 37%. But the revenue growth largely compensated. From 2004 to 2007, earnings per share tripled and the stock did the same (including the recent 50% drop of the stock).

Silver medal: W.P. Stewart

Our investment in W.P. Stewart was extremely disappointing. WPS is an asset management firm with an approach similar to ours (even though they are more concentrated on US blue chips). It has been in existence since 1975 and has substantially enriched his clients during three decades (an investment of $10,000 with them in 1975 would be worth $2,000,000 today).

In the last few years, the returns are not as good as they were in the past. Indeed, from 2002 to 2007, the annual performance was 10% compared to 13% for S&P 500. In the last five years, the trend of investing in quality securities at a fair price was not as rewarding as in the past. Unfortunately, what emphasized the problem is that certain employees decided to leave the firm (taking part of the assets with them). WPS lost more than half of its clientele these last two years. Revenues dropped by half and earnings were reduced to almost zero in 2007.

Our investment in this company was about 4% of our capital and to this date, we cumulated a loss of 80%. Since we got a 5% dividend during many years, the actual loss is smaller. But nonetheless, we lost the equivalent of 3% of our capital, which is our worst loss ever.

I have no problems acknowledging my mistakes; there would be a problem if they would not be recognized and not acted upon. But in the WPS case, our analysis was well done. We perfectly understood the company and followed quite regularly their portfolios composition. At the beginning, I estimated the assets would yield around 10% a year and I was not far from reality. In our original scenario, the earning growth of 10% that would follow combined to the 6% dividend should have brought us a very acceptable total return.

What I underestimated was the impatience of their clientele, the pressure of the intermediaries and the attraction of Hedge Fund (and their often speculative method of realizing short-term high returns). Of course, a perspicacious partner could blame us for not selling as the bad news were coming. Certainly, the company made changes to rectify things. We thought the problems would be temporary and the situation would improve eventually. We were wrong.

At the very end of February, we learned that WPS hired Merrill-Lynch to find a potential buyer. So we should know the outcome of this investment probably in the months to come.

It is a good thing to learn from our mistakes. I can assure you that my knowledge of the investment management industry is much better than it was five years ago. It was a mistake but, at the same time, we have to recognize with humbleness and realism that it is in the nature of the business world to have occasional unsuccessful investments.

Gold medal: Shoppers Drug Mart

I've been following Shoppers Drug Mart since the time the business was part of Imasco many years ago. In November 2001, the company came public at $18 per share. I knew that, when becoming independent, SDM could greatly improve its margins. Therefore, the earnings per share of $0.41 realized in 2001 did not reflect the true earning power of SDM. Not even the EPS of $1 then expected for 2002. Therefore, I should have disregarded the high P/E of the stock. I knew the drugstore industry very well and thought SDM had the potential to become an even more dominant leader in Canada.

In 2003, we bought shares of Walgreen's. Its very long-term growth perspectives seemed higher than SDM. At that time, we observed Jean-Coutu venturing in the US, knew that they would meet more problems then expected and that it would be a good opportunity for SDM to take on Quebec's market even more aggressively. Jean Coutu did encounter difficulties in the United States eventually. During that time, in Quebec, SDM opened impressive drugstores that were really successful.

The fact that we invested in Walgreen's should not have prevented us from investing in SDM as well. Even if the growth rate of new drugstores was higher at Walgreen's than SDM, they succeeded better in improving their margins (due mostly to the success of their private label). In 2007, SDM earned $2.28 a share (more than double those of 2002) and the stock is at $51 today. We would have tripled our money in an investment where the risk was very small.

This deserves a gold medal.

Conclusion

Despite errors inherent to the investment world and the business world in general, we know that owning stocks is the best wealth creator in our capitalist world. On the long-term, equities have generated approximately 10% per year in return and our own experience since 1993 was even more positive. But the price to pay for better returns is to live with fluctuations – sometimes quite pronounced – of the stock market world. The other essential ingredient is patience, the catalyst to make it through difficult times.

If there is a recession in 2008, we are ready. Historically, recessions in North America were temporary. More importantly, they always represented incredible opportunities to buy shares from solid companies at great prices. It is futile to try to time these purchases: the stock market has a tendency to drop a lot sooner than the recession becomes official and to climb six to twelve months before recovery.

Our businesses have good balance sheets and they will profit from slowdowns by taking market shares from weaker competitors or make acquisitions at good prices. Moreover, a lot of our businesseses can take advantage of the market weakness to repurchase their own stock. We believe that presently our group of businesses is the most solid we ever owned and their market valuations have never been so low.

We are therefore very enthusiastic about the long-term return prospects of our portfolio.

I wish a very good year 2008 to all our partners!



François Rochon and the entire Giverny Capital team

Giverny Capital Inc.

Letter to our partners 2008



Dil Hildebrand
Untitled (dusk), 2008
Collection Giverny Capital Inc.

If you don't have time to read the complete letter, please read this :

The opportunity of a generation

To Giverny Capital's partners,

2008 was a difficult year in the stock market, to say the least. We believe that the market drop – and the high level of pessimism – has created great investment opportunities, to a degree we have seldom seen in the modern history of financial markets.

From these depressed levels, we believe that the potential rewards for stocks are very high. We believe that the potential returns for stocks in general have not been that promising since 1979:

- Valuation for stocks in general are very low. The price-earnings ratio to normalized profits is around 9 times for the S&P 500.
- Consumer confidence in the US is at an all-time low of 25 (1985=100). The lowest it had reached before was 42 in 1974.
- Just in the US, there are around 7000 billions of dollars in cash (waiting to get back in the market). This is a sufficient amount to acquire all the S&P 500 companies.
- Interest rates on treasury bills are almost zero. The bond alternative is far from attractive.
- Most investors are pessimistic. Institutions have a very low asset allocation for stocks. Historically, these were signs of future great returns for stocks.
- We can purchase shares of outstanding companies at a third of their intrinsic value, a situation we have rarely seen.
- Finally, the legendary investor Warren Buffett is very optimistic toward stocks: he urged investors to invest for the first time since 1979. He wrote: "*A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors.*"

At Giverny Capital, we're ready for the next bull market !



François Rochon and the Giverny Capital team

Giverny Capital Inc. – Annual letter to partners 2008 ©

For the year ending December 31st 2008, the return of our portfolio was -5.5% compared to approximately -22.0% for our weighted benchmark. It is an added value of +16.5%. These returns both include a gain of 16% related to the fluctuation of the Canadian currency.

Since our beginning on July 1st1993, our annual compounded return is +14.0% compared to +6.4% for our comparative index group. If we exclude the increase of the Canadian currency, our portfolio would have generated an annual return of +14.4% compared to +6.7% for the indexes.

Our long-term (and ambitious) goal is to maintain an annual return of 5% higher than the indexes.

The art work on the cover of our letter

Since 2004, we illustrate our letter with an art work from our corporate collection. This year, we choose a work on paper by the Quebec artist Dil Hildebrand titled "Dusk". We do believe that the bear market could be near its end and we could soon see the lights of the next bull market.

The Giverny portfolio (in Canadian currency): Our returns since July 1st 1993.

Returns *	Giverny	Index **	+ / -	$US/Can	S&P 500	+ / -	Giverny ***	Index ***	+/-
1993 (Q3-Q4)	37.0%	9.5%	27.6%	3.3%	8.4%	28.6%	34.4%	7.4%	27.0%
1994	16.5%	3.7%	12.7%	6.0%	7.3%	9.2%	12.0%	-0.3%	12.3%
1995	41.2%	24.0%	17.2%	-2.7%	32.9%	8.3%	43.8%	26.3%	17.5%
1996	28.0%	22.8%	5.2%	0.3%	22.7%	5.3%	27.7%	22.5%	5.2%
1997	37.7%	28.6%	9.2%	4.3%	36.7%	1.0%	33.4%	24.5%	8.9%
1998	20.6%	18.8%	1.8%	7.1%	37.7%	-17.0%	14.5%	12.8%	1.7%
1999	15.1%	16.3%	-1.2%	-5.7%	14.1%	1.0%	20.6%	21.9%	-1.3%
2000	13.4%	3.2%	10.2%	3.9%	-4.6%	18.0%	9.7%	-0.2%	9.9%
2001	15.1%	-0.4%	15.5%	6.2%	-5.7%	20.8%	9.4%	-5.3%	14.7%
2002	-2.7%	-18.3%	15.6%	-0.8%	-22.0%	19.3%	-2.0%	-17.7%	15.7%
2003	13.6%	14.0%	-0.4%	-17.7%	5.7%	7.9%	33.7%	34.1%	-0.5%
2004	1.6%	6.2%	-4.5%	-7.3%	2.8%	-1.1%	8.3%	13.1%	-4.8%
2005	11.5%	3.6%	7.9%	-3.2%	1.5%	10.0%	14.5%	6.7%	7.8%
2006	3.5%	17.0%	-13.5%	0.2%	15.7%	-12.3%	3.3%	16.8%	-13.5%
2007	-14.4%	-12.0%	-2.4%	-14.9%	-10.0%	-4.4%	-0.3%	2.4%	-2.7%
2008	-5.5%	-22.0%	16.5%	23.1%	-21.7%	16.2%	-21.5%	-35.4%	13.9%
Total	654.7%	159.4%	496.8%	-4.5%	157.4%	500.1%	701.9%	175.2%	526.7%
Annualized	13.9%	6.3%	7.6%	-0.3%	6.3%	7.7%	14.4%	6.7%	7.6%

* Green section: All the returns are adjusted in Canadian dollars
** Indexes are a hybrid index (S&P/TSX, S&P 500, Russel 2000) which reflects the asset class weight
*** Estimated without the effect of the currency.

Note: the returns in Canadian dollars were audited by Price Waterhouse Coopers.

The US Giverny portfolio

Since 2003, we also publish the Giverny portfolio returns in US dollars. It mostly corresponds to the American part of the Giverny portfolio. In 2008, the US Giverny portfolio returned -24.3% compared to -35.7% for the S&P 500. Since the beginning of the portfolio, our return is 600.7% which is 13.4% on a annualized basis. During the same period, the S&P 500 returned 171.4%, which is 6.7% annualized. Our annual added value is therefore +6.7%.

Year	Giverny US	S&P 500	+ / -
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	36.6%	18.2%
1996	27.0%	22.3%	4.8%
1997	32.9%	31.0%	1.9%
1998	11.0%	28.5%	-17.5%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-8.2%	19.5%
2001	8.1%	-11.2%	19.3%
2002	-4.4%	-21.4%	16.9%
2003	31.6%	28.6%	3.0%
2004	9.3%	10.7%	-1.4%
2005	12.5%	4.9%	7.6%
2006	3.3%	15.4%	-12.1%
2007	-1.7%	5.5%	-7.2%
2008	-24.3%	-35.7%	11.4%
Total (en $US)	600.7%	171.4%	429.3%
Annualized (en $US)	13.4%	6.7%	6.7%

Note: these returns were audited by Price Waterhouse Coopers.

Portefeuille Giverny Canada

In 2007, we started the Giverny Canada portfolio. It mostly corresponds to the Canadian part of the Giverny portfolio. In 2008, the Giverny Canada portfolio returned -24.6% compared to -32.9% for the S&P/TSX. Since the beginning of the portfolio, our return is -9.7% which is -5.0% on a annualized basis. During the same period, the S&P/TSX returned -26.3%, which is -14.2% annualized. Our annual added value is therefore +9.2%.

Year	Giverny Canada	S&P/TSX	+/-
2007	19.7%	9.8%	9.9%
2008	-24.6%	-32.9%	8.3%
Total	-9.7%	-26.3%	16.6%
Annualized	-5.0%	-14.2%	9.2%

Note: these returns were audited by Price Waterhouse Coopers.

The year 2008 in review

Last year, we ended our letter with these words : "If there is a recession in 2008, we are ready". We did enter into a recession last year. Here is a review of some of the main news of a year that was far from ordinary:

- From their peak, World markets were down by more than 50%. Even those that were considered (wrongly it seens) "decouple" from the US economy went down. Markets in China, Brasil, Russia and India were down form 50 to 75%.
- Most industrialised country went into recessions.
- Housing prices were down by 20% in most industrialised countries.
- Three of the top five stock brokers in the US have vanished or have been forced to merge into a new entity (Bear Stearns, Lehman Brothers and Merrill Lynch).
- The three financial titans AIG, Freddie Mac and Fannie Mae collapsed.
- Short term Interest rates in Canada and US are almost zero.
- The S&P 500 dividend yield is higher than 10 year treasury bonds by more than 1%, something that last happened in the mid 1950s.
- It is estimated that around one of three hedge funds could close because of the crisis.
- Oil prices went from a peak of 147$US in July to a low of 35$US in December.
- The Canadian dollar dropped 23% compared to its US countepart.
- The Canadian stock market was not immuned : from its peak, the S&P/TSX dropped 50%, the small-cap index by 60% and the TSX Venture by 75%.

We are always psychologically ready for recessions or market corrections. At the same time, we share the same agnosticism as Warren Buffett's as for the capacity to predict them (we leave that to astrologists, market strategist and other fortune-tellers). We have accepted since the start that market and economic cycles are parts of our capitalist systems and manage our assets accordingly.

Since 1945, there have been 11 recessions. Four times, the stock market dropped by more than 40%. And crisis have one thing in common: they all ended !

The recent economic crisis originated from the drop in real-estate prices and in the huge consequences on the financial institutions, worldwide. Afterward, the crisis spread to all industries. The market correction was then amplified by the huge number of speculators that crowded the investment world in the years 2006-2007. For example, we wrote to you last year that at some point, there were $200 billions of oil contracts owned by investors. These were not destined to utilisation. Speculators were hoping to find "other" buyers to purchase their contracts before the delivery date. Forced to sell, losses were tremendous for most of them. There was also, the private equity firms (a new name for LBOs) that acquire companies by leveraging them to a dangerous levels. Many of them were forced to sell securities to improve their balance sheet. All this deleveraging process is still hurting the economy.

And as always, market drops created by the selling of speculators have created more fears for many other investors (even those that don't need to sell). It is hard for many investors to keep a long term view during market corrections, especially when it lasts many months. But they have to. It is impossible to know when but this crisis will pass too we can be certain of that. Our civilization have went through tougher times! A wise man once said that history doesn't repeat itself exactly the same way but it rimes!

Our portfolio did pretty well in the circumstances. We always have focussed our capital in solid companies with great balance sheets and good profit margins. They also share an important ingredient: honest and accountable people at the helm. Our companies are not immuned to recessions. But we believe that they have what it takes to pass through them. Some of them will emerge even stronger! Finally, we are prudent in the price we pay for stocks. That helps in bear markets.

Some of our companies were quite hurt by the recession but in general our investment philosophy has helped us this year to beat the market, the same way we have done it since 1993. And we are taking advantage of the market crash to purchase great bargains. As Warren Buffett would say: "*be greedy when others are fearful"*

The level of undervaluation of stocks in general

Although we're stock pickers (not investors in the market per se), we do closely follow the general valuation level of the S&P 500 (in our opinion, the most important index in the World).

To value the S&P 500, we take into consideration three parameters: operating earnings, normalized earnings to smooth out the economical ups and downs and long term interest rates in the US. The last parameter is used to compare price-earnings ratio (P/E) to bond alternatives. Over a long period of time, the market P/E tends to follow the inverted yield of interest rates. Of course, in periods of optimism, the normalized P/E of the S&P 500 can be way higher than interest rates would justify. And in periods of pessimism (like right now!), P/Es can be way lower than their intrinsic value.

If we look at the following chart, the S&P 500 seems to us undervalued by more than 50%, a discount rarely seen (note: in 2008 we use a 4% level for the 10 years bond although it was 2.5% at year end).

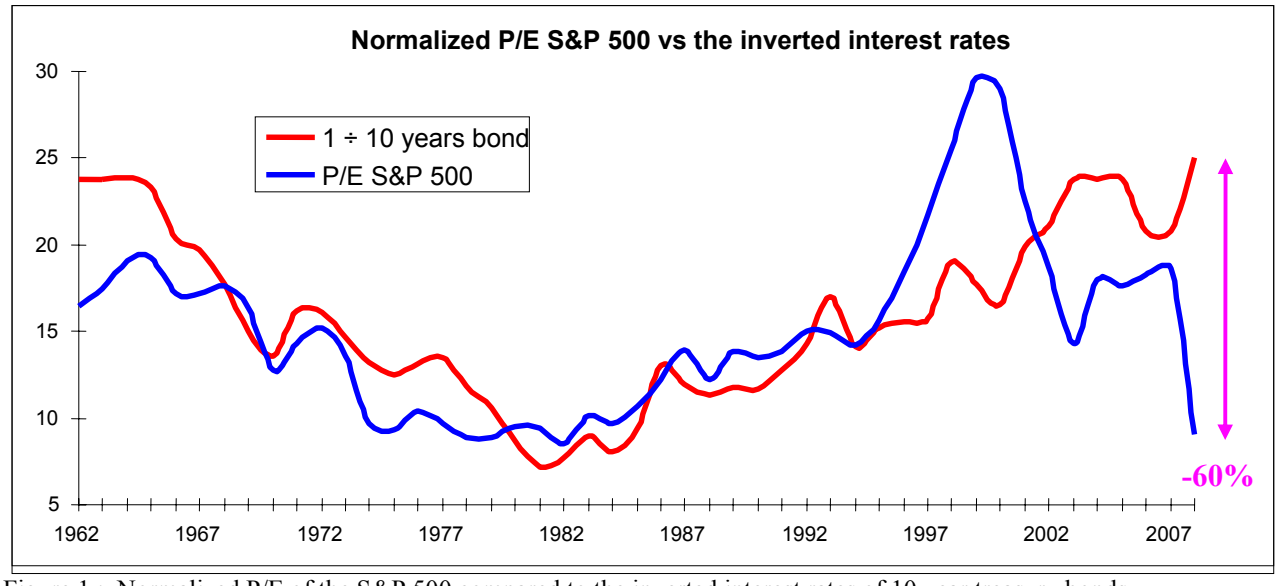


Figure 1 : Normalized P/E of the S&P 500 compared to the inverted interest rates of 10 year treasury bonds.

Such a level of undervaluation for stocks – and a huge potential of future appreciation attached to it – usually happens once per generation. So we are quite optimistic for the years to come. We don't know what the market will do in the next few quarters, but over the next 5 years or so, the potential returns seems to us way higher than the historical norms.

Historical returns and their fluctuations

There is one reason – and only one – that stocks have created so much wealth to their owners in the last century: on average, companies have maintained a 12% return on equity (ROE). After dividends, this ROE has translated into a 7% annual increase in corporate earnings. This annual increase, combined with the average dividend of 3%, have yielded a total annual return for stocks of 10%. This is better than any other asset class. All equity owners should then have been rewarded at such a rate over time. In reality, this is far from the case.

The stock market is an entity created and composed by human beings. So it has some of its qualities and flaws. The market has periods of huge optimism followed by periods of huge pessimism (although not in a linear fashion). For example, the S&P 500 increased by three fold in 5 years from 1995 to 1999. And it has dropped by 50% in 2008. Usually, the patern of behavior is more or less similar : in periods of increases, investors tend to forget that stocks can also go down and buy them at any level without consideration of their intrinsic values. And then, after a big drop, they sell believing that never again stocks will be a rewarding source of wealth (or they wait for a "better" time to buy time, meaning when they will have gone up a lot). They make the same mistake as in bull markets: they do not focus on intrinsic value.

We believe that the nature of financial markets do not favor such timing investment strategies. In fact, historically, 90% of stock returns happened during 1.5% of trading days. Statistics are way against those that think they can outsmart the market over a long period of time.

We do realize that the last 10 years have been quite difficult for investors in general. It even gives them the impression that stocks ownership is not a rewarding activity (and enjoyable even less). We can look at the following graphic to realize how tough were the last 10 years:

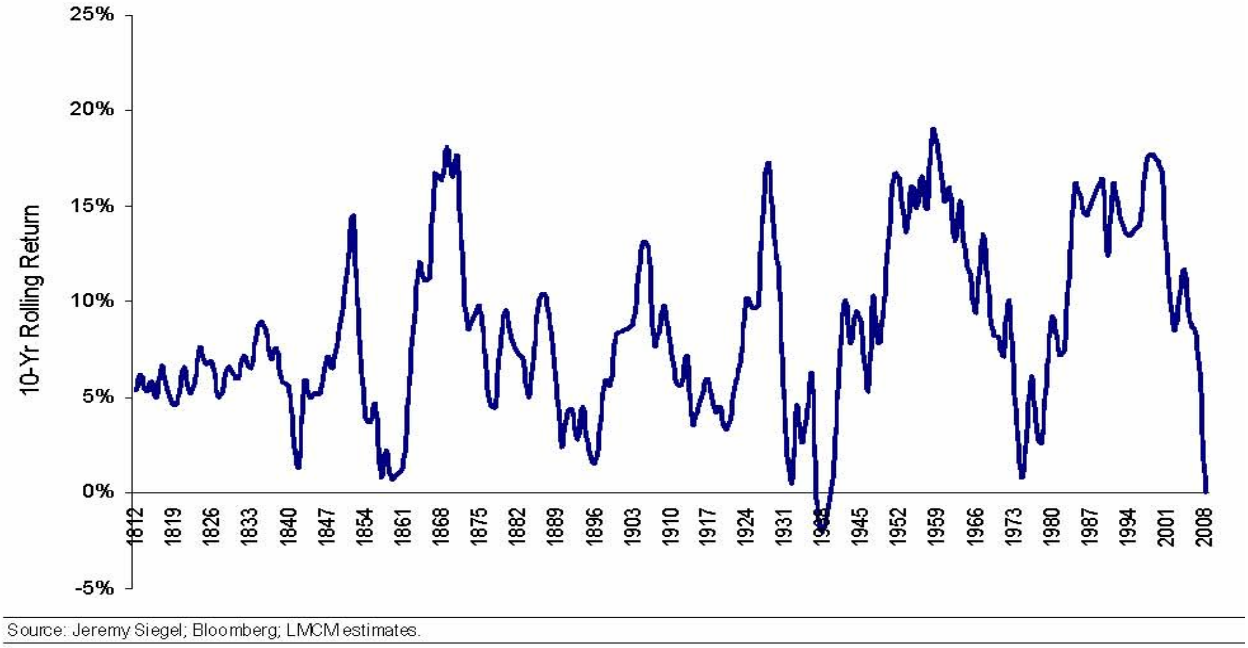


Figure 2 : The S&P 500 annual returns for the previous 10 years since 1812.

In 2008, the rolling 10 years average returns of the S&P 500 was less than -1%. It was only the second time in the last 200 years that this return was bellow 0% (the other time was for the 1929-1939 period). In 10 years, the market has gone from overvalued to undervalued.

But in the end, the only way to lose money in the stock market over the long run is to sell during corrections or recessions. So the emotional goal of the typical investor is not to fall into the "trap" of bear markets. This "trap" awaits those that can not be impervious to stock market fluctuations. Although it is far from easy, the key to attain such wisdom is to consider stocks as parts of businesses. And – big news ! – that's what they are. Nothing else!

Owner's earnings

If the vast majority of investors perceive the daily market quotes as an ultimate judge of value, we have a different view. At Giverny Capital, we do not evaluate the quality of an investment this way. In our mind, we are owners of the businesses we invest in. Consequently, we study the growth in underlying earnings of our companies and their long-term perspectives. Every year, we submit a table showing the growth of the intrinsic value of our businesses that we measure using the term invented by Warren Buffett: owner's earnings.

We therefore come to an estimate of the intrinsic value increase of our portfolio by adding to the growth in owner's earnings, our average dividend yield. In 2008, our owner's earnings decreased by 3%. It is not a great accomplishment but it was way better than the 30% drop in the S&P 500 operating earnings (note: earnings in 2008 for the S&P 500 varies a lot depending on how we account for them. We have used the one calculated by the firm Standard & Poor's)

	Giverny			S&P 500		
Year ***	Intrisic Value *	Market **	+ / -	Intrinsic Value *	Market **	+ / -
1996	14%	29%	15%	13%	22%	9%
1997	17%	35%	18%	11%	31%	20%
1998	11%	12%	1%	-1%	28%	29%
1999	16%	12%	-4%	17%	20%	3%
2000	19%	10%	-9%	9%	-9%	-18%
2001	-9%	10%	19%	-18%	-11%	7%
2002	19%	-2%	-21%	11%	-22%	-33%
2003	31%	34%	3%	15%	28%	13%
2004	21%	8%	-12%	21%	11%	-8%
2005	14%	15%	0%	13%	5%	-8%
2006	14%	3%	-11%	15%	16%	1%
2007	10%	0%	-10%	-1%	6%	6%
2008	-3%	-22%	-19%	-30%	-36%	-6%
Total	386%	247%	-140%	73%	82%	9%
Annualisé	13%	10%	-3%	4%	5%	0%

* Owner's earnings growth (approximately) plus dividends
** Stock Market performance, including dividends
*** All the results are estimated without currency fluctuations

According to this calculation, our companies have increased their intrinsic value by 386% (almost 5 fold) but their stocks – in aggregate – increased by 247%. The main difference can be explained by the median P/E contraction from 16x to 11x. We must add that this year's corporate earnings – ours and those of the companies making up the S&P 500 – are depressed because of the recession. In some way, they distort the calculation of intrinsic value. Only time will tell to which degree.

Besides ups and downs in the economy, over the long run, market quotes will follow the increase in the earnings of the underlying companies.

The flavour of the day in 2008: guaranteed impoverishment

Regularly, we try to assess what is the flavour of the day, in other words what needs to be avoided. The stock market tends to get excited from time to time by all sorts of financial assets: it could be a sector, a country, an asset class, a new major "trend", etc. In 1999-2000, it was all about tech stocks. In 2006-2008 (first six months), it was all about commodity and resources stocks. Today, what looks to us very dangerous are – ironically – the treasury bills.

Today, there are around $7000 billions in liquid assets in the US alone. This is enough money to purchase all the companies of the S&P 500 (or 5 times the complete Canadian stock market). At year's end, the interest rate on those liquid asset was 0.07%. The interest rate on 10 years government bonds was 2.2% and the 30 years bonds 2.7%. Those that purchase those assets – in a some sort of collective delusion – believe that they are acting in a prudent way while in fact it could be the riskiest! It is so because it guarantees yearly impoverishment because the yield that they receive will be lower than the inflation rate.

Historically, the inflation rate has been around 3% per year. Although, in 2009 it will probably be lower, investors have to realize that the politic of many governments to inject huge sums of money in the banking system will probably create inflation. In the next 10 years, it could even be a little higher than historical norms, perhaps around 4% a year on average. If we use 3.5%, it means that the bonds yielding 2% will in fact be creating a LOSS of 1.5% per year in real terms. Over 10 years, this is total loss of 14%. Moreover, if that 2% is taxed, the total loss climbs to 21% (not bad for a riskless asset). For 30 years bonds, it's even worse: a non-taxable account will lose 26% of its purchasing power and in a taxable one, 45% !!

That is why we believe that the risk of owning treasury bills has rarely been so high. Impoverishment is guaranteed !

<u>Our companies : 2008 in review and their future potential</u>

In 2008, many of our companies saw their earnings reduced or stagnated. In some cases, the reduction was significant. Some of our businesses, we must add, did increase their earnings and some other made important acquisitions while their competitors were paralysed with fear.

Nitori Co.

Our best stock in 2008 was Nitori, a Japanese company we acquired last year. Nitori is a retailer of household products (furniture and accessories). It has an everyday low price strategy so it has been

gaining market shares in these difficult times. In 2008, earnings were up 13%. The stock went up 30% (to 7000 yens) and we got a little bonus because the yen gained 40% against the Canadian dollar.

Wal-Mart

Wal-Mart increased its profits by 6% in 2008. Its same store sales (SSS) were up 3%. In this very tough environment, it was quite an accomplishment. For example, Target saw its SSS decreased by 3%. Wal-Mart is one of the rare retailers that increased its traffic and SSS in 2008.

The top management's decision to reduce the level of new store openings and instead buy back shares looks to us like a wise decision. The stock has been quite resilient this year as it increased by 18% compared to last January.

Bank of the Ozarks

Our little bank of Little Rock (Arkansas) accomplished what very few of the 4000 or so banks in the US did this year : increase profits. Assets were up 19% and earnings were up 9% (even after a large increase in loan reserves). The efficiency ratio was down to 42.3%, an exceptional performance. Return on assets was a solid 1.14%.

I've met with the management of Bank of the Ozarks in 2006. I came back from Little Rock quite enthusiastic. Its CEO, George Gleason, acquired the bank for $10 000 at age 25 some 29 years ago. Bank of the Ozarks had then 28 employees et $28 millions in assets. In 2008, assets were $3 billions (an increase of 10 000%) and the bank was worth $500 millions. Mr. Gleason still owns some 22% of the outstanding shares and is paid a very reasonable salary. The culture he has impregnated onto the bank is based on conservatism and a long term horizon. Ozarks did not participate in the "sub-prime" madness and was prudent with its real-estate loan portfolio (there was few speculation in Little Rock considering that the median price of a home is $130 000).

Mr. Gleason is our kind of businessman and we're happy to be partners with him!

Wells-Fargo

Wells-Fargo (WFC) made a bold acquisition in 2008 by acquiring Wachovia at a very good price. They paid around $15 billions. This was the equivalent of 17% of its own market cap. In return, WFC doubled its assets. Moreover, we believe that with the charges that they will make to Wachovia books, they could save billions in future income taxes, that could prove to be almost the level of the purchase price.

WFC is so big, it could hardly escape the recession linked problems in 2008. It increased its level of reserves but still was profitable. Earnings were down 25% and we believe they will be lower by as much – at the very least – in 2009.

As always, we look beyond the next few quarters. We believe that once the economy gets back on the growth track, WFC will be able to double its earnings. So we believe that in next cycle, WFC could earn $4 a share. The stock could then reach the $60 level. This is many times the current level of the stock so the potential of appreciation is quite high.

Allied Irish Bank

In 2008, we had acquired a small weight in the largest bank in Ireland: Allied Irish Bank (AIB). At its average price of $25 in 2008, the stock was trading at 3 times earnings! AIB had two large investments: $3 per share in a minority holding of M&T Bank and $4 per share in Zachodni WBK, one of the most important bank of Poland. So in fact, we were paying $18 for $6 of EPS. And the dividend was 10%. It looked to us as a very rewarding opportunity.

But it did not turned out the way we had hoped. The economy of Ireland went down in turmoil and its three banks collapsed in the stock market. AIB ended the year at $5. At this price, we were *paid* $2 to own the most important bank in Ireland (with 41% market share it is the Irish equivalent of a combined Bank of Montreal and Royal bank of Canada).

In the beginning of 2009, there was an incredible event: the Irish government nationalized the third most important bank, Anglo Irish Bank, something very unimaginable just a year ago. Ireland is not a socialist country or a third-world country. Its GDP per capita is 15% higher than in Canada! But political interference makes our analysis futile and predicting the outcome quite impossible. Clearly, at today's price, investors believe that AIB will be almost totally diluted. We follow the situation closely but for the moment, we decided to just keep our shares.

Disney

Walt Disney Co. had a good year in 2008. EPS were similar to those of 2007. The recession should impact 2009 EPS but in the long run, this is one of the best companies we own. Moreover, it is brilliantly managed by its current CEO Robert Iger. The stock was a bargain at $30 at the beginning of the year but that did not prevent it from going down to $20. Obviously, in times of great pessimism, a stock trading at half its intrinsic value can go down to a third of its value. At today's level, Disney trades at 10 times earnings, a level not seen since the mid 1960s. We are still buyers of the stock.

American Express

AMEX owns a solid brand name, probably one of the best in the financial sector. But the year 2008 was very difficult for the company. Reserves had to be increased and EPS went down by 28%. The year 2009 doesn't look better. The stock went down to $19. At this level, it trades at around 7 times earnings.

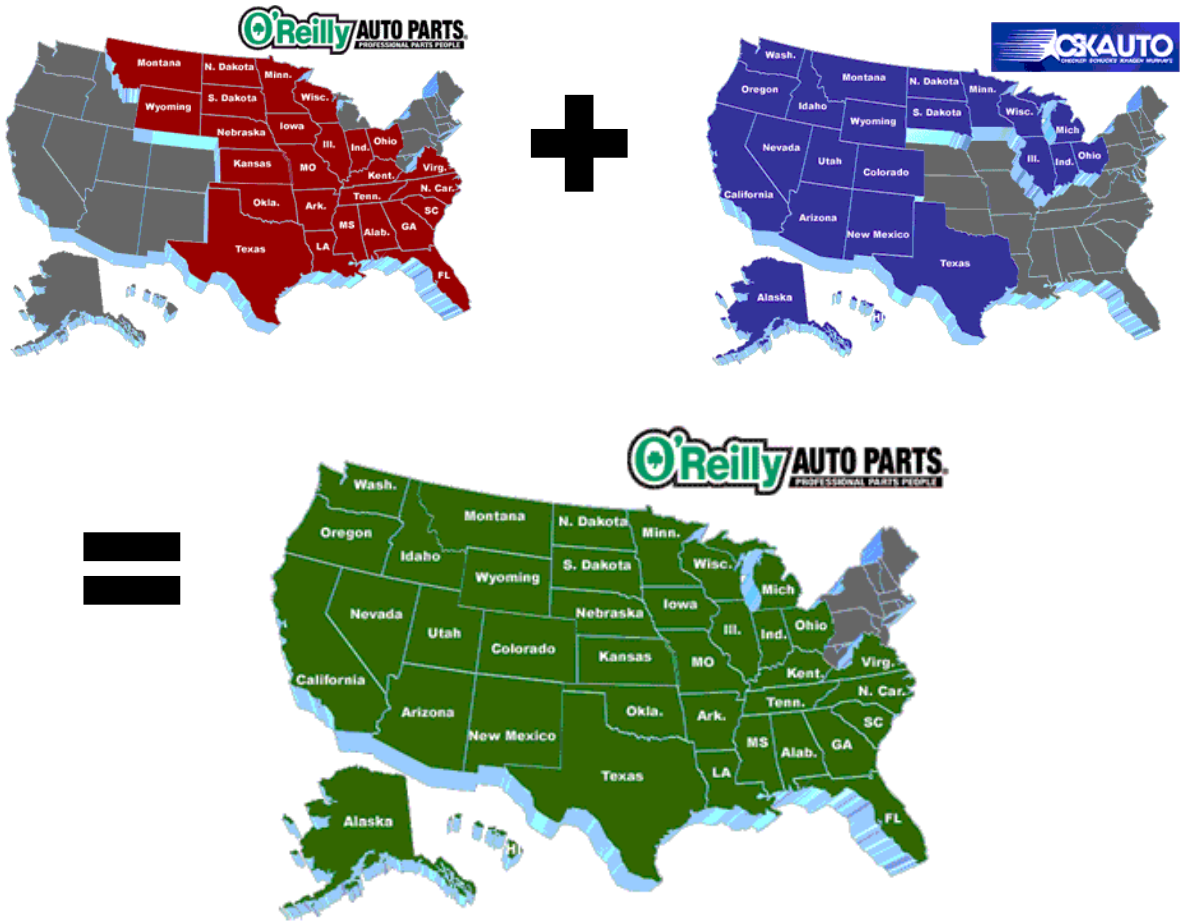
It is difficult to know how hard AMEX will be hurt by the recession. We do believe that the company's brand is intact and that in the next cycle, earnings should rebound. If it earns $4.25 and the P/E gets back to normal levels, this stock could reach $65, more than four times the current level.

O'Reilly Automotive

Four years ago, we acquired shares in O'Reilly Automotive, one of the most important retailers of auto parts in the US. We had paid around $20 and the company was earning $1.12 per share at that time. O'Reilly had grown by 20% a year since its IPO in 1993. Future prospects looked good to us. We had visited its headquarters in Springfield (Missouri) and were impressed by its top people. They built a strong culture and had a very long term horizon in their investment process.

In 2008, EPS reached $1.64. Even though it's 46% higher than in 2004, we believe that these earnings are not totally reflective of their true earning power. The store number has increased from 1200 to 3200 during those four years. The stock has been quite rewarding in this down market since it ended the year at $30.

Of the 2000 stores increase, a large part of it came from this year's acquisition of CSK Auto (1342 stores). It expanded the reach of O'Reilly to the whole country. And the price paid for CSK seems to us to be very reasonable. So the future of O'Reilly continues to look quite promising.



Fastenal

We are shareholders of Fastenal since 1998. So far, we have been rewarded to a large degree by this superb company from Winona (Minnesota). In the movie "*Other People's Money*", Lawrence Garfield (interpreted by Danny DeVito) likes businesses that are "*Dull but making a decent buck*!". At Giverny Capital, we share this admiration for such businesses. And Fastenal is making more than "decent" returns with its capital!

Fastenal started by selling fasteners but its CEO for many years, Robert Kierlin, diversified the company into many other lines of products as it expanded to around 2000 retail sites. My personal favorite line of products is the janitorial one.



We first purchased shares of Fastenal during the Asian crisis in October of 1998 at around $5 a share (adjusted for splits). In 1998, Fastenal earned $0.35 per share. In 2008, EPS reached $1.91, an increase of 450% in 10 years (18% annualized). The stock – as it should – has gone up by 500%.

The stock has been weak lately: the first few months of 2009 are difficult. But we do believe that in the next cycle, Fastenal will be able to again double sales and profits. And the stock should, at the very least, follow its underlying growth rate.

MTY Food

The Quebec based enterprise MTY Food had a good year in 2008. Its sales increased by 12% and EPS by 8%. MTY acquired two franchises: Tutti Frutti et Taco Time. The number of restaurants under the umbrella of MTY has crossed the 1000 level this year. The stock had a tough year as it went down from $12.6 to $7.3, a 42% drop. The company still has a great balance sheet. It shoud help to make other acquisitions in 2009 as the opportunities arise.

Pason Systems

Our Calgary oil services company, purchased four years ago, had a good year in 2008. Its US division is doing extremely well and helped the company earned record profits. EPS were up 25% in 2008 but 2009 looks much more difficult (the number of oil rigs are way down as of this writing). We admire Pason's CEO, Jim Hill, tremendously and we talk to him on a regular basis. We are optimistic about the long term prospects of this very impressive Canadian company.

5N Plus

5N Plus, a young and dynamic Quebec based company, is a World leader in metal purification. Their products are mostly used in photovoltaic cells for solar panels. For their last fiscal year (ending in May), revenues were up 41% and EPS 83%. After two quarters into 2009, revenues and profits are up 120%. The company has successfully completed its German plant and it's doing very well so far.

The stock was very volatile in the stock market. It started the year by going up from $8 to $13 and then went down the $4.6. The company – with some wisdom – issued more shares at $11 so it has a reserve of $1.2 per share in cash. So in fact, we're paying $3.4 for the company or around 10 times estimated profits for 2009. Such a low P/E for a fast growing company looks very attractive to us. Moreover, we know its founder and CEO very well and have great faith in his managerial skills.

Resmed

We purchased shares of Resmed in 2003, an Australian company that is the World leader in sleep disorder medical products. This segment is growing rapidly as more and more people are getting aware of the dangers of apnea. Resmed not only sells products, it helps the medical World and the population get more acquainted with the problem.

In 2008, sales were up 16% and EPS up 13%. Few companies had such a good performance in this economic environment. More importantly, it gained back some market shares from Respironics (now a division of the Dutch company Philips). The stock has over performed the indexes by going down only 29% (!). We believe that the company warrants its premium to the average company. So we are hanging on to ours shares even though they do not look as undervalued as some of our other holdings.

Knight Transportation

The trucking industry had to surf through a wave of problems in 2008: retail sales in constant descent, increase competition from railroads and high fuel prices (for a good part of the year). But that did not prevent Knight to continue to earn great returns: revenues were up 8% and EPS were down only 9%. Its efficiency ratio (the most important measure of competitive advantage) was maintained at 84%, more than 10% better than competitors. Its balance sheet is still without debt and with an excess cash level of $54 millions, even after having paid a dividend and repurchased shares.

This is why Knight Transportation was one of the few stocks to increase this year, ending up 9% compared to last year. When we first acquired shares of Knight in late 2003, we labeled it "an oasis in the desert" as it was a great company in a lousy industry. And it's in great drought that we recognize the best sources!

Walgreen's

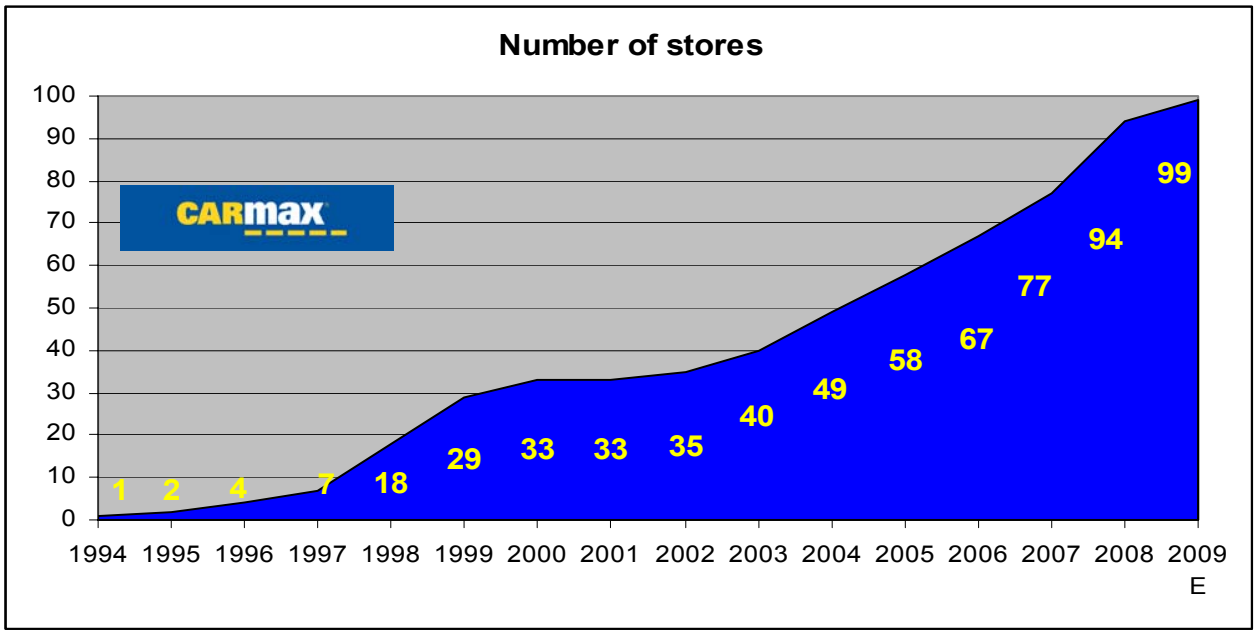
It was a tough year for Walgreen's, the leading pharmacy chain in the US. SSS went up but at a lower growth rate than the company had accustomed its shareholders. EPS were similar to those of 2007. The stock should have done well in the stock market because of its "defensive" status. But there were few of those in 2008 in Wall Street: the stock went down 34% to $25, doing as poorly as the index.

As always, what counts is the increase in intrinsic value not what the stock does in the short run. It seems to us that long term fundamentals are not as good as they used to be. The company has reduced its long term target of store openings and decided to focus on increasing margins. Although it might be the wisest choice, this is not good news. When we purchase the stock some 6 years ago, the company was growing at a 16-17% growth rate and had maintained that rate for the previous 30 years. Very very few companies had such a track record!

A look at the industry leads us to believe that competition has increased lately. And from a larger base, Walgreen's growth rate should be lower going forward (probably 7-10%). The stock looks incredibly cheap (at a P/E of 11x) and has discounted even worse growth perspectives that we envision. But we are reconsidering this investment as we are finding even better opportunities in other stocks.

Carmax

Carmax is the US largest retailer of used cars. Headquartered in Richmond (Virginia), it currently operates 99 used car superstores in 46 markets. In addition, Carmax offers financing to most of its clients (through its CAF division). Loans from clients with good credit scores are pooled and sold on the securitization market. When FICO scores are low, they are sent to Bank of America. Carmax has been growing since its founding some 15 years ago. It went from one store to 99 stores as revenues reached $8 billions in 2007.



It is hard to imagine a worst economic flood for the auto industry than the year 2008 (although it looks like 2009 is going for the record). Sales of cars (both new and used) have gone down by 25%, a decrease rarely seen since its entry into our civilisation. In addition, Carmax had to cope with a terrible securitization market for most of the year and had to accept much lower margins. They also had to increase reserves for delinquencies. So the financial arm lost money in 2008. So in two years, EPS went from $0.92 to $0.11.

We had purchased a starting participation in 2007. As bad news were coming out, we decided to wait to purchase more shares. That does not change our view that the long term fundamentals of Carmax are great. Few companies have so much growth potential. The used car market is highly fragmented and the consumer can gain better services (and less problems) by purchasing at Carmax instead of the local dealer. In just a few years, Carmax has built an impressive brand name that is without equivalent in the industry. With only 2% of market shares, it could grow by 15-20% per year for the next decade and still own less than 10% of the market.

So we believe that we should be patient with that investment and even perhaps considering increasing our holding at some point in the future.

Mohawk Industries

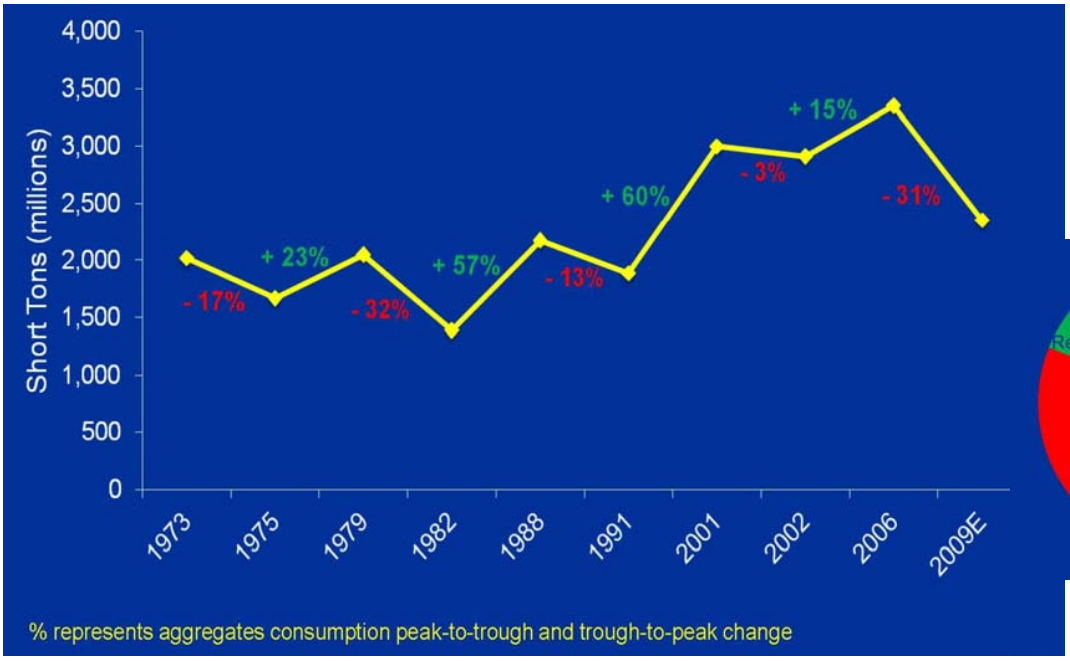
Mohawk Industries is one of the two main players in the flooring industry in the US. It is also an important player worldwide. The year 2008 was very difficult for the industry and for Mohawk. EPS went down 50%. Sales of carpets, tiles and hardwood floors we're down across all segments (commercial, residential and new home construction). Moreover, the increase in oil prices (until August) had a huge impact on gross margins (carpets are made from oil based products). Margins should improve later in 2009 as the company goes through its FIFO inventory. It is worth noting that its main US competitor, Shaw industries (a division of Berkshire Hathaway) had a similar drop in profits. So, it seems that Mohawk has not lost market shares. The other important ingredient is its CEO, Jeff Lorberbaum, who we admire greatly.

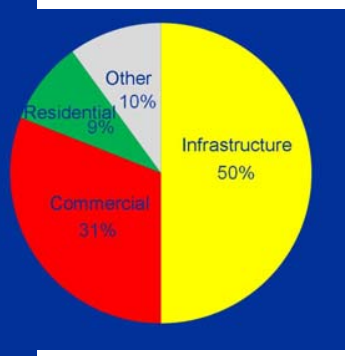
The stock had a volatile year. It fluctuated between $83 and $24, ending the year at $43. At its low, it traded at 3 times the earnings of the last cycle peak (2006). If in 5 years, the company returns to a more normal profitability level and trades at a P/E more in line with its historical norm, this stock could reach $120. So Mohawk stock looks to us as being quite undervalued.

New purchases in 2008

Martin Marietta Materials

We acquired shares of Martin Marietta Materials (MMM), the leading US aggregate producer. The company has strong competitive advantages and long life reserves (84 years). Because of the recession – including the drop in new home sales – aggregates consumption has its worst drop since 1982 as shown in the following chart. So we believe that there is a strong recovery potential.





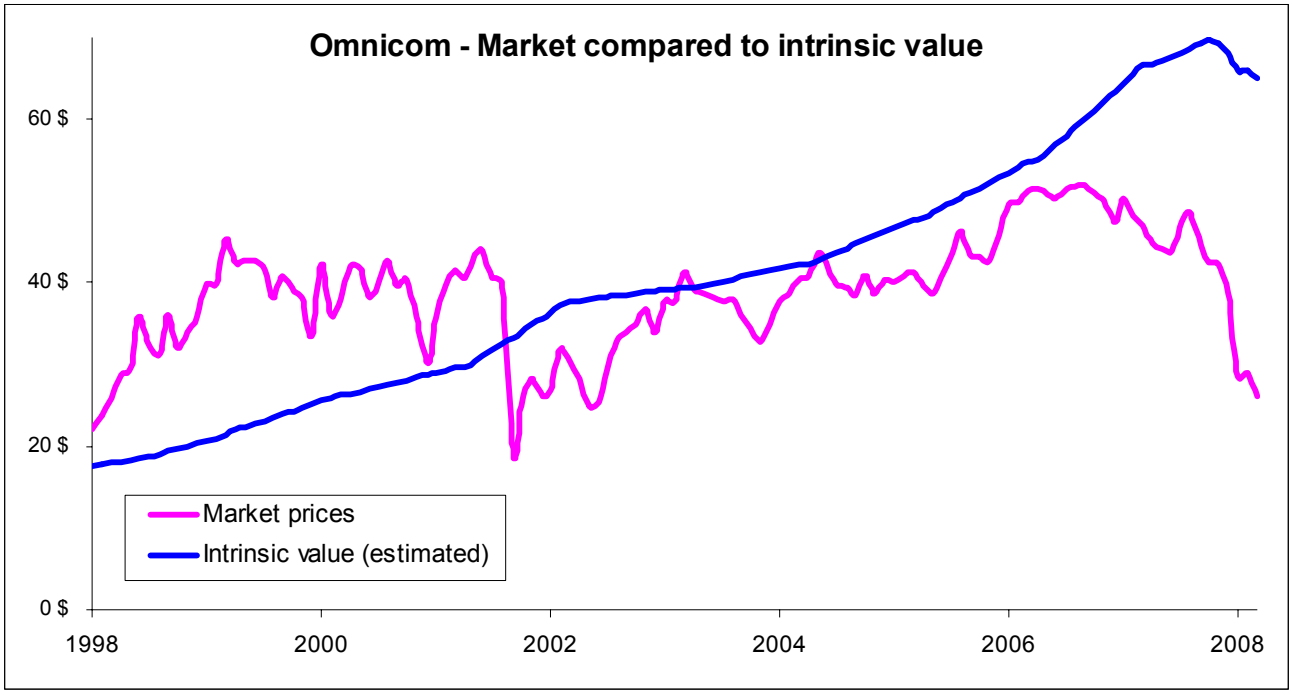
Moreover, according to our analysis, the mid and long term economics of this company are very promising. Around 50% of revenues come from infrastructure projects. This division should rebound in the next few quarters in light of the fact that the newly elected president Barack Obama has announced a major program of investments in that area. And, at some point, new home sales will go back up. So we believe that within the next 5 years or so, MMM earnings could more than double.

Omnicom

We have been following Omnicom since 1998. In fact, in 2006, the stock was in the "mistake *du jour*" section of our annual letter to partners. I explained that in 2002, the stock went from $49 to $18 on rumors of a financial scandal (that turned out to be unfunded). The stock had afterward rebounded to $53 in 2006. So I had lots of regrets to have stayed on the sideline four years earlier.

But in the stock market, we shall never lose patience. In 2008, the stock lost more than half its quoted value and was at $27 at year's end. The recession will have an impact on Omnicom's profitability but we believe that over the long term, its intrinsic value is intact.

It is interesting to note that in 2002, Omnicom realized EPS of $1.72 . In 2008, EPS reached $3.17. So the stock today is even more undervalued (at a P/E of 8x) than it was in 2002 at its low (P/E of 10x). Historically, Omnicom has traded at around 22 times earnings. So at its current level, we believe it is trading at a third of its underlying intrinsic value.



If you believe that decrease in stock value is bad for shareholders, we would tend to think otherwise. Since 2002, the company has bought back 60 millions of its own shares (or 16% of outstanding). It is way better for Omnicom to buy back its stock at 8 times earnings than at 16 times. So we think we will be rewarded from that investment in two ways: First by acquiring shares well bellow intrinsic value. Secondly, Omnicom increases shareholder's wealth by repurchasing its own shares at cheaper level.

Five years post-mortem : 2003

We try, on a regular basis, to do a post-mortem of our investment process when sufficient time has gone by. We believe that by studying our past decisions, we can learn from them.

In 2003, we had acquired shares of Factset Reseach, Expeditors International, Harley Davidson, Walgreen's, Fifth Third Bank, Resmed and bought back some First Data. Four of these companies were still in our portfolio at year's end (Factset, Expeditors, Walgreen's and Resmed).

Although we believe its brand to be solid, we sold Harley-Davidson a few months after our purchase. We were not comfortable with their finance division. Our fears were justified. Although it took a few years to materialize, the year 2008 was difficult for Harley. In addition to slower sales, the financial division is worrisome. And its stock went from a peak of $70 to $12 lately. This summer, I went to Milwaukee and visited the newly constructed Harley-Davidson museum. We can realize the strength of the company and of its brand. There are very few brands that people are ready to get tattooed on their body. Harley-Davidson is one of them!

First Data turned out ok. We sold our investment in 2005. The company was then split in two with the spin-off of Western Union. The other part was acquired by a private equity fund afterwards.

Finally, Fifth Third Bank was a poor investment. We sold our shares at around $40, two years after their purchase with a loss of 20%. The Cincinnati bank had a great history of outstanding returns for its shareholders. But sometimes, in capitalism, success creates its own anchor. When we look at today's price of $2 (I have to clean up my screen to be certain that there is not another digit in front of the "2"), we have no regrets that we sold our shares.

Mistakes *du jour*

> Success *is a lousy teacher. It seduces smart people into thinking they can't lose.*
>
> - Bill Gates

As we do every year, here are our three modals for "best" mistake of the year just passed. As usual, it is with a constructive attitude that we share them with our partners and go into detailed analysis. In the hope to always improve ourselves as investors.

Bronze Medal: First Cash Financial

We owned shares of First Cash Financial Services (FCFS) for a few months in 2007. We had purchased them at around $17 and sold them under $10. It was not a good transaction. FCFS had two divisions. The first one was a chain of pawn shops, in the US and in Mexico. This division is highly profitable and almost immune to recessions. But FCFS had a second division, much smaller, that sold used cars with "easy" payments. I was not a fan of that business but since it was a modest part of the profits, we decided to invest a small weight. As usual, we started with a small weight to slowly learn to know management a little better (there nothing like implication to learn about something).

In 2007, the car division turned out to be losing money. The stock fell in half on the news of the December quarter of that year. We believed that FCFS had to sell that division (even give it away, liabilities included). To my great disappointment, FCFS top management decided to keep the trouble division believing that they could solve its problems.

For a few days, I reflected on the situation. I believed that it is was a mistake to continue holding on to the car division. One important criteria when we acquire shares in a company is to have confidence in its top people. Once we are shareholders, if we do not agree with them, we are faced with a tough decision. Obviously, we have no chance on making them change their mind. We either have to accept their decisions or sell our participation. We decided to sell.

The car division continued to lose money in 2008 (and profits to increase in the pawn shops division). But after a few quarters into 2008, FCFS' management decided to depart from that business. The stock promptly rebounded to $17. It was hard to predict such a turnaround in a management decisions (ego sometimes block wisdom in many human beings in powerful positions). It was frustrating since FCFS did chose the path we believe was best.

Was it a mistake to sell? I don't think so. Our reasons were valid. Could we have been more patient with the management of the company? I believe the answer to that question is yes.

Silver Medal: Ritchie Brothers Auctioneers

Ten years ago, a fellow money manager recommended to me Ritchie Brothers Auctionneers (RBA), a Canadian company specialized in farm and industrial equipment auctions. A dull business if there is one! RBA gets a percentage on every transaction so their capital needs is quite low. The difficulty lies in the ability to built a strong reputation to attract a critical mass of buyers and sellers. Once that difficulty is surmounted, auctioneers can be a great business (we just have to think of the solidity of Christie's and Sotheby's).

I knew in 1998 that RBA a built a strong nice but I was worried that the farm and industrial equipment auctions would be a cyclical activity. So RBA's P/E of 15x seemed a little high at that time. During the recession of 2001-2002, the company did well and after that the stock continued to trade at high P/Es (sometimes in the high 20s). So far this year, RBA has held up fine.

So after 10 years of following from the stands – for a better price – we can look at the numbers since 1998: sales and earnings have increased three fold and the stock has quadrupled.

Gold Medal: Mastercard

In May 2006, Mastecard went public at $45 a share. I knew the company pretty well since we were shareholders of American Express since 1995 (although we have bought and sold the stock at a few occasions over the 14 year period). Mastercard is not as solid as Visa or AMEX but it is a good business that would do well as a newly independent entity. I knew that momentum was pretty good (because of their "priceless" ad campaign). And that margin expansion potential was high.

The stock looked a little high considering that the company earned $1.98 in 2005. But since I knew that margins could be improved, I should not have been too influenced by its high P/E.

I took the time to compare market shares, spending per card and profitabilites of all three most important card companies. I believed that AMEX had the best brand. But I also knew that Mastercard and Visa did not lend to consumers, as AMEX was. Mastercard and Visa were just transaction processors and that it was the banks that carried the loans on their books. The two companies just received a fee for their work. It is a pretty good economic model.

I considered reducing AMEX by half and acquire some shares of Mastercard. But I finally decided to keep all our shares of AMEX, believing the long term growth perspectives were better even if the sensibility to recessions was higher.

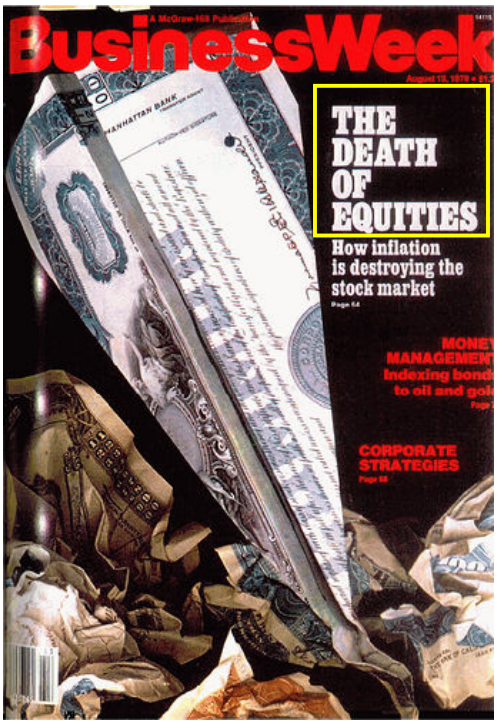
As noted above, today's recession has hurt AMEX a lot and the company had to increase its reserves for bad loans. Mastercard was immune to such charges. EPS in 2008 for Mastercard reached $9, a four and a half fold increase in three years. And the stock is up 200%.

Owning this stock in our portfolio would have been quite rewarding.

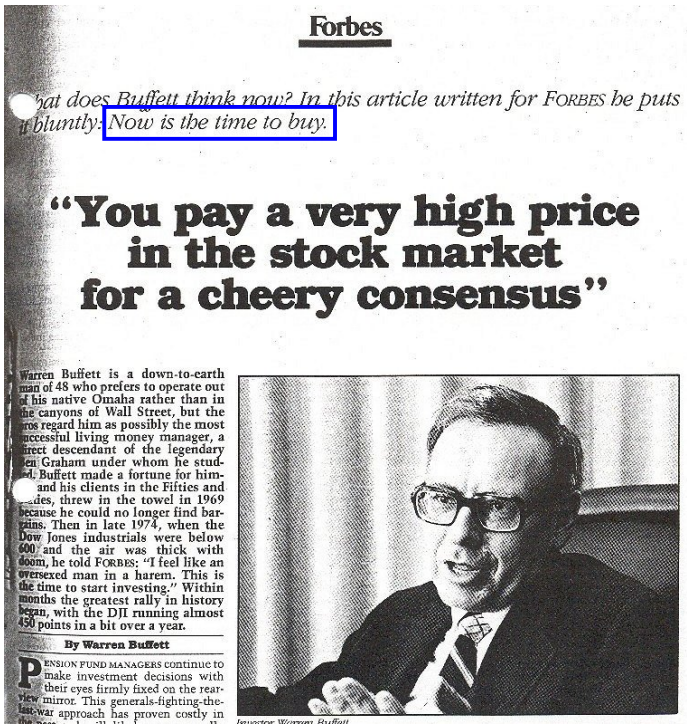
Conclusion : Warren Buffett recommends to buy stocks for the first time since 1979

By far, the best investor of all time is Warren Buffett. I have read everything I could find (past and present) about him. In only two instances in the past, Mr. Buffett had recommended to invest, with enthusiasm, in the stock market: in 1974 and 1979. Until this year.

In 1979, the stock market was depressed to a point that *Business Week* published its now famous edition entitled: "The Death of Equities". At about the same time, Warren Buffett published an article in *Forbes* entitled: "You pay a very high price in the stock market for a cheery consensus".



Source : Business Week (August 1979)


Forbes

...hat does Buffett think now? In this article written for FORBES he puts it bluntly: Now is the time to buy.

"You pay a very high price in the stock market for a cheery consensus"

Warren Buffett is a down-to-earth man of 48 who prefers to operate out of his native Omaha rather than in the canyons of Wall Street, but the pros regard him as possibly the most successful living money manager, a direct descendant of the legendary Ben Graham under whom he studied. Buffett made a fortune for himself and his clients in the Fifties and Sixties, threw in the towel in 1969 because he could no longer find bargains. Then in late 1974, when the Dow Jones industrials were below 600 and the air was thick with doom, he told FORBES: "I feel like an oversexed man in a harem. This is the time to start investing." Within months the greatest rally in history began, with the DJI running almost 450 points in a bit over a year.

By Warren Buffett

PENSION FUND MANAGERS continue to make investment decisions with their eyes firmly fixed on the rear-view mirror. This generals-fighting-the-last-war approach has proven costly in

Source : Forbes (August 1979)

In its 1979 article, Warren Buffett explained that it was not optimism but pessimism that was the friend of the true long term investor. That it is pessimism that creates the bargains in the stock market that lead to enrichment in the years to follow.

What has that market done in the following 10 years of these two articles (from 1979 to 1989)? A total return of 400% or 17% on an annual basis, one of the best decade in market's history!

Almost 30 years later, Warren Buffett wrote a similar article in the *New York Times* edition of October 17th 2008. He strongly urged investors that take advantage of the recession and the high level of fears that were (and still are) present in the stock market.

He was once again an aggressive buyer of stocks when others were selling!

To our partners

We are deeply aware of your vote of confidence in us and look forward to reward it in the years to come. It is imperative for us to not only select outstanding companies but also to have great stewardship in the managing of your capital. So we never let our emotions dictate our decisions, particularly during financial crisis.

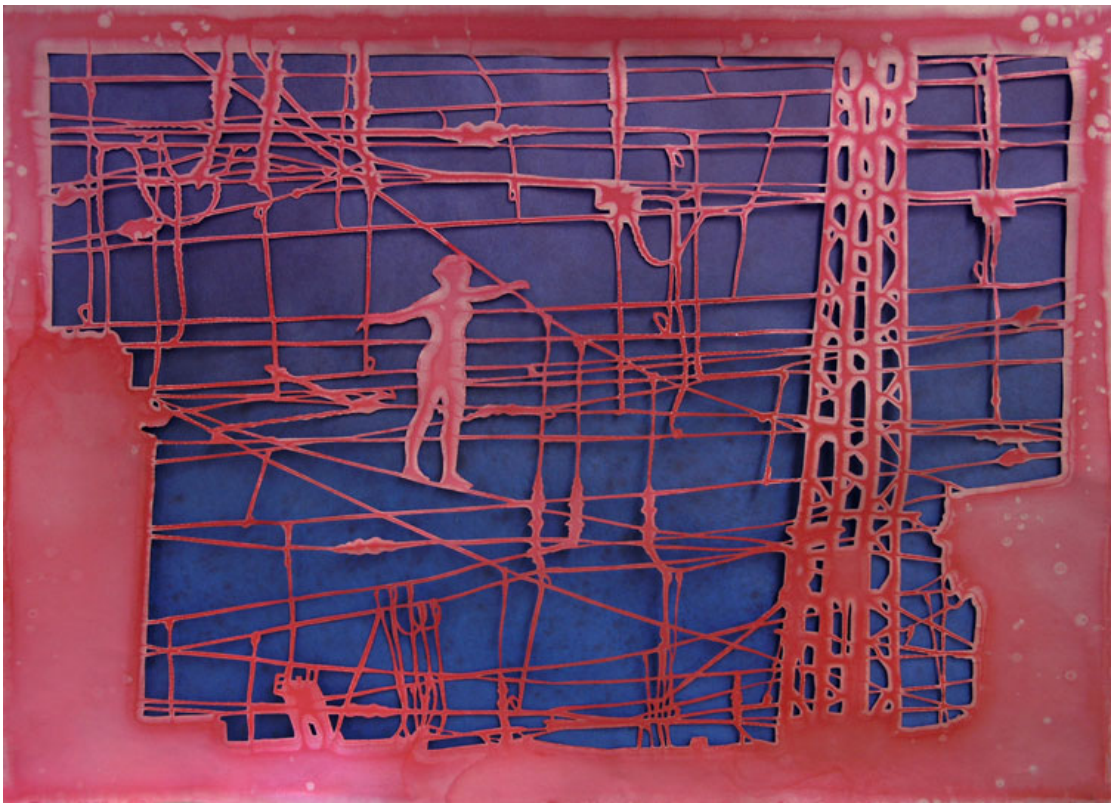
We wish all of our partners a great year 2009.



François Rochon and the Giverny Capital team

Giverny Capital Inc.

Annual Letter to our Partners
2009



Ed Pien
Girl on a wire, 2009
Giverny Capital Collection

Giverny Capital Inc. – 2009 Annual Letter ©

For the year ending December 31st 2009, our portfolio's return was 11.8% versus 12.2% for our weighed benchmark. Our annual return, which included a loss of approximately 16% due to fluctuations in the Canadian currency, was therefore 0.4% lower than our benchmark.

Since our inception, on July 1st 1993, our annual compounded rate of return has been 13.8% versus 6.7% for our weighed benchmark, or an annualized outperformance of 7.1% over this period. When we exclude the effect caused by the appreciating Canadian currency since our inception, which represents an annualized increase of 1.2%, our portfolio has returned 15.1% annually versus 7.9% for our benchmark. Our long-term (and ambitious) objective is to maintain an annual return that is 5% higher than our benchmark.

The Artwork on the cover of our Letter

We illustrate the cover of our letter with a copy of an artwork from our corporate collection since 2004. We chose the work of Ed Pien, a Canadian artist of Taiwanese descent, for this year's cover. The piece, titled "Girl on a wire", seemed the perfect representation of 2009 which was an emotion-filled year when investors felt as though they were walking a tightrope across what seemed, at times, like an economic ravine.

The Giverny Portfolio (in Canadian dollars): Returns Since July 1st 1993.

Return *	Giverny	Index **	+ / -	$ US/Can	S&P 500	+ / -	Giverny ***	Index ***	+ / -
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	3.3%	8.4%	**28.6%**	**34.4%**	7.4%	27.0%
1994	**16.5%**	3.7%	**12.7%**	6.0%	7.3%	**9.2%**	**12.0%**	-0.3%	12.3%
1995	**41.2%**	24.0%	**17.2%**	-2.7%	32.9%	**8.3%**	**43.8%**	26.3%	17.5%
1996	**28.0%**	22.8%	**5.2%**	0.3%	22.7%	**5.3%**	**27.7%**	22.5%	5.2%
1997	**37.7%**	28.6%	**9.2%**	4.3%	36.7%	**1.0%**	**33.4%**	24.5%	8.9%
1998	**20.6%**	18.8%	**1.8%**	7.1%	37.7%	**-17.0%**	**14.5%**	12.8%	1.7%
1999	**15.1%**	16.3%	**-1.2%**	-5.7%	14.1%	**1.0%**	**20.6%**	21.9%	-1.3%
2000	**13.4%**	3.2%	**10.2%**	3.9%	-4.6%	**18.0%**	**9.7%**	-0.2%	9.9%
2001	**15.1%**	-0.4%	**15.5%**	6.2%	-5.7%	**20.8%**	**9.4%**	-5.3%	14.7%
2002	**-2.7%**	-18.3%	**15.6%**	-0.8%	-22.0%	**19.3%**	**-2.0%**	-17.7%	15.7%
2003	**13.6%**	14.0%	**-0.4%**	-17.7%	5.7%	**7.9%**	**33.7%**	34.1%	-0.5%
2004	**1.6%**	6.2%	**-4.5%**	-7.3%	2.8%	**-1.1%**	**8.3%**	13.1%	-4.8%
2005	**11.5%**	3.6%	**7.9%**	-3.2%	1.6%	**9.9%**	**14.5%**	6.7%	7.8%
2006	**3.5%**	17.0%	**-13.5%**	0.2%	15.7%	**-12.3%**	**3.3%**	16.8%	-13.5%
2007	**-14.4%**	-12.0%	**-2.4%**	-14.9%	-10.0%	**-4.4%**	**-0.3%**	2.2%	-2.5%
2008	**-5.5%**	-22.0%	**16.5%**	23.1%	-21.7%	**16.3%**	**-21.5%**	-35.4%	13.9%
2009	**11.8%**	12.2%	**-0.4%**	-13.7%	9.6%	**2.9%**	**27.7%**	27.7%	0.1%
Total	**743.1%**	**191.1%**	**552.0%**	**-18.1%**	**179.2%**	**563.9%**	**924.9%**	**251.3%**	**673.6%**
Annualized	**13.8%**	**6.7%**	**7.1%**	**-1.2%**	**6.4%**	**7.4%**	**15.1%**	**7.9%**	**7.2%**

* Green section: all returns are adjusted to Canadian dollars
** Index is a hybrid index (S&P/TSX, S&P 500, MSCI EAFE, Russell 2000) which reflects the weight of the underlying assets
*** Estimated without the effect of currency

Note: Canadian dollar returns audited by PricewaterhouseCoopers

The Giverny US Portfolio

We have been publishing the returns of the Giverny US Portfolio, which is entirely denominated in US dollars, since 2003. The Giverny US Portfolio corresponds to the American portion of the Giverny Portfolio. In 2009, the Giverny US Portfolio realized a return of 28.7% compared to 26.5% for our benchmark, the S&P 500. This return and our benchmark are all in US dollars and include dividends paid during the year. Since its inception in 1993, the Giverny US Portfolio has returned 803.8%, or 14.3% on an annualized basis. During this same period, the S&P 500 has returned 239.5%, or 7.7% on an annualized basis. Our added value has therefore been 6.6% annually.

Year	Giverny US	S&P 500	+/-
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	37.6%	17.2%
1996	27.0%	23.0%	4.1%
1997	32.9%	33.4%	-0.4%
1998	11.0%	28.6%	-17.6%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-9.1%	20.4%
2001	8.1%	-11.9%	20.0%
2002	-4.4%	-22.1%	17.7%
2003	31.6%	28.7%	2.9%
2004	9.3%	10.9%	-1.6%
2005	12.5%	4.9%	7.5%
2006	3.3%	15.8%	-12.4%
2007	-1.7%	5.5%	-7.2%
2008	-24.3%	-37.0%	12.7%
2009	28.7%	26.5%	2.2%
Total	803.8%	239.5%	564.3%
Annualized	14.3%	7.7%	6.6%

Note: Giverny US returns audited by PricewaterhouseCoopers - S&P 500 returns comes from Standard & Poors

Giverny Canada Portfolio

We introduced a portfolio that is 100% focused on Canadian equities in 2007. This corresponds to the Canadian portion of the Giverny Portfolio. In 2009, the Giverny Canada Portfolio returned 28.2% versus 33.3% for our benchmark. Since 2007, the Giverny Canada Portfolio has returned 15.7%, or 5.0% on an annualized basis. During this same period, our benchmark had a loss of 1.8%, or a loss of 0.6% on an annualized basis. Our annual added value is therefore 5.6%.

Year	Giverny Canada	S&P/TSX	+/-
2007	19.7%	9.8%	9.9%
2008	-24.6%	-32.9%	8.3%
2009	28.2%	33.3%	-5.1%
Total	15.7%	-1.8%	17.9%
Annualized	5.0%	-0.6%	5.6%

Note: Returns audited by PricewaterhouseCoopers

Giverny International Portfolio

We introduced an international portfolio in 2008. This portfolio corresponds to the portion of the Giverny Portfolio that represents companies domiciled outside of North America. In 2009, the Giverny International Portfolio returned 12.9% versus 10.0% for our benchmark, the MSCI EAFE (adjusted to Canadian dollars). Since 2008, the Giverny International Portfolio has had a loss of 5.6%, or a loss of 2.9% on an annualized basis. The MSCI EAFE had a loss of 20.0%, or a loss of 10.7% annually, over the same period. Our annual added value was therefore 7.8%.

Year *	Giverny Intl	MSCI EAFE	+/-
2008	-16.3%	-27.3%	11.0%
2009	12.9%	10.0%	2.9%
Total	-5.6%	-20.0%	14.4%
Annualized	-2.9%	-10.7%	7.8%

* All returns are adjusted to Canadian dollars

Note: Returns audited by PricewaterhouseCoopers

2009: A Year in Review

We began our 2008 Annual Letter with a simple phrase: "The opportunity of a generation."

We wrote this in February of 2009 when the markets were freefalling to levels not seen since 1997. There were plenty of bargains and some of the world's best companies were trading at enormous discounts to their intrinsic values. We may never see these sorts of valuations again in our lifetime (except for maybe Jean-Philippe who, with his daily diet of kefir, is likely to live to 120).

During the first quarter of 2009, many of the companies in our portfolio were trading at a third, and in some cases, at a quarter of their intrinsic values. We invested every dollar we could find, our own as well as those of some of our courageous partners, into these bargains. The markets and our portfolio rebounded and our holdings rose nearly 28% for the year (12% when adjusted to Canadian dollars). This 28% return on the Giverny Capital Portfolio was slightly less than our corresponding benchmark due to the underperformance of three large holdings that spanned across our three portfolios: Berkshire Hathaway (US), MTY Food (Canada), and Nitori (International). Despite this underperformance in the stock prices of these holdings, it is important to note that these companies still had a good year in 2009 when we assess their progress in growing their intrinsic values.

The market's sharp rise since its March 9th bottom will not make us forget that 2009 was perhaps the worst year in economic history since the Great Depression of the 1930s. It was unthinkable just a few years ago that the aggregate revenue of all companies would drop by 20% in a single year. Never would we have heard chatter about a possible nationalization of the American banking system—the very foundation of the best capitalist society in history. The Irish banking system collapsed while the British banks, formerly the crown jewel of banking, struggled to survive. The stock markets in the BRIC (Brazil, Russia, India and China) tumbled between 55% and 75%.

I remember a conference last March where my longtime friend Bernard Mooney attempted to convince a skeptical audience that this was the time to invest in the market. Certain attendees were visibly hostile and shouted that this was the end of capitalism.

In the beginning of the year, many investors, including some of the most experienced, had a significant portion of their portfolio in cash and highly liquid investments, despite the fact that the return on these investment was essentially nil. For a short period of time, the return on US Treasury bonds was negative. Rarely, if ever, have we reached such a level of pessimism. At the bottom of the market, as we mentioned in last year's letter, there was enough liquidity in the US to purchase all the companies in the S&P 500. Still, there is little use having all this liquidity if you wait for an even lower level to buy into the market…

And at the end of the day, capitalism survived, the system did not collapse and those who were courageous to hold onto their shares were rewarded.

What lessons have been learned from the crisis of 2008-2009?

We find it helpful to read historical writings in times of pessimism in order to keep current events in perspective. Abraham Lincoln wrote in 1859:

> "It is said an Eastern monarch once charged his wise men to invent him a sentence to be ever in view, and which should be true and appropriate in all times and situations. They presented him the words: 'And this, too, shall pass away.' How much it expresses! How chastening in the hour of pride! How consoling in the depths of affliction!"

It is the nature of our civilization, for better or for worse, to have periods of both economic expansion and economic contraction. When we look at our scorecard, however, our civilization has made constant progress—progress towards a higher standard of living.

But one of the side effects of our system is that during periods of expansion, some participants try to hasten their journey towards greater wealth by using the lever of debt. This works for some time and the neighbor, who considers himself just as intelligent, concludes after considerable reflection: "Why not me?" This continues to work for a while… until a period of contraction presents itself, always without an official announcement. And those who were imprudent are punished. Unfortunately, during several quarters, all participants are punished whether they acted prudently or not.

Many people who have lost their jobs, for example, were forced to sell stock at abnormally low prices. But this wasn't the case for everyone. Those who have the opportunity to wait for better days should remain emotionally immune against market drops. Because, at some point, the market will rise and reach new heights as the upward human quest for progress return to its historical road.

Economists who attempt to predict such cycles and the market in the short term fail to realize that they need to keep track of several hundred million factors which are the several hundred million human beings who participate in this vast activity. What's involved here doesn't just entail tracking a dozen economic indicators. Such economists remind me of the scientists from a thousand years ago who simplistically separated all the elements into four: earth, water, air, and fire.

Here are the lessons we can draw from the crisis (note: some of these were principles already known):

- Everything that cannot rise forever will someday stop. This certainly occurred with the speculation on derivative products, technology stocks in 2000, American residential real estate

in 2005, Dubai real estate earlier this year, biotech companies in the early 1990s and with the price of oil in more recent years. These are just a few recent examples!

- It is the nature of things that with every economic cycle, some businesses disappear while new ones are born. This reminds us of the cycle of life here on Earth.
- Companies that went bankrupt all had faced a common pitfall: too much debt. The companies that withstand crises are most often the ones with solid balance sheets and with leadership that is prudent, trustworthy and devoted. Isn't this perfectly logical?
- Warren Buffett once said that investors should not be in the market if they are not willing to accept a temporary drop of 50% in the values of their portfolios. I always mention to our partners that that this was likely to happen once in their life as an investor—I knew it would happen but I didn't know "when".
- Many investors who were on margin at the beginning of 2009 were forced to sell at the worst possible time. An investor who uses margin to invest can do well for 30 years and then lose everything in a single day of irrational market movements.
- The irrationality of short-term market fluctuations makes derivative products extremely volatile (options, swaps, etc.) When many people try to sell these instruments at the same time, derivative products can become worthless overnight. When this is combined with leverage (debt), you end up with an explosive cocktail.
- The good news is that the market, as Ben Graham wrote 60 years ago, ultimately renders an accurate assessment of the intrinsic value of companies over the long term. To remain calm and rational in the face of wild fluctuations in stock prices is, beyond the shadow of a doubt, the most significant quality an investor can have or try to have.
- At the end of the day, in order to build wealth, there is a simple approach which we have followed for 17 years at Giverny Capital: investing for the long term in high-quality companies purchased at attractive valuations—investing in companies that will survive the crises of our civilization and the short-term irrationally of our economic system.

But even such a sound philosophy isn't enough to succeed in the market—another quality is necessary. In 1949, Ben Graham wrote the following in the conclusion to "The Intelligent Investor":

> "Have the courage of your knowledge and experience. If you have formed a conclusion from the facts and if you know your judgment is sound, act on it—even though others may hesitate or differ." (You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right.) Similarly, in the world of securities, courage becomes the supreme virtue after adequate knowledge and a tested judgment are at hand."

Review of the Decade

2009 wasn't the only difficult year in the last decade—quite to the contrary. The beginning of the decade started on a note of extreme overvaluations, particularly with technology stocks. The NASDAQ reached 5000 on March 6, 2000, a level not to be reached again anytime soon. Investing in the market, aside from a few sectors tied to natural resources, has not been a pleasant experience since. Over the course of the last 100 years, the last decade was the only decade when the S&P 500 actually lost value aside from the 1930s. The market that was highly overvalued in 1999 is one that became highly undervalued in 2009.

A significant number of companies disappeared almost overnight over the last decade (the corporate cemetery is full of companies formerly believed to be indestructible). Nevertheless, others were born

or reborn and became titans of industry within a few years (Google, Apple, Amazon, Intuitive Surgical, PetroChina, Tata Group, etc.) If there is one constant in the business world, it is change!

In the graph below, we can clearly see that the most important world indices experienced very modest gains over the last decade, well below their average 10% annualized returns. The market returns were further weakened by an additional 3% annually due to the strengthening Canadian dollar over the last 10 years. The Loonie climbed from $0.69 to $0.95 over the decade.

Out of the markets in the West, Canada was one of the only markets to counter this trend, with an approximate annual return of 5.6%. It is worth noting, however, that Canada only represents 3% of the world economy. While Canada benefited from its high concentration in natural resources over the last ten years, it is also important to consider that Canada is well behind many countries in terms of productivity and innovation in knowledge-based industries such as technology and medicine.

Decade 2000-2009	Annualized Returns	In $CAD
MSCI World	0.2%	-3.0%
UK	0.9%	-2.4%
Japan	-5.7%	-7.8%
US	-1.0%	-4.1%
Average	-2.3%	-5.3%
Canada	5.6%	5.6%
Giverny Global	**7.2%**	**4.4%**

The holdings in the Giverny Global Portfolio had an annualized return of 7.2% which outperformed our benchmark by over 6% on an annualized basis. In Canadian dollars, our annualized return was 4.4%. We are confident that the intrinsic value of the companies in our portfolio increased at a much higher rate than their average annual market performance of 7%.

We also believe that the current level of the Canadian dollar is higher than a level that would be in line with purchasing power parity between the Canada and the US (which would be around $USD 0.84). We are therefore confident that the appreciation of the Loonie since the year 2000 is unlikely to continue to such a degree (if any) in the next decade.

We can conclude that the next decade is likely to differ sharply from the preceding one in terms of returns, for both world indices as well as our portfolio.

Owner's Earnings

We do not evaluate the quality of an investment based on short-term stock quotations, but instead, take the perspective of ownership in the companies in which we invest. As such, we analyze the growth in earnings for our companies and study their long-term prospect.

Each year, we present to you a chart indicating the growth in the intrinsic value of the companies in our portfolio using a method created by Warren Buffett: owner's earnings. This enables us to estimate

the intrinsic value of our companies by adding the growth in earnings per share and the average dividend yield of our portfolio.

The intrinsic value of our portfolio companies remained flat for 2009. This is nothing to write home about but we are satisfied given the extremely challenging economic environment.

The market value of our companies, according to the stock quotes provided by the market, increased 28% in 2009. This increase in market values made up some of the lost ground in terms of the relative difference between intrinsic value and market value that had developed over the last several years.

	Giverny			S&P 500		
Year ***	Value *	Market **	Difference	Value *	Market **	Difference
1996	14%	29%	15%	13%	22%	9%
1997	17%	35%	18%	11%	31%	20%
1998	11%	12%	1%	-1%	28%	29%
1999	16%	12%	-4%	17%	20%	3%
2000	19%	10%	-9%	9%	-9%	-18%
2001	-9%	10%	19%	-18%	-11%	7%
2002	19%	-2%	-21%	11%	-22%	-33%
2003	31%	34%	3%	15%	28%	13%
2004	21%	8%	-12%	21%	11%	-8%
2005	14%	15%	0%	13%	5%	-8%
2006	14%	3%	-11%	15%	16%	1%
2007	10%	0%	-10%	-1%	6%	6%
2008	-3%	-22%	-19%	-30%	-36%	-6%
2009	0%	28%	28%	3%	27%	23%
Total	386%	344%	-42%	79%	132%	53%
Annualized	12%	11%	-1%	4%	6%	2%

* Estimated growth in earnings per share plus dividend yield
** Market performance, inclusive of dividends
*** Results estimated without consideration of currency fluctuations

Since 1996, according to our calculations, the intrinsic value of our companies has increased by 386% (nearly a fivefold increase) while their stock prices have increased by 344%. In the long term, despite the ups and downs of various economic cycles, the stock prices of companies will follow the growth in earnings per share of their underlying businesses fairly closely.

It should be noted that our stocks outperformed the S&P 500 since 1996 (by about 5% annually) for the primary (and simple) reason that their underlying businesses outperformed the S&P 500. It is in this manner, rather than through any speculation on market quotations, that we intend to continue meeting our objective of outperforming the market.

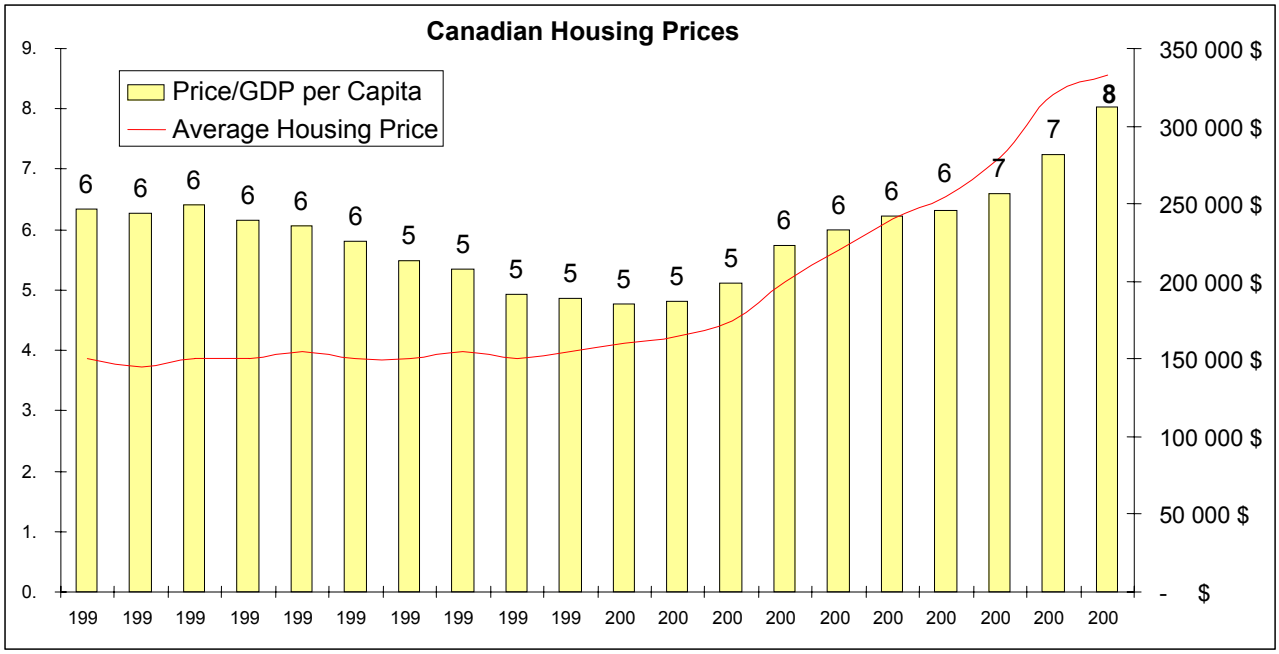
The Flavor of the Day for 2009: Canadian Residential Real Estate

We are asked regularly about the current flavor of the day—in other words, what we should avoid. After technology stocks in 1999-2000 and natural resource stocks in the last couple of years, the segment of the market which we consider alarming is the Canadian residential real estate market.

Warren Buffett likes to say that there is no greater sedative than money easily made. While Canadian residential real estate has been a tremendous source of wealth since 2000, those with a longer memory will recall that real estate prices didn't move one iota during the preceding decade. So, the first phase of this increase is a simple "catch up" on the price of the intrinsic value of a home (typically tied to disposable income per capita). Like all assets linked to supply and demand, a sharp increase often creates its own momentum which leads to a second phase of an increase when fundamentals can be left behind in favor of speculation.

The beauty of the capitalist system is that its invisible hand always ultimately equilibrates prices—each exaggerated rise is therefore followed by a readjustment. This occurred during the most recent recession in the US as well as nearly all countries in Europe. The decrease in the US was of a magnitude not seen since the Great Depression (-30%), with enormous consequences on the overall economy.

Canada, to this day, has avoided this readjustment in prices—with the reason seemingly more rooted in politics rather than economics. The federal government strongly encouraged banks to continue lending with the assistance of the Canadian Mortgage and Housing Corporation (CMHC) to support borrowers. Canadian consumers, boastful about the fact that housing prices had not fallen, continued to spend and even, in some cases, considered themselves immune to the global recession. Housing prices continued to rise.



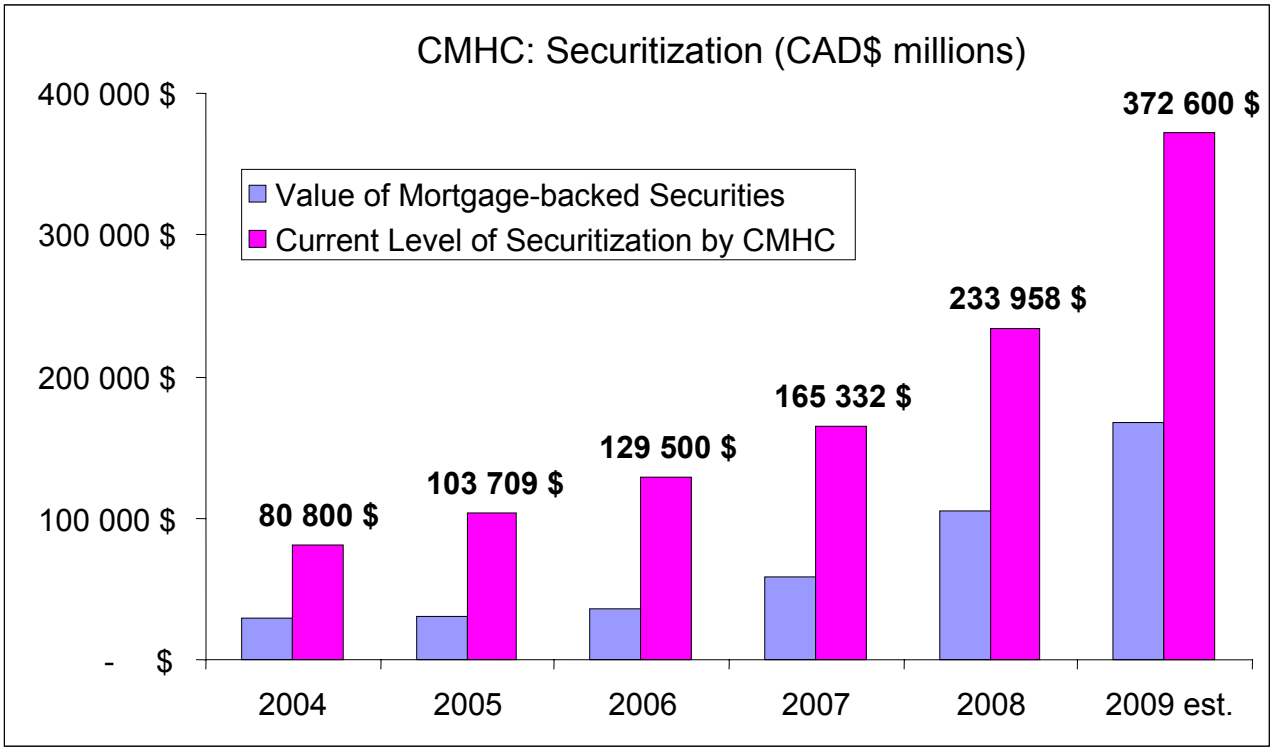
Source: Giverny Capital Inc.

We can see that the average price of a home sold in Canada reached $333,000 in 2009. If we look at this number through the lens of GDP per capita, this is a ratio of 8:1. The historical average for this ratio is 6:1. We conclude that current prices are roughly a third higher than their historical prices, especially in western Canada.

In the US, during the great real estate bubble, a large portion of mortgage titles were transferred from banks to the quasi-governmental agencies, Fannie Mae and Freddie Mac. These mortgage titles were subsequently securitized and sold on secondary markets. When housing prices collapsed, the

American government was forced, in order to save the system from floundering, to take over Fannie and Freddie and the billions of dollars in securitized mortgages that they stood behind.

Back in Canada: in order to counter the recession, the federal government decided to encourage the CMHC to increase its level of involvement in residential mortgages. The CMHC therefore increased its level of mortgage securitization and, with the seal of approval from the federal government, had no problem finding eager buyers thirsting for guaranteed fixed rate investments. From 2007 to 2009, in only two years, the total for securitized mortgages supported by the CMHC ballooned from $CAD 165 billion to $CAD 373 billion.



Source: 2008 CMHC Annual Report

This financial commitment on the part of the CMHC is a significant potential liability on the part of the Canadian federal government—and I think we all know who could end up with the bill. Canadian banks do not hesitate to provide loans to home buyers since they know that the CMHC is essentially guaranteeing a significant portion of the loan. Fueled by low interest rates and accessible money, Canadians continue to buy houses at ever-increasing prices. Here's how we summarize the situation:

- Canadian housing prices in relation to GDP per capita is at a record level
- Mortgage rates are at rock-bottom levels (many are able to borrow at 2%) which means that mortgage payments are abnormally low in relation to the cost of homes.
- Money is easy to borrow, thanks to the CMHC which repackages these debts and resells them to people looking for a savings vehicle.
- The percentage of equity to assets at the CMHC has dropped from 4.2% to 2.8% over the last five years.
- Home buyers are convinced that the price of their homes will never drop. Real estate is somehow viewed as an investment without risk. Our general experience in the markets tells us that real risks are at their apex when they are perceived to be at their low point.

No one knows the future and we are the last to want to play the prophets of doom. We just happen to believe that housing prices are high, especially in the west and in Ontario, and that these artificially high levels seems to us propped up by political rather than economic arrangements. We keep this in mind and our investment decisions are affected accordingly.

There is, of course, many non-financial advantages to owning your own home. There is no doubt that home ownership is a source of great personal fulfillment for human beings—and, in the long term, housing prices will continue on their upward movement. But it is important to realize that all the ingredients are in place for potentially several years of difficulty as prices are readjusted in this segment of the Canadian economy.

Our Companies

"Character: the virtue of hard times."

- Charles de Gaulle

In another year of recession, many of our companies have seen their earnings stagnate or decrease. Yet, like last year, some of our companies also achieved a veritable tour de force and increased their earnings. But, even more importantly, the majority of our companies continued to widen their competitive moats relative to their competition.

Wells Fargo (WFC, $27)

Wells Fargo ended 2009 on a strong note. Its acquisition of Wachovia in 2008 has so far proven quite profitable and the company's interest margin of 4.3% was more than 1% higher than that of its peers. The bank's profit before bad debt reserves reached $40 billion—more than double the $19 billion from 2008. The company has benefited from the recession and double its size at a reasonable cost in terms of dilution.

We believe that within a couple of years, once the recovery is well underway, that Wells Fargo should have roughly $1.5 trillion in assets. If the company is able to maintain a return on assets of 1.4%, this would translate into earnings per share (EPS) of approximately $4.50. We therefore believe that this stock could reach $60 within a couple of years and consider the possibility for stock appreciation at Wells Fargo as excellent.

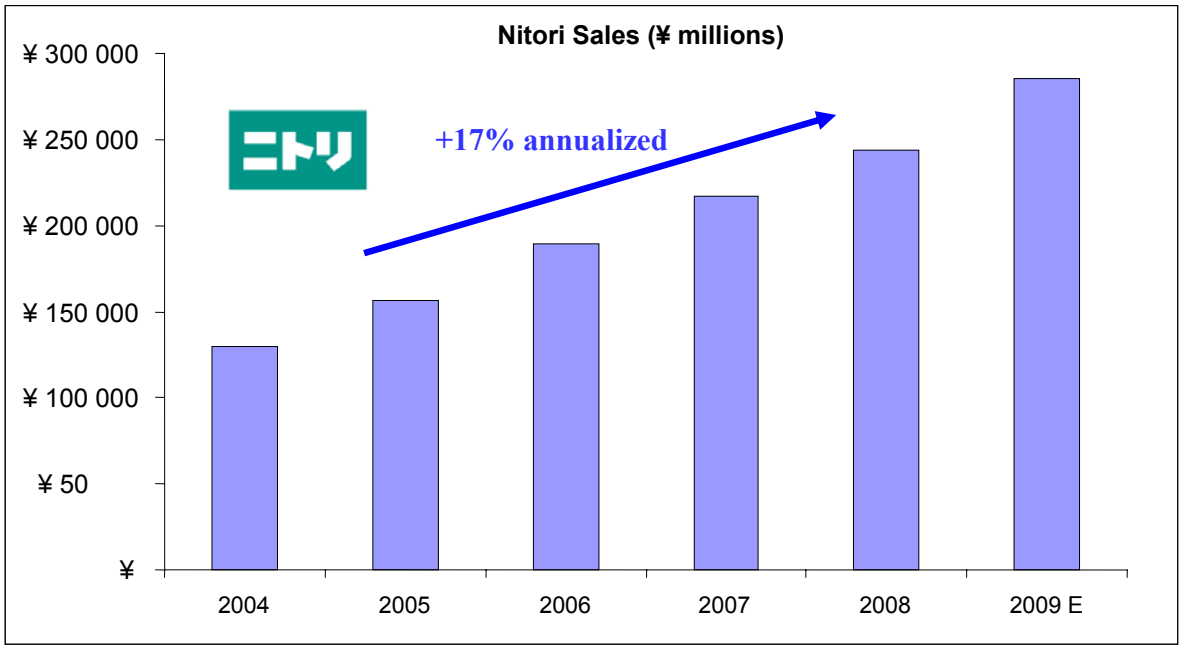
Astral Media (ACM.A-T, $33)

Astral Media had an excellent year in 2009 despite weakness in the sale of TV and radio advertising. The company still increased net income by 7% which we considered very positive. Astral also substantially reduced its debt which had been necessary to complete the acquisition of Standard Radio two years ago. Astral also launched a number of new brands such as HBO Canada, Teletoon Retro and NRJ. We admire this outstanding Canadian enterprise and its founders, the Greenberg family.

We believe that the company's stock is trading at a level that does not accurately reflect the value of the business.

Nitori Co. (9843-Tokyo, ¥ 6930)

Nitori is a Japanese company in the home furniture retail market. The company's products are sold under a low-price policy that has enabled it to gain market share during these difficult times.



Nitori increased sales by 17% in 2009, reaching nearly ¥300 billion, and its profits increased 30%. Strangely, the company's stock price didn't budge during the year. In fact, since our purchase two years ago, the company's earnings have increased 60% while the company's stock has only risen 15% on the Tokyo market (in addition, the Yen has appreciated by roughly 25% against the Loonie since our purchase).

We are optimistic about the future returns of Nitori's stock price, not only because of the rise in the company's intrinsic value but also from the market assigning a greater multiple on the company's earnings.

Omnicom (OMC, $39)

It was a difficult year for marketing and advertising companies. Omnicom's earnings decreased 20%, although the company's stock price has still advanced 40% since our purchase.

A significant portion of advertising dollars is spent by auto companies and we don't need to remind anyone that these companies had a horrible year. Large agencies like Omnicom are also facing more and more competition from young dynamic firms as well as from new distribution channels. Nevertheless, we believe that the major players in this industry (Omnicom, WPP, Publicis and Interpublic) remain excellent businesses providing an essential service. These businesses also require very little incremental capital—and that's the type of economic model we like to own.

We consider Omnicom to be the best and most geographically diverse out of all the major advertising firms, with more than half of its revenue from outside the US

Bank of the Ozarks (OZRK, $29)

Our small bank in Little Rock, Arkansas, has yet again performed well despite the great difficulties of the American banking industry. Although assets decreased 14%, net interest revenue climbed 19%. While the bank had to significantly increase its bad debt reserves, like its peers in the industry, the company was able to compensate for its bad debt write-offs through investment gains (which was also a factor in the decrease of its assets). At the end of the day, profits rose 7% in 2009 and the bank's efficiency ratio reached an exceptional level of 38%. Its return on assets was 1.23% and its equity to asset ratio rose from 7.8% in 2008 to 9.7% in 2009. We believe that the company's balance sheet is stronger than last year.

George Gleason, the CEO, is also the type of leader we like to have as a partner.

Berkshire Hathaway (BRK.B, $3286)

The company led by Warren Buffett had an excellent year in 2009. The company's intrinsic value increased approximately 20% (using Berkshire's book value as a measure). The company's insurance division (General Re, GEICO, etc.) experienced a 40% decline in underwriting profits while its float increased to $62 billion. Berkshire's public utility division (MidAmerican Energy Holdings) also generated lower profits. The other divisions, as a whole, saw their profits drop by half. Even Buffett's companies are not immune to recessions but, as he often reminds shareholders, what matters most is that Berkshire's companies continue to increase their competitive advantages during these times.

The drop in profitability at Berkshire's companies was offset by gains in the investment portfolio. In the fall of 2008, Buffett invested approximately $21 billion in new securities which have thus far appreciated by $5 billion and generated another $2 billion in dividends and interest. At the end of 2009, the most important news on the acquisition front was the purchase of Burlington Northern Santa Fe. We'll come back to that in the conclusion of our letter.

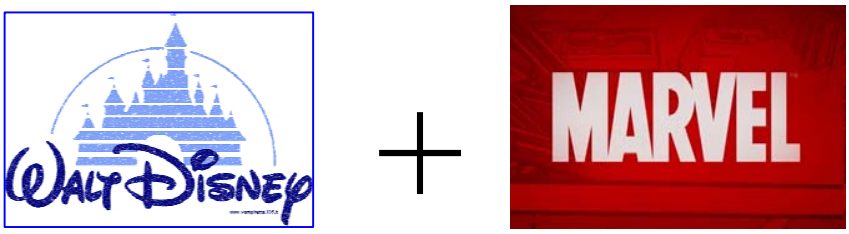
Our view is that shares of Berkshire Hathaway, like the majority of our portfolio holdings, are undervalued by the market.

Disney (DIS, $32)

Disney had another good year. Net income per share decreased 6% from 2008—an impressive performance given the circumstances of the recession. The company finished the year on a strong note, with net income for the December quarter rising 15%.

Bob Iger, the talented CEO of Disney, continued his great work. In 2009, he announced the acquisition of Marvel, the company which owns the rights to a vast array of comic book superheroes (Spider-Man, Iron Man, Hulk, etc.) Marvel has performed extremely well in the last several years due to the onset of new digital technologies that have enabled the company's characters to come to life in a spectacular manner.

The synergy between Marvel and Disney seems self-evident. Like Mickey Mouse or the Lion King, Spider-Man and Iron Man are enduring characters with the profits they generate accruing to their owner: the company. One of the benefits of a company like Disney, as a former CEO used to say, is that "Mickey has no agent." Disney is well positioned to optimize the commercialization of the new cast of Marvel characters, as it has done so well with its own animated superstars.



Disney's stock had a good year in 2009 and rose almost 40%, from $22 to $32. It is worth noting that this stock dropped to as low as $16 in March of 2009. We did everything we could to find every possible dollar to increase our stake in this outstanding company which very seldom trades at such a bargain price. We will not see Disney trading at eight times earnings very often!

American Express (AXP, $41)

Despite a difficult 2009, the outlook for AMEX has been improving. Write-offs on credit card debt have begun to ease and we are confident that the company's profits will strengthen and revert more closely to their historical mean in 2010.

American Express has more than a century of operating experience and a legendary brand. Yet, none of this helped prevent an extraordinarily volatile year for the company's stock. From a high of $65 in 2007, the stock tumbled to a low of $10 in March of 2009, only to the end the year at $41. We estimate EPS of $2.66 for 2010 and a return to the profitability of 2007 ($3.37 per share) is conceivable for 2011 or 2012.

We have been shareholders of American Express since 1995. Since then, the stock has appreciated 300% or 10% on an annualized basis. If we include dividends as well as the additional shares we received after the spin-off of Ameriprise, the stock has returned around 12% annually. This is roughly 5% more than the S&P 500 over the course of the same period. So, despite its ups and downs on the market, this has been a worthwhile investment.

Microsoft (MSFT, $30)

Microsoft had a strong finish to 2009, bolstered by the launch of its new operating system, Windows 7. During the last quarter of the year, sales of Windows 7 licenses reached 60 million which is a record for a new operating system. Revenues increased by 4% and net income rose by 28%. The company has a bright outlook for 2010.

This stock continues to appear undervalued to us. The company has $43 billion in cash (equivalent to almost $5 per share) and should earn close to $2.15 per share in 2010. So, at the current price, we are only paying 11 times earnings for a rock-solid and dominant business.

Resmed (RMD, $52)

We first purchased shares in Resmed in 2003. The company, started in Australia, specializes in medical products aimed at the sleep apnea market (primarily masks and humidifiers). Sleep apnea is not a minor medical condition, as it can lead to serious cardiovascular problems, and Resmed has played a significant role in educating the population about sleep apnea. This segment of the medical devices industry has been experiencing rapid growth.

Resmed had another good year in 2009, with an 18% increase in revenue along with a 41% increase in earnings. Reimbursements for sleep clinic studies were approved by Medicare in 2008 which helped increase knowledge of the health concerns related to sleep apnea. The company also brought to market several new products in 2009, including a gel-based mask (Mirage SoftGel) and the company's growth potential remains strong.

Martin Marietta Materials (MLM, $89)

2009 was a difficult year for Martin Marietta Materials. The volume of aggregates (gravel) sold fell 23%, which was only partially offset by a 2% increase in prices. Despite a 50% drop in earnings, free cash flow fell by only 8%. The company increased its dividend and reduced its long-term debt while also lowering its cost structure to 1997 levels.

The prospects for 2010 seem better for two of the company's segments: infrastructure and residential construction. Only 15% of the budget allocated for infrastructure projects under the economic recovery measures passed by the American government was actually spent in 2009. Commercial construction, on the other hand, seems likely to continue struggling in 2010 and should offset some of the gains made on the infrastructure side.

We believe that Martin Marietta Materials, in the long term, is very well positioned to profit from an economic recovery and we are confident that its competitive advantage as a business remained intact during the recession.

Mohawk Industries (MHK, $48)

Mohawk, our flooring covering products company, experienced a very difficult year. Earnings tumbled by half due to a combination of the slowdown in commercial real estate along with a weak residential construction market. Despite these challenges, Mohawk remained profitable and the company's balance sheet strengthened through lower inventory levels which bolstered its cash position. We are also beginning to see some early signs of improvement (at last) in residential construction.

Mohawk's stock is trading at six times the profits it earned during the last cycle and we see great potential for the stock's appreciation once a recovery is underway. We also know that Mohawk is in good hands under the leadership of Jeff Lorberbaum. We remain patient with this solid business despite the current headwinds in this sector.

5N Plus (VNP-T, $6)

5N Plus, a young and dynamic Quebec-based business, is a global leader in the purification of metals used in photovoltaic solar panels. Its primary product is purified Tellurium used by First Solar in its solar panels. These panels are considered more economical than those made from Silicon and are gaining market share.

The company had a strong start to 2009 and then experienced some challenging quarters in the last part of the year. Revenue and order backlog stopped growing while gross margins decreased upon the renewal of the First Solar contract. With 80% of 5N's revenue tied to First Solar, we see this as both a weakness and a strength for the company: strength in the fact that First Solar is probably the most solid

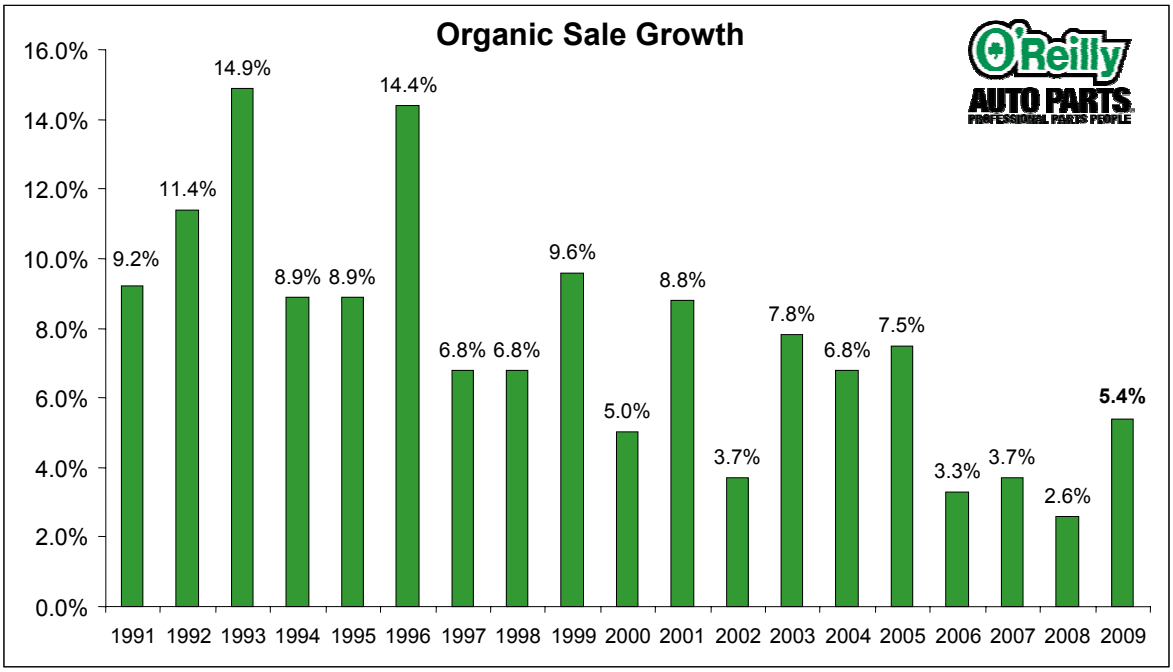
company in the industry, and weakness since relying too heavily on a single customer is never an ideal situation. 5N made an acquisition late last year which should help reduce its dependence on First Solar in the future.

We believe that the current stagnation in the photovoltaic solar panel industry is temporary and that we are in the very nascent stages of the solar energy business. We therefore see a bright future for panels made by First Solar with the help of 5N.

5N Plus remains highly profitable and has a pristine balance sheet with no debt and $69 million in cash. We also have high confidence in the company's management.

O'Reilly Automotive (ORLY, $38)

We acquired shares in O'Reilly Automotive, one of the largest retailers of auto parts, five year ago. At the time, the company had 1250 stores and we paid $20 when the company was earning $1.12 per share. The company nearly tripled its number of stores, to 3421 in 2009. Approximately 800 of those stores were from organic growth while 1400 were from acquisitions (primarily CSK Auto). Organic sales growth has been excellent:



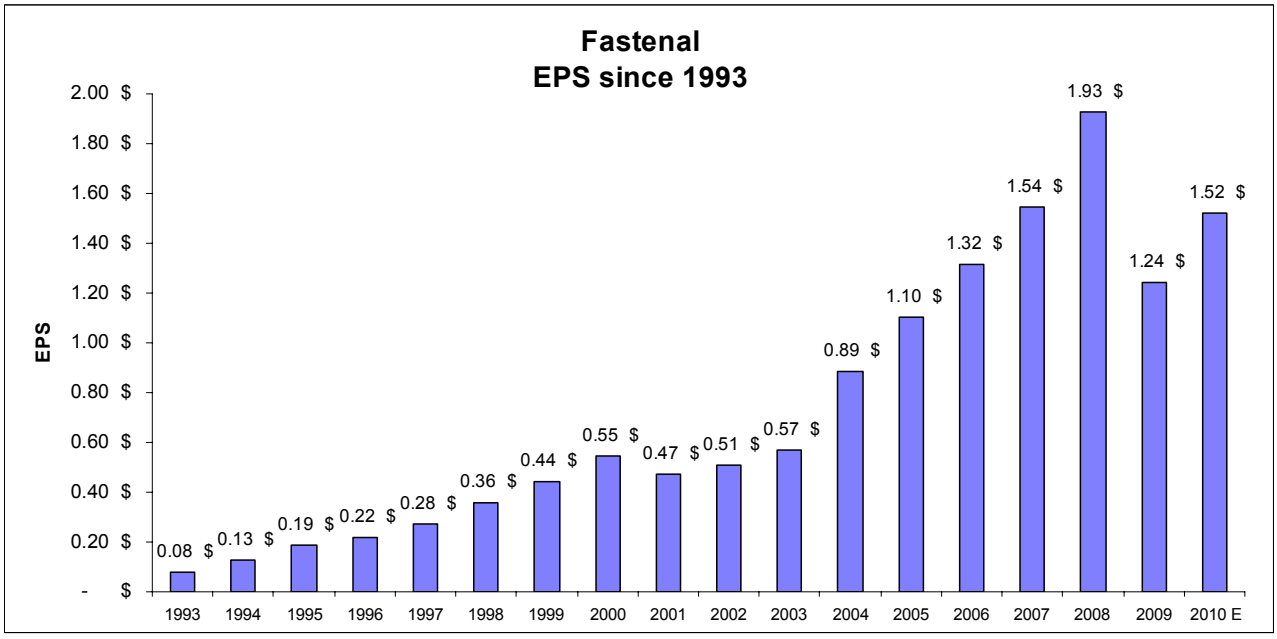
O'Reilly's revenue climbed 36% to $4.9 billion in 2009 and net income per share reached $2.26—38% higher than in 2008 and double what the company earned five years ago. The company's stock price rose to $38 during this period, which almost perfectly parallels its growth in earnings. We remain highly satisfied with this investment.

Fastenal (FAST, $42)

We have been shareholders in Fastenal for more than 11 years and have been handsomely rewarded by this terrific business based out of Winona, Minnesota. We first bought shares in the company in 1998 for approximately $5 per share (adjusted for splits). At the time, while the Asian financial crisis was

raging, the market offered us a great opportunity to buy shares in this outstanding company at a compelling price. Fastenal earned $0.35 per share in 1998 and earned $1.91 in 2008—a 450% increase in ten years (or 18% annually).

In 2009, however, revenues declined 17% while net income decreased by 35% to $1.24. Fastenal's stock price still increased from $36 to $42, though most of that increase was likely tied to a readjustment from the steep decline the stock experienced in the fall of 2008 when expectation for future profitability were lowered significantly. The current level of the stock price still corresponds to more than eight times our original cost.



In January 2010, the company announced a 2% sales increase—the first since November 2008. This bodes well for 2010. We have high confidence in the leadership of Willard Oberton and the future outlook for Fastenal remains excellent.

Morningstar (MORN, $48)

All in all, Morningstar had an acceptable year. Revenues dropped by only 5% while EPS declined 11%. We are using the word "only" since Morningstar provides information to the financial services industry and it is fair to say that this universe has cooled considerably in the last years.

The company has attempted to benefit from this cooling off by completing no less than six acquisitions in 2009, including four outside the US. We enjoy using the tools provided by Morningstar for our own work and are admirers of the company's CEO, Joe Mansueto. We have only a small position in this company for the primary reason that its valuation still looks a little high.

Knight Transportation (KNX, $19)

The trucking industry had to yet again navigate through a number of challenges in 2009. Nevertheless, Knight remained profitable. Revenues (net of gas surcharges) were flat while EPS fell by 10%. The

company's efficiency ratio was 86% (costs over revenues), which is more than 10% better than the industry average.

Knight's balance sheet remains debt-free and the company finished the year with $96 million in cash, even after paying its dividend and repurchasing some of its own shares. Knight's stock price, to our astonishment, has remained flat throughout this recession and during the sharp decline in the markets. So, on a relative basis, it is fair to say that Knight is not as attractively valued as other businesses in our portfolio.

MTY Food Group (MTY-V, $9)

MTY Food, a Quebec company that owns restaurant franchises, had an exceptional year in 2009. The company's revenues rose 51% while adjusted EPS increased 32%. The company made three acquisitions: Tutti Frutti, Taco Time, and the most significant, Country Style. The company now operates 570 restaurants under 25 brands.

MTY Food has several attributes that characterize the majority of our companies:

- It owns several excellent brands.
- The nature of its business is unexciting and therefore attracts little competition.
- It has no debt on its balance sheet, has strong returns on its capital, and generates lots of cash.
- The company's leader, Stanley Ma, is brilliant, disciplined and totally dedicated to shareholders.

Further, the company's stock is trading at only ten times its estimated profits for 2010. Our experience prevents us from being blindly optimistic towards all investment in the market, but we would admit that we are very enthusiastic about owning shares of MTY Food.

Carmax (KMX, $24)

We didn't expect Carmax to have a record year in terms of profitability in 2009. Despite another difficult year for auto sales, earnings were bolstered by a return to profitability at the company's financial division. Carmax's EPS reached $1.15, a 25% increase from the prior record of $0.92 reached in 2006.

Carmax has 33% more stores than it did in 2006 (up to 100 stores) and only has 2% of the used car market. The company's long term growth prospects remain impressive.

New Investments in 2009

M&T Bank (MTB, $67)

M&T Bank isn't really a new holding for us. Quite to the contrary: we first purchased shares in the company at around $40 in 1998. Then, in 2007, we nearly sold our entire holding at $100 and held on to a very small (symbolic) position. Since our first criteria when purchasing stock in a company is the quality of management, we were less than enthusiastic when Robert Wilmers retired and new management took over M&T. We view Bob Wilmers as a living legend of the banking world and he was our primary reason for our 10-year stake in this Buffalo-based bank.

Bob was brought back to the helm of M&T following the crisis. We went to meet him in August of 2008 and came back reassured about M&T's prospects. We again became buyers of the stock when it dipped below $40 in the beginning of 2009. We paid an average of $38 per share—a price we considered approximately a third of the company's intrinsic value.

While earnings decreased 34% in 2009, we remain satisfied with these results given the economic climate. M&T profited, as we anticipated, from the debacle in the banking sector by taking market share at low costs. The bank acquired branches from Bradford Bank and also acquired Provident Bankshares, both based in the Baltimore-Washington market. These acquisitions helped M&T grow its asset base by 10%.

The company's shares performed very well and rose to $67, or an appreciation of 76% from our purchase price from about a year ago. We are very pleased to have partnered with Bob Wilmers again and are confident that there are several excellent years ahead for M&T.

China Fire & Security Group (CFSG, $14)

When the Chinese market crashed in the beginning of 2009 by dropping 75% from its high, we decided to look for companies that met our investment criteria. We studied many businesses but found that most were too young and only had a limited track record to analyze.

CFSG seemed to us as the most interesting. The company sells unexciting products: fire detection systems mostly used in steel mills. CFSG became the leader in this niche market with 7% of the market and we were also optimistic about the Chinese government having passed safety regulations mandating that steel mills adopt higher safety standards. The company's revenue had grown at 40% annually for five years.

We paid roughly $10 per share when we first purchased stock in early 2009. When adjusting for a net cash position of $1 per share, we ended up buying shares at a P/E ratio of 9! This looked as a very low valuation for such a fast growing company. Lately, CFSG obtained several large contracts and we decided to increase our holding. Despite a 40% increase in the price of its shares, the company's forward P/E ratio has remained the same as when we first bought shares of CFSG.

Buffalo Wild Wings (BWLD, $40)

It was back in 2007 when Jean-Philippe spoke to me, with great enthusiasm, about a young American restaurant chain similar to our popular Quebec chain, the "Cage aux Sports". We took the opportunity, while visiting M&T Bank in Buffalo, to go have lunch at Buffalo Wild Wings (why not eat while doing out financial research at the same time?) Their chicken wings are excellent by the way.

Although we liked their wings, it's the numbers that convinced us! The company has grown rapidly since its IPO at the end of 2003, with the number of restaurants rising from 245 to 660 and revenues quadrupling. The company is highly profitable, earning $31 million on $275 million in assets (which includes $50 million in net cash).

In 2009, a tough year for the industry, EPS climbed 24% and the company is confident that they can maintain growth of 15-20% for several years. We therefore decided to take a stake in this young and dynamic company from Minneapolis.

Medtronic (MDT, $44)

It was pure coincidence that another portfolio purchase from the end of 2009 was Medtronic, also based in Minneapolis. Medtronic is the largest manufacturer of medical products addressing cardiac problems (pacemakers, valves, defibrillators, etc.) Long-term partners of the firm will remember that we have already been shareholders in companies within this industry: Cordis (acquired by Johnson & Johnson in 1995) and St-Jude Medical which we owned from 1993 to 1996. I've been following Medtronic for more than 16 years now.

Over the course of the last several years, Medtronic has been diversifying their product mix into ancillary markets such spinal health and diabetes (with insulin pumps, glucose meters, etc.) The company's products address vital medical problems that will continue to grow as Western populations continue to age. Like many of our businesses, Medtronic has a significant portion of its revenue originating outside of North America.

The company has maintained its high level of growth by consistently leading the market with innovative products. Medtronic also has a solid balance sheet. What held us up in the past from buying a stake in this company was the high valuation that the market assigned to this superb business. The market's optimism reached its apex ten years ago when the stock reach $60 as the company was only generating $1 per share in earnings. We were able to purchase shares at $43 lately, which is 13 times the estimated EPS of $3.44 for 2010.

Five-year Post-mortem: 2004

Like we do every year, we go through a five-year port-mortem analysis. We believe that studying our decisions in a systematic manner, and with some hindsight, enables us to learn from both our achievements and our errors.

In the beginning of 2004, we bought shares in Knight Transportation at around $10 per share. With the stock at $19 today, this investment turned out to be a good one. Knight has performed better than just about everyone in the trucking industry, including Heartland Express (the company closest to Knight in terms of productivity). It seems that our competitive analysis of the industry was accurate.

Yet, we are still a bit disappointed with this investment since the company's growth rate, which was around 26% at the time of our purchase, dropped sharply during the recession. This is normal given the circumstances but we would have liked to see the company be more opportunistic about their growth given the numerous expansion opportunities available these days. We are nonetheless confident that the next economic cycle will offer us a better litmus test to judge the quality of this investment.

In a completely different line of reasoning, in our "Mistake du jour" section for 2004, we awarded ourselves a gold medal for selling Yahoo! at $8 when it subsequently climbed to $38. There are some interesting conclusions to be drawn, given that the stock is currently trading at $15 and that the company seems to have lost much of the competitive advantages I had mentioned back in 2004.

The first observation is that competitive advantages in the technological world are rare and often not durable. The rapid progress in technology, while delightful to consumers, is rarely a source of riches for shareholders. Yahoo! lost a good portion of its competitive advantage in 2004 to another business that went public that year: Google.

We learned to consider it dangerous to judge the merits of an investment too quickly. Years, many years, are often necessary to reach a valid conclusion. Even the most patient investors can reach a hasty conclusion. In the business world, as in the world of art, time remains the most objective (and often the most merciless) judge in regards to the durability of one's work.

Nothing gives more wisdom than perspective.

Mistake "du jour"

"Anyone who has never made a mistake has never tried anything new."

- Albert Einstein

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2009. It is with a constructive attitude, in order to always become better investors, that we provide this detailed analysis. As is often the case with stocks, errors from omission (non-purchases) are often more costly than errors from commission (purchases).

Bronze Medal: BYD

During the Berkshire Hathaway shareholder meeting last May, I listened attentively to Charlie Munger's discussion of BYD, a Chinese company led by Wang Chuan-Fu. Charlie said with great admiration that "Chuan-Fu is a combination of Thomas Edison and Jack Welch: I have never met such a businessman." When we consider that Charlie is 86 years old and that he has probably met the greatest businessmen of the last two generations, it's an extraordinary comment. His words didn't fall on deaf ears and I was instantly interested in BYD.

The company manufactures an array of products but the most important is a revolutionary battery used in electric cars. Based on this invention, BYD launched itself fearlessly into the car manufacturing business. As a fervent believer in the future of the electric car, I became enthralled with this high-potential company. Keep in mind that, with revenues of over $5 billion in 2009, BYD wasn't exactly the new kid on the block.

My enthusiasm was cooled when I saw the company's valuation on the market. The stock was trading at $15 on the Hong Kong market while the company only had EPS of $0.50 in 2008. A P/E ratio of 30 times seemed exaggerated in my mind. So being a persistent man, I woke up each morning to look at BYD's closing price in Asia hoping that the stock had dropped so I could buy a stake in the company at a more reasonable valuation. This was in vain.

The company had an exceptional year in 2009. After nine months, BYD's revenues climbed 39% and their new car division grew 50%. The company's EPS has yet to be announced but it's likely to have doubled to $1.06 for 2009 and analysts expect $1.84 in EPS for 2010.

The stock has soared 400% in a year, reaching its current level of $65. Sometimes, the artistic side of investing is to know when to let go, in a rare and exceptional moment, of market valuations and simply make a leap of faith based on an exceptional human being.

Silver Medal: TJX Companies

TJX owns chains of retail clothing stores. Its sweet spot in the marketplace is selling branded clothing at discount prices by buying discontinued apparel lines, surplus inventory, etc. In the US, the company's brands include T.J. Maxx, HomeGoods and Marshalls. In Canada, it owns Winners and Homesense. TJX is highly profitable and its returns on capital are unmatched by competitors. I have known this company for a decade or so. In 2000, the stock had fallen to $10 per share and was trading at 10 times earnings. I thought of buying shares at the time but decided to pass on the idea—with great regret.

The company grew its EPS at 12% annually during the decade. This rise in earnings seemed surprisingly high since sales were only growing at 5-7% per year and, with 2743 stores, this retail concept seemed quite mature.

The key to success at TJX is in the management of its capital. Through opportunistic buyback of its stock and continuous margin improvement, the company was able to create enormous wealth for its shareholders.

I knew two things when the stock lost half of its value at the end of 2008: that the company's business model was well suited for a recession (subsequently proven by the company's EPS soaring 48% in 2009), and that the company would buy back some its shares at these attractive valuations. The P/E ratio was once again at 10, and once again, I remained motionless.

The stock doubled in a year and is now trading at four times its price from 2000. Despite this rise, TJX is still only trading at 12 times its 2010 estimated earnings. When a stock doubles in a year and is still undervalued, it shows how much undervalued it was before.

Gold Medal: Cabela's

Cabela's became publicly traded in 2004. Since 1961, the company has been the leader in catalog sales (and now on the Internet) for products related to hunting, fishing, camping and scuba diving. The company more recently began operating "big box" retail stores. Michael Shearn, our friend from Austin (Texas), had spoken to us with great enthusiasm about this business based out of Sidney, Nebraska. Though the stock didn't seem attractively priced at the time of its IPO at $24 per share, we knew that this company's competitive advantage merited that we pay particular attention.

In the summer of 2004, I visited one of the company's new (and very impressive) stores in Kansas City. I was highly impressed with this retail concept.

Two years later, Michael and Jean-Philippe visited the company and spent the afternoon in Sidney meeting with upper management. They returned persuaded that the company had compelling competitive advantages and an able management team.

Still, we all shared some reservations about the high level of capital required to open the company's extremely large stores (and their low return on capital). We were also concerned that a substantial portion of the company's profits were from its financial division which issued credit cards to customers of Cabela's.

On the other hand, we also believed that the company could eventually realize certain economies of scale with a larger network of stores and that this should improve the company's returns on equity over time. We decided to buy a few shares, if anything to simply follow the company more closely.

The stock of Cabela's fell sharply in 2008, from a high of $28 in 2007 to a bottom of $4. The retail sector was practically torn apart by the drop in consumer spending. On top of that, everyone on Wall Street avoided companies with financial divisions like the plague, regardless of the quality of a company's loan portfolio. Cabela's was different, with its loyal (if not fanatical) customers. The company's customers were also wealthier than average and had higher credit scores.

It's not surprising then that EPS dropped relatively little, from $1.31 in 2007 to $1.14 in 2008. When it was trading between $4 and $5, the P/E ratio on Cabela's shares was only four times. Without any future growth, such a valuation corresponds to an annual return of 25%!!

To find a high-quality business that is dominant in its industry and is trading on the market for four times its earnings is a rare event in the life of an investor. I could have used the excuse that we were fully invested and that all our stocks were undervalued. But I certainly could have sold another stock in our portfolio that was trading at half of its intrinsic value to buy Cabela's that was trading at one fifth of its value. Selling a 50-cent dollar to buy a 20-cent dollar makes a lot of sense.

The company's earnings rose 18% to $1.35 per share in 2009. The company has performed extremely well despite the tremendously challenging economic headwinds. Wall Street regained its wits about the value of this business and the stock has risen to $16 in just a few months. This error of omission, with a price tag of 300%, merits a gold medal.

Conclusion: Warren Buffett's Big Wager

One of the most significant events of 2009 for our portfolio was the acquisition, through a tender offer, of Burlington Northern Santa Fe (BNSF). We had owned stock in BNSF since 2007-08 and, in November of 2009, Berkshire Hathaway offered $100 per share for Burlington—a 27% premium to the current price of the company's stock.



Warren Buffett and BNSF Chairman Matthew Rose (Source : CNBC.com)

This $34 billion acquisition is by far the largest over the course of Warren Buffett's long and illustrious career. In his press release, Buffett makes this pertinent comment:

> "Our country's future prosperity depends on its having an efficient and well-maintained rail system. Conversely, America must grow and prosper for railroads to do well. Berkshire's $34 billion investment in BNSF is a huge bet on that company, CEO Matt Rose and his team, and the railroad industry. Most important of all, however, it's an ALL-IN wager on the economic future of the United States. I love these bets."

M. Buffett, regardless of the metaphor used in the press release, is no gambler. In fact, the master of intelligent investing is faithful to a rule he laid out some 50 years ago: "To succeed in the stock market, be fearful when the others are greedy and greedy when the others are fearful".

We are, as M. Buffett, very optimistic about the future of our companies. Despite a satisfactory year in 2009 as far as our returns, we believe that the next few years will be quite rewarding for our businesses and their shareholders.

We also want you to know that we are fully aware and grateful for your vote of confidence. It is imperative for us to not only select outstanding companies for our portfolios, but to also remain outstanding stewards of your capital.

We wish a great 2010 to all our partners.



François Rochon and the Giverny Capital team

Giverny Capital Inc.

Annual Letter to our Partners

2010



Barry Allikas
Fly-over, 2010
Giverny Capital Collection

Giverny Capital Inc. – 2010 Annual Letter ©

For the year ending December 31st 2010, our portfolio's return was 16.1% versus 13.8% for our benchmark. Our return, including a loss of approximately 5% due to fluctuations in the Canadian currency, therefore outperformed our benchmark by 2.3%.

Since our inception, on July 1st 1993, our annual compounded rate of return has been 13.9% versus 7.1% for our weighed benchmark, or an annualized outperformance of 6.8% over this period. When we exclude the effect caused by the appreciating Canadian currency since our inception, which represents an annualized increase of 1.4%, our portfolio has returned 15.5% annually versus 8.5% for our benchmark. Our long-term (and ambitious) objective is to maintain an annual return that is 5% higher than our benchmark.

The Artwork on Our Letter

We have illustrated the cover of our letter with a copy of an artwork from our corporate collection since 2004. We chose the work of a Quebec artist, Barry Allikas, entitled "Fly-over". This work seemed fitting of the year 2010—a year when the companies in our portfolio continued to fly over much of the ambient doom and gloom and, as a group, generated record profits.

The Giverny Portfolio (in Canadian dollars): Returns Since July 1st 1993

Return *	Giverny	Index **	+ / -	$ US/Can	S&P 500	+ / -	Giverny ***	Indices ***	+ / -
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	3.3%	8.4%	**28.6%**	**34.4%**	7.4%	27.0%
1994	**16.5%**	3.7%	**12.7%**	6.0%	7.3%	**9.2%**	**12.0%**	-0.3%	12.3%
1995	**41.2%**	24.0%	**17.2%**	-2.7%	32.9%	**8.3%**	**43.8%**	26.3%	17.5%
1996	**28.0%**	22.8%	**5.2%**	0.3%	22.7%	**5.3%**	**27.7%**	22.5%	5.2%
1997	**37.8%**	28.6%	**9.2%**	4.3%	36.7%	**1.0%**	**33.4%**	24.5%	8.9%
1998	**20.6%**	18.8%	**1.8%**	7.1%	37.7%	**-17.0%**	**14.5%**	12.8%	1.7%
1999	**15.1%**	16.3%	**-1.2%**	-5.7%	14.1%	**1.0%**	**20.6%**	21.9%	-1.3%
2000	**13.4%**	3.2%	**10.2%**	3.9%	-4.6%	**18.0%**	**9.7%**	-0.2%	9.9%
2001	**15.1%**	-0.4%	**15.5%**	6.2%	-5.7%	**20.8%**	**9.4%**	-5.3%	14.7%
2002	**-2.8%**	-18.3%	**15.6%**	-0.8%	-22.0%	**19.3%**	**-2.0%**	-17.7%	15.7%
2003	**13.6%**	14.0%	**-0.4%**	-17.7%	5.7%	**7.9%**	**33.7%**	34.1%	-0.5%
2004	**1.6%**	6.2%	**-4.5%**	-7.3%	2.8%	**-1.1%**	**8.3%**	13.1%	-4.8%
2005	**11.5%**	3.6%	**7.9%**	-3.3%	1.5%	**10.0%**	**14.5%**	6.7%	7.8%
2006	**3.5%**	17.0%	**-13.5%**	0.2%	15.7%	**-12.1%**	**3.3%**	16.8%	-13.5%
2007	**-14.4%**	-11.6%	**-2.8%**	-14.9%	-10.0%	**-4.2%**	**-0.3%**	2.2%	-2.5%
2008	**-5.5%**	-22.0%	**16.5%**	22.9%	-22.2%	**16.7%**	**-21.5%**	-35.4%	13.9%
2009	**11.8%**	12.2%	**-0.4%**	-13.7%	9.6%	**2.2%**	**27.7%**	27.7%	0.1%
2010	**16.1%**	13.8%	**2.3%**	-5.3%	9.0%	**7./%**	**21.7%**	19.3%	2.5%
Total	**878.4%**	**232.8%**	**645.6%**	**-22.4%**	**205.3%**	**673.2%**	**1149.6%**	**320.5%**	**829.2%**
Annualized	**13.9%**	**7.1%**	**6.8%**	**-1.4%**	**6.6%**	**7.3%**	**15.5%**	**8.6%**	**7.0%**

* Green section: all returns are adjusted to Canadian dollars
** Index is a hybrid index (S&P/TSX, S&P 500, MSCI EAFE, Russell 2000) which reflects the weight of the underlying assets
*** Estimated without the effect of currency

Note: Canadian dollar returns audited by PricewaterhouseCoopers. See "notes on the returns" in the appendix.

The Giverny US Portfolio

We have been publishing the returns of the Giverny US Portfolio, which is entirely denominated in US dollars, since 2003. The Giverny US Portfolio corresponds to the American portion of the Giverny Portfolio. In 2010, the Giverny US Portfolio realized a return of 21.9% compared to 15.1% for our benchmark, the S&P 500. This return and our benchmark are all in US dollars and include dividends paid during the year.

Since its inception in 1993, the Giverny US Portfolio has returned 1002.0%, or 14.7% on an annualized basis. During this same period, the S&P 500 has returned 290.7%, or 8.1% on an annualized basis. Our added value has therefore been 6.6% annually.

Year	Giverny US	S&P 500	+/-
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	37.6%	17.2%
1996	27.0%	23.0%	4.1%
1997	32.9%	33.4%	-0.4%
1998	11.0%	28.6%	-17.6%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-9.1%	20.4%
2001	8.1%	-11.9%	20.0%
2002	-4.4%	-22.1%	17.7%
2003	31.6%	28.7%	2.9%
2004	9.3%	10.9%	-1.6%
2005	12.5%	4.9%	7.5%
2006	3.3%	15.8%	-12.4%
2007	-1.7%	5.5%	-7.2%
2008	-24.3%	-37.0%	12.7%
2009	28.7%	26.5%	2.3%
2010	21.9%	15.1%	6.9%
Total	1002.0%	290.7%	711.4%
Annualized	14.7%	8.1%	6.6%

Note: Returns audited by PricewaterhouseCoopers
S&P 500 returns provided by Standard & Poors. See "notes on the returns" in the appendix.

We outperformed the S&P 500 for a third consecutive year and the smaller companies in our portfolio led the way in 2010: Fastenal, Resmed, Bank of the Ozarks and O'Reilly Automotive. It is now the larger companies in our portfolio that seem undervalued—and therefore with the greater potential for future appreciation.

We believe that American blue chips, relative to other stocks, are now trading at the kinds of compelling valuations that we have not seen in decades. If you take a moment to reread our 1998 letter (available on our website), you will see how these valuations are the exact opposite of what occurred 12 years ago when large capitalization companies were much more expensive (and, of course, much more popular). The average P/E ratio for companies in this category have dwindled from 33x at that time to 11x currently.

Giverny Canada Portfolio

We introduced a portfolio that is 100% focused on Canadian equities in 2007. This corresponds closely to the Canadian portion of the Giverny Portfolio. In 2010, the Giverny Canada Portfolio returned 26.7% versus 17.6% for our benchmark (a blend of the S&P 500 and the TSX). Since 2007, the Giverny Canada Portfolio has returned 46.6%, or 10.0% on an annualized basis. During this same period, our benchmark had a gain of 15.3%, or a gain of 3.6% on an annualized basis. Our annual added value is therefore 6.4%.

Year	Giverny Canada	S&P/TSX	+/-
2007	19.7%	9.8%	9.9%
2008	-24.6%	-32.9%	8.3%
2009	28.2%	33.1%	-4.9%
2010	26.7%	17.6%	9.1%
Total	46.6%	15.3%	31.2%
Annualized	10.0%	3.6%	6.4%

Note: Returns audited by PricewaterhouseCoopers. See "notes on the returns" in the appendix.

Our Canadian stocks performed very well in 2010 and we have outperformed the TSX for three out of four years. The largest holding in our Canadian portfolio is MTY Food Group which rose approximately 50% for the year.

2010: A Year in Review

We finished our 2009 letter with the following sentence: "Despite a satisfactory year in 2009 as far as our returns, we believe that we are only at the beginning of a bull market that will last for years to come." The bull market began to take hold in 2010 as Western economies began to recover. GDP growth in North America for 2010 likely neared 2.6%, which is about 1% less than historical averages but still a clear sign that the recession is behind us.

It seems that the apocalyptic scenarios and predictions of another Great Depression have not materialized, and the civilization of free enterprise survived another financial crisis! Like is often the case, solid companies endured while weak ones were restructured or simply disappeared.

Plenty of problems remain, however. Canadian consumers remain overly indebted (their debt/revenue ratio reached a record of 150%), Western governments continued to stretch their borrowing capacities (in North America and Europe), and global competition has never been more intense. If this wasn't enough, governments are also interfering more and more with the business models of those rare enterprises that have succeeded at building wide competitive moats. For example, Visa/Mastercard, Google, and many medical products companies, were all subject to more governmental scrutiny in 2010. While these actions have generally been good for the popularity of politicians in the eyes of their electorate (something so ephemeral), this may not turn out to be ideal for neither the long-term wellbeing of a country nor for human progress. Allowing excellence to bear the fruits of its labor is the only way to encourage future excellence.

But our opinion, regardless whether it is justified, is secondary to our role as stewards of your capital—we are required to face life as it is. Humility, realism, and reason, provide bearing to navigate the difficult waters of the business world. And an unwavering confidence in human potential

in the long term stands as a lighthouse guiding us towards our destination in the investing world—particularly when the storms are raging.

The loss of an investing legend: Roy Neuberger (1903-2010)

On December 24th, Roy Neuberger died at the age of 107. Mr. Neuberger was a Wall Street pioneer. He started his career in 1929, just a few months before the Crash. The stroke of genius of his youth was to sell short shares of one of the crowd's favorite stocks of this era: RCA (radio was the new technology of the time). Due to this transaction, he only lost 15% of his capital during the Crash and went on to cofound an investment management firm that became a titan in this industry: Neuberger Berman—which today has $180 billion under management.

Even well beyond the age of 100, Mr. Neuberger remained deeply passionate about the market. During the midst of the financial storm (in March 2009), he called Jeff Bolton—a Neuberger Berman executive—to his office. He told him: "Listen young man [Mr. Bolton was only 69], if you don't find a way to invest my cash, I'm going to find someone else to do it." Jeff Bolton, due to Mr. Neuberger, massively bought into the market at the bottom.

I was deeply struck by the first of two books written by Mr. Neuberger: "So Far, So Good: The First 94 Years". Although the market highs and lows are often described as bull markets or bear markets, Mr. Neuberger—with his unique sense of humor, liked to say that the market was most often a sheep market. According to him, most investors follow the crowd while as the same time attempting to predict the direction of the crowd.

Having lived through an incredible number of investing fads (like bowling alley companies in the 1950s) for a period of 80 years, he liked to say that it was wise to study the past and to become your own historian.



Bloomberg News
Mr. Neuberger in 2003

But my fondness of Mr. Neuberger also exists on another level. Aside from his passion for the market, he also had a great passion for art. He decided at age 25 that he wanted to become rich on Wall Street so that he could use his fortune to purchase works of art. He had the clairvoyance, for example, to purchase one of the earliest works by Jackson Pollock, as well as an extraordinary painting by Edward Hopper (Barber Shop, 1931). He was also a major patron of numerous burgeoning artists such as Milton Avery. In 1974, he opened his own museum at SUNY-Purchase with the help of the then

governor of New York, Nelson Rockefeller (another great philanthropist). Art within the workspace was always an integral part of the culture at Neuberger Berman—something that continues to this day.

Owner's Earnings

We do not evaluate the quality of an investment based on short-term stock quotations, but instead, take the perspective of ownership in the companies in which we invest. As such, we analyze the growth in earnings for our companies and study their long-term prospect (see the appendix for a review of our investment philosophy).

Each year, we present to you a chart indicating the growth in the intrinsic value of the companies in our portfolio using a method created by Warren Buffett: owner's earnings. This enables us to estimate the intrinsic value of our companies by adding the growth in earnings per share and the average dividend yield of our portfolio.

In 2010, the aggregated intrinsic value of the companies in our portfolio rose 22%. The stock market value of our portfolio also rose 22% (without the effect of currency fluctuation)—in line with the growth in intrinsic value of the underlying companies. You will note that this is only the third year (out of 15) when the two experienced a similar annual performance. Market performance and corporate performance are rarely synchronized over the course of a calendar year. But as more time goes by, the synchronization between the two begins to affirm itself.

	Giverny			S&P 500		
Year ***	Value *	Market **	Difference	Value *	Market **	Difference
1996	14%	29%	15%	13%	23%	10%
1997	17%	35%	18%	11%	33%	22%
1998	11%	12%	1%	-1%	29%	30%
1999	16%	12%	-4%	17%	21%	4%
2000	19%	10%	-9%	9%	-9%	-18%
2001	-9%	10%	19%	-18%	-12%	6%
2002	19%	-2%	-21%	11%	-22%	-33%
2003	31%	34%	3%	15%	29%	14%
2004	21%	8%	-12%	21%	11%	-10%
2005	14%	15%	0%	13%	5%	-8%
2006	14%	3%	-11%	15%	16%	1%
2007	10%	0%	-10%	-4%	5%	9%
2008	-3%	-22%	-19%	-30%	-37%	-7%
2009	0%	28%	28%	3%	26%	23%
2010	22%	22%	0%	45%	15%	-30%
Total	493%	440%	-53%	162%	167%	5%
Annualized	13%	12%	-1%	7%	7%	0%

* Estimated growth in earnings plus dividend yield
** Market performance, inclusive of dividends
*** Results estimated without currency effects

For 2010, the growth in owner's earnings for the S&P 500 was higher than that of our portfolio companies. One must bear in mind that the profits of the S&P 500 had fallen much further during

2007-08. If we do a quick calculation of the profit growth at our companies since 2007, we can see that it has considerably outpaced the growth of the companies included in the S&P 500.

	Giverny			S&P 500		
Recession	Value	Bourse	+/-	Value	Bourse	+/-
2007-2010	30%	22%	-8%	0%	-3%	-3%

Since the beginning of 2007, our companies have grown their owner's earnings by 30% while the S&P 500 experience 0% growth in its owner's earnings. The value of our companies on the stock market rose 22% (without currency effect) while the value of the S&P 500 lost 3%. The businesses that make up our portfolio, in aggregate, not only made it through the recession but were also able to increase their market share and increase their profitability.

When we look at it from a longer term perspective (since 1996), our companies have increased their intrinsic value by 493% according to our estimates—a factor of nearly 6 times—while the market value of these companies increased by 440% (without the effect of currency). During this same period, the companies in the S&P 500 saw their intrinsic values rise by 162% while their market values rose by 167%. Despite the economic highs and lows, in the long term, the market prices of companies approximately follow the growth in owner's earnings of its underlying business.

Our stock holdings have outperformed the S&P 500 by 5% annually for the simple reason that the underlying companies in our portfolio have increased their intrinsic value at a rate that is 5% greater than the average. It is in this manner—rather than by speculating on the market—that we anticipate continuing to meet our objective of adding value to your (and our) capital.

The flavor of the day for 2010: Gold

We've discussed the current popularity of gold on a few occasions over the course of the last years. We recently echoed a commentary from Warren Buffett on this topic. Gold seems a tenacious relic from another era—from a time when indefinite and successive warfare would make it impossible to have an effective currency without the mutual reference point of a precious metal.

Until very recently, for example, Canadian coins represented their fair value in silver. The five cents coins were twice as small as dimes (though during the 1920s, nickel was used to make the five cents coins larger since too many people were losing them).

Today, there exists a stability in our financial systems (especially when compared to prior centuries) and the need for currency to have their equivalent value in a precious metal is obsolete. The price of most commodities (wheat, copper, nickel, steel, etc) generally follows inflation rates. Actually, historical commodity prices (as represented by the CRB index) have failed to keep up with inflation by about 1% annually. The reason is simple: human ingenuity has made the extraction of these products more and more efficient.

At its current high of $1400 an ounce, gold prices are 74 times higher than they were 100 years ago—an annual return of 4.3% versus for 3.3% for inflation. So gold has slightly outperformed inflation over this period (though if we used gold prices from 5 years ago, we would have a return equal to inflation). It is worth noting that stocks have returned 1,300,000% over the same 100 years—approximately 200 times better than the performance of gold. An unequivocal truth stems from taking

an historical perspective: in the long term, gold has not been a better investment than stocks and barely outperforms Treasuries. Once inflation is taken into consideration, the source of wealth creation has been stocks.

There is a certain logic to all of this. The activity of lending money to governments does not create wealth. Owning a few kilograms of a yellow metal in a safe doesn't either. Businesses create products that meet the needs of consumers, new technological tools that improve our lives, new medicines that allow us to live longer, and services that help us better manage our activities. And we must admit that the capacity of businesses to develop new ways of entertaining us seems without limit. To own an economic participation in these businesses is an authentic source of wealth creation. And the long-term performance numbers adequately illustrate this.

But this doesn't prevent people from speculating on gold these days. The most often invoked reason behind the rise of gold prices is the loss of confidence in our capitalist system. No one knows the future (regardless of what "they" say) but, historically, betting against the progress of humanity and the improvement of our standard of living as always been a losing proposition. The desire to progress and build a better life for ourselves is bound within the genes of a human being. I believe that those who speculate on gold will eventually lose capital—or as a better outcome, hold on to an asset that will standstill for several years. Nothing gets built in the long term with pessimism.

I would be remiss to not share with you a quote from Charlie Munger, Warren Buffett's longtime partner:

> "I don't have the slightest interest in gold. I like to understand what works and what doesn't in human systems. To me that's not optional; that's a moral obligation. If you're capable of understanding the world, you have a moral obligation to become rational. And I don't see how you become rational hoarding gold."

The American and Canadian markets

This discussion on gold would not be complete without mentioning the Canadian stock market. In late 2010, about 14% of the TSX was comprised of gold stocks. This almost suggests that one in seven jobs in Canada is linked to gold extraction! Canada only produces three million ounces of gold annually, so at $1400 an ounces, this equals about $4.2 billion in annual revenue—or about 0.3% of Canadian Gross Domestic Product (GDP). Now it is true that large gold companies carry out the majority of their extraction activities outside of Canada, but the disparity between the economic weight and the value assigned by the stock market to these activities remains fascinating.

If we look at the Canadian stock market at its current level, it is 158% of its GDP (based on a currency constant with purchasing power parity). For the US market, the figure would be 103% which is much more in line with historical levels. One should note that approximately 25% of Canadian GDP is exported (three quarters of that going to the US), though this is also the case for American companies which export about a quarter of their revenue.

This disparity between Canadian and US markets is partly due to an overvaluation of the Canadian dollar by about 20% (the OECD estimates the fair value of purchasing power parity of the loonie to be $ 0.82). The other source of disparity is linked to the slightly higher P/E ratios for the Canadian market.

As always, we remain agnostic vis-à-vis fluctuations in the markets, the economy and currency levels. Our work, however, is to compare the relative valuations of the securities we can acquire. From this perspective, we believe that in the years to come, the 55% disparity between the two stock markets will diminish and that the Canadian market is at risk of underperforming its American counterpart.

This doesn't prevent us from finding terrific Canadian companies. In the last years, in fact, we have acquired three young and exceptional Quebec companies: MTY Food Group, Dollarama and 5N Plus (see the next section for more details).

Our companies

"To open a shop is easy, to keep it open is an art"

- Chinese proverb

Our companies, as a group, had an excellent year in 2010. While many of our companies reached record profits, even more important is the fact that many of them continued to widen their competitive moats relative to their competitors.

Wells Fargo (WFC, $31)

Wells Fargo had an excellent year, with adjusted earnings per share (EPS) of $2.54—an increase of 45% compared to 2009. Its balance sheet continued to improve with its equity ratio rising from 6.5% to 8.3% over the year. EPS for 2010 was actually better than EPS from 2006, before the crisis began. Assets have grown from $482 billion to $1,227 billion in four years (an increase of 155%). This growth was achieved by issuing an additional 55% of its shares outstanding (following the acquisition of Wachovia). Thereby, assets per share rose 64% during the worst period of the US banking sector since the Great Depression.

Return on assets (ROA) was 1.09% in 2010, compared for 1.76% in 2006. The earning power of Wells Fargo is therefore far from its peak. Our estimate is that in 2015, Wells Fargo could have assets of $1,800 billion and have an ROA of 1.5%. This would result in an EPS of $5.25—so shares in Wells Fargo seem bright with potential. We took advantage of the stock dropping to $23 last fall (for no reason) and increased our holding.

Bank of the Ozarks (OZRK, $43)

Our small bank from Little Rock (Arkansas) avoided, this year again, the slump that marred much of the US banking industry. Even better, Bank of the Ozarks benefited from the misfortunes of competitors and was able to be very active on the acquisition front during 2010. Why open new branches and raise new assets at great marketing costs when it's possible to acquire those of competitors at a fraction of the price? With the help of the Federal Deposit Insurance Corporation (FDIC), Bank of the Ozarks was able to get its hands on five struggling banks in a year. Here is a list of acquisitions with their respective asset bases:

- Unity National Bank of Cartersville (Georgia) in March ($295m)
- Woodlands Bank of Bluffton (South Carolina) in July ($390m)
- Horizon Bank of Bradenton (Florida) in September ($170m)

- Chestatee State Bank of Dawsonville (Georgia) in December ($240m)
- Oglethorpe Bank of Brunswick (Georgia) in January 2011 ($210m)

In short, Bank of the Ozarks was able to increase its asset base by $1.3 billion, an increase of 47% of its assets. Already in 2010, EPS blasted ahead from $2.18 to $3.75. Although certain components of this current level of profitability are not recurring in nature, we anticipate that the earning power per share for 2011 will be more than $3. The stock, therefore, still seems to us to be trading at a reasonable valuation.

M&T Bank (MTB, $87)

Like Wells Fargo and Bank of the Ozarks, M&T Bank has excellent year in 2010, with EPS rising 65% to $5.84. Charges related to bad debts dropped from 1.01% in 2009 to .67% in 2010, and ROA rose from .71% to 1.17%. Return on equity reached 19%.

M&T also made a significant acquisition towards the end of the year: Wilmington Trust. Wilmington Trust is the dominant bank in Delaware, with 23% of the market. This bank has $10 billion in assets—enabling M&T to increase its asset base by 15%. M&T paid $350 million for Wilmington Trust and assumed $330 million in loans from the government under the TARP program. This acquisition cost corresponds to only 7% of the market capitalization of M&T Bank.

M&T Bank is a truly exceptional bank. The bank has been profitable for 138 quarters in a row and, since Robert Wilmers took the helm in 1983, EPS has grown at an annual rate of 15% (for a total compounded growth of 4300%). During the crisis, M&T was the only bank in the S&P 500 to neither reduce its dividend nor issue equity.

Omnicom (OMC, $46)

The global economic recovery helped Omnicom improve its profitability in 2010. Revenues climbed 7% and EPS rose by 8%. We estimate that Omnicom will reach its pre-crisis profitability level in 2011. The stock has risen 80% since our purchase in 2008 but still trades at only 14 times its profit anticipated for 2011. This seems a reasonable ratio for a company that has strong returns on equity, offers a vital service for other businesses, dominates its industry and has a strong presence in numerous countries.

Berkshire Hathaway (BRK.B, $80)

Berkshire Hathaway and its legendary president, Warren Buffett, continued to reap the fruits of its investments from 2008-2009. All in all, Mr. Buffett invested more than $50 billion during the crisis, half in equity/debt instruments and the other half for the acquisition of Burlington Northern Santa Fe (see our 2009 Annual Letter). His investments in Goldman Sachs, GE and Swiss Re created very considerable wealth for Berkshire shareholders. BNSF had an outstanding year and it's already apparent that Mr. Buffett proved highly opportunistic in his acquisition from the year before.

Shares in Berkshire rose approximately 20% in 2010. Still, when looking at the company from a longer term perspective, the stock has failed to follow the growth in intrinsic value of the underlying company. According to our estimates, we consider the intrinsic value of Berkshire to be 30% higher than what it was before the crisis—meaning approximately $130 to $140 per share. We therefore continue to have a significant allocation of our portfolios to this company.

Microsoft (MSFT, $28)

Microsoft had an excellent 2010, with the migration towards Windows 7 leading the way. The company has already sold 300 million licenses for this operating system and Windows 7 is now installed on about 20% of PCs. On the entertainment front, the company's new gadget for its Xbox console, the Kinect sensor, has been a great success: the company sold no less than 8 million of them in 60 days! Always looking to work for the benefit of our partners, I tried the Kinect during the holidays (watching me waddle in front of the television, I couldn't help to think that the process of fundamental research has evolved over the years).

For the last twelve months ending in December, EPS at Microsoft rose by 25%. This growth in intrinsic value has yet to be reflected in the company's stock price, with its price finishing the year right around where it started. From another perspective, however, the company continued to benefit from the undervaluation of its shares by buying back some of its own shares. During the last quarter alone, Microsoft bought back $5 billion of its own shares. This stock seems a bargain to us.

Resmed (RMD, $35)

It's been six years since we first acquired shares in an exceptional Australian company: Resmed. The company is the global leader in medical equipment for sleep disorders (sleep apnea, etc). Resmed has tripled its profitability since we first acquired it and, in 2010, its EPS grew by 26%. The company is highly profitable, with net income of roughly $220 million on $1.8 billion in assets (with $600 million of those assets being in cash with no debt on its balance sheet). Resmed's stock price has followed its growth in earnings since 2004—climbing 200%.

Despite its rapid growth, problems with sleep apnea remain largely unknown, with a small percentage of those suffering from it actually being diagnosed. The company continues to work to increase awareness of this medical condition.

5N Plus (VNP-T, $7)

5N Plus, a young and dynamic Quebec company, is one of the worldwide leaders in the purification of metals needed to build photovoltaic solar panels. Its primary product is cadmium telluride used by companies like First Solar. Solar panels based on CdTe are gaining market share since they are more economical to manufacture than those based on silicon.

5N Plus experienced a difficult first half of the year with profits declining. The company's renewal contract with First Solar—its largest client— lowered margins but increased future volume commitments from First Solar. 5N Plus, however, did post very positive numbers for its latest quarter with a return to high growth and a rapid increase in its backlog.

Solar energy is not an easy industry to analyze and forecast. Still, we consider 5N Plus to possess durable competitive advantages and, more importantly, to be led by a CEO we greatly admire and trust.

O'Reilly Automotive (ORLY, $60)

O'Reilly had a fabulous 2010. EPS increased 35% due to improved same-store sales (+8.8%) and a successful integration of its CSK Auto acquisition from late 2007. This increase in EPS is not cyclical

in nature, with 2010 EPS roughly doubling from 2006 EPS. We first bought shares in O'Reilly in the summer of 2004. Since then, EPS has tripled and the stock price has followed suit (though not necessarily in a linear fashion), as depicted by this stock chart:



O'Reilly Auto 2004-2010 (Source: Bigcharts.com)

American Express (AXP, $43)

After two difficult years, Amex has returned to growth and profitability in 2010. Revenues increased by 13% and EPS reached $ 3.41—121% higher than in 2009 and higher than the 2007 EPS of $3.37 (the year before the start of the financial crisis).

Amex is the only company issuing fully integrated credit cards, meaning that they assume all of the following roles: banker, transaction provider, and card issuer. Its competitors are not only Visa and MasterCard but also banks like JP Morgan and Bank of America. On the banking side, Amex gained market share during the crisis. In 2010, the growth in transactions at Amex was 15%, versus 5% and 3% for JPM and BoA, respectively. The rate of bad loans in 2010 was also much lower than its competitors (approximately 5% versus 8% for JPM and BoA).

The company reiterated its goal to grow EPS by 12-15% annually. Although the crisis marked a "pause" in this noble and ambitious goal, we are confident that Amex will continue to grow its intrinsic value at a rate greater than the average. With this in mind, the current P/E ratio of Amex stock (12x) vis-à-vis the P/E of the S&P 500 (14x) seems unjustified.

Astral Media (ACM.A-T, $42)

Revenues at Astral Media rose 6% in 2010 while EPS rose by 12%. This growth in EPS for 2010 comes after 5% growth in 2009 and 10% growth in 2008. The television division experienced another year of robust growth with profits rising 12%, while radio (-4%) and outdoor advertising (-1%) were more stagnant. Astral is a high quality Quebec company with stable growth rates and, to this day, has more or less, been sheltered from economic cycles. It seems to us that this solid business deserves a higher P/E than its current P/E of 12x.

China Fire & Security Group (CFSG, $7)

It was a difficult year for CFSG. This young Chinese company (founded in 1995) dominates a niche market: fire prevention and detection systems used in industrial settings. Steel production in China, the primary market for CFSG's products, slowed in 2010—thus impacting the company's sales. We were used to CFSG growing at 40% annually. But EPS were down by 40% for 2010, at $0.52, though everything had been indicating a potential 50% growth at the beginning of the year (they had an impressive backlog). The stock therefore dropped by half.

It seems premature to us to conclude that the company's problems are permanent rather than temporary but we continue to follow the situation closely.

Mohawk Industries (MHK, $57)

Mohawk sells floor covering products (carpets, tiles, hardwood floors, etc). The company has remained profitable despite the severe impact of the recession on this industry. There was a 38% improvement in the level of profitability in 2010 versus 2009 (measured by adjusted earnings).

Though currently depressed, we believe that a turnaround is near for the residential construction industry. The good news is that there are a million new households created each year in the United States and buying a home there has rarely been so affordable. We anticipate that in a normalized environment, Mohawk should earn $8 in EPS—meaning that the current stock has excellent potential for appreciation.

Fastenal (FAST, $60)

Fastenal had an exceptional year, with sales growing 18% and EPS rising by 45%. The company opened 127 new stores (an increase of 5.4%) and continued to benefit from the recession by widening its competitive moat relative to competitors. Revenue has risen from $2.1 billion to $2.3 billion since the end of 2007—Fastenal has increased its revenue by 10% during the recession. As for EPS, they grew 16% in three years.

2011 is off to a good start, with 19% annual sales growth in January with 11% growth in employees. Fastenal is truly a well-oiled machine.

We bought Fastenal 12 years ago (during the Asian crisis) and the stock has gone up tenfold since then. We continue to believe, however, that the company has many great years of growth in its future and we are holding on to our shares.

Knight Transportation (KNX, $19)

Our trucking company based in Phoenix (AZ) had a strong year. Revenues climbed 12% while EPS rose 20%. Knight continued to take market share within an industry that was devastated by the recession (2000 companies disappeared!) The company's operating cost ratio decreased from 85.7% to 84.5% and Knight's cost structure is about 10% less than the average for the industry (in other words, profit margins are twice the industry average).

The company rewarded us at the end of the year with a special dividend of $0.75 (a yield of about 4% at the time). Since the company's stock seems appropriately valued by the market, we have reduced

the weight of this holding in our portfolio during the last couple of years. Knight once commanded a much greater allocation in our portfolio but we continue to believe that the company is exceptionally solid.

Medtronic (MDT, $37)

Medtronic, one of the largest medical manufacturing equipment companies in the world, experienced flat sales in 2010. EPS rose 8% which is acceptable but not spectacular. The CEO, William Hawkins, also announced that he would leave the company next spring and it is too early to know his successor's game plan for revitalizing growth. He will have to juggle, among many other things, the health care reform in the US.

This multinational company is an industry leader and its stock seems extremely undervalued by the market, trading at about 11 times earnings.

Carmax (KMX, $32)

Carmax broke all profitability records in 2010. This company, which primarily sells used cars, grew EPS by 43%. The crisis of 2008-09 was particularly harsh for the auto industry, but Carmax emerged stronger and is now 80% more profitable than before the recession!

We were not rewarded immediately though we acquired this stock in 2007 at about $21. During its low of November 2008, Carmax was trading at $7. But our patience has paid off and we believe that Carmax has a very bright future. Still, we should have bought more stock during that low had we had foresight in addition to patience.

MTY Food Group (MTY-T, $14)

MTY Food has been our largest Canadian investment for a few years already. The company has become the Canadian leader in restaurant franchises (with over 1700)—mainly located in food courts. MTY has achieved excellent growth in its number of restaurants, revenues and earnings. The company's EPS (adjusted for the amortization of intangible assets) reached $0.91 which is an increase of 23% from 2009 and 78% from 2007 (when we became shareholders). The company became listed on the Toronto Stock Exchange during the spring and also announced the acquisition of Valentine in August. Lastly, MTY acquired a food factory at the end of the year to become more vertically integrated.

During the year, we also met again with Stanley Ma, the CEO of MTY Food. We remained confident after our meeting that MTY remains in good hands and continues to have excellent growth prospects.

Sales of 2010

We sold our shares in Martin Marietta and Morningstar during the year. We deemed each of these stocks to be less undervalued than others and decided to sell them. We continue to believe that these two companies are excellent businesses.

Nitori

We sold our shares in Nitori in early 2011. We initially bought this superb Japanese retailer in June of 2007 at around ¥6000. One of our reasons for our purchase was the weakness of the Yen—we

believed the Yen to be undervalued by about 20% at the time, partly due to the "carry trade" where Japanese bonds were sold short in large quantities.[1] Since Nitori was buying most of its inventory from China (where the currency is tied to the US dollar) and then reselling it within Japan, an increase in the value of the yen would have had a very positive impact on the company's gross margins. Nitori also seemed well managed and had strong sales growth (around 15-17% annually).

We sold for two reasons. The most important was that sales growth had slowed during its latest quarters, to around 10% annually. This was a very acceptable rate but not the strong growth of prior years. Profits had grown even more rapidly, thanks to an increasing in margins from an appreciation of the Yen. The level of the Yen (and therefore the company's margins) now seemed difficult to sustain going forward—meaning that we anticipated EPS growth to dip below 10%.

The second reason for selling was due to the higher level of the Yen relative to the US dollar. The Yen had gained 50% in three and half years against the US dollar. Even relative to the strong Canadian dollar, the Yen rose by 33%. We locked in a 65% gain on our Nitori holding from 2007 and, due to the high level of both the company's stock and the Yen, we were confident that prospects for future returns were better elsewhere.

New investments for 2010

Dollarama (DOL-T, $29)

We discussed our purchase of Dollarama in our letter from the first quarter of 2010. We have always been admirers of its founder, Larry Rossy, and we were very disappointed when the company agreed to be acquired by a private equity fund (Bain Capital) in 2004 instead of having an initial public offering (IPO). The company then resurfaced on our radar screen when it announced an IPO in late 2009.

Dollarama is, by a wide margin, the leader in "dollar stores" (though many items are more expensive) in Canada, with over 620 stores across the country. Despite its dominance, we anticipate that there is still significant growth potential for this company. The penetration rate of dollar stores in Canada, for example, is about half of the rate of the US.

In its first year as a public company, sales at Dollarama jumped 14% and same store sales grew by 8%. EPS came in at $1.65. Based on its current price, the stock trades at about 15 times expected 2011 profits—this seems very reasonable.

Visa (V, $71)

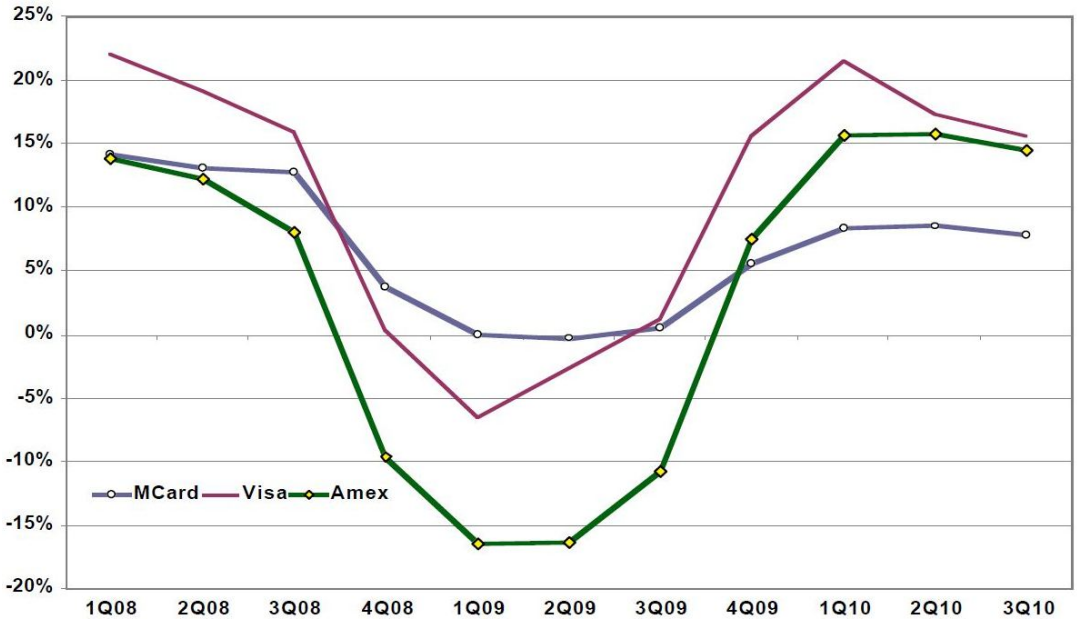
We like companies in the credit card industry, dominated by Amex, Visa and MasterCard. Our interest is nothing new: we first purchased shares of American Express in 1995. In 2006, MasterCard had its IPO and were able to see firsthand the remarkable profitability of these companies (a triopoly is just a little less than a duopoly).

It's been 30 years since an excellent book was published on investment: The Money Masters (by John

[1] Financial transaction that exploits interest rate differentials between different currencies. The idea behind the *carry trade* is to borrow (and/or by selling short) in a currency from a country where interest rates are low and to invest these borrowed funds in another currency where interest rates are high.

Train). Warren Buffett, then totally unknown, was interviewed. Something he said always stuck in my mind: "The best types of businesses to be acquired are those which have the equivalent of a royalty on the growth of others." We believe that this applies to credit card companies.

Visa finally became a public company in 2008 and we were determined to follow this company closely. Shares shot up from $60 to $90 while EPS was only $2.47. We unfortunately couldn't say that this was an attractive P/E ratio. Two years later, however, the situation was different. The company had shown great resilience during the crisis (see chart below) and EPS reached $4.22 in 2010—an increase of 72% in two years. Meanwhile, the stock had dropped from a high of $97 to $70 during the second half of 2010.



Growth rates of the three credit card companies 2008-2010 (Source : Argus Research)

Visa is the leader in terms of both market share and technological innovation (nothing against MasterCard and Amex). Visa's balance sheet is immaculate, with no debt and $3.5 billion in cash ($5 per share). So, we are paying $66 for about $5 in estimated EPS for 2011—about 13 times profits. The company is taking advantage of its stock valuation by buying back some of its own shares.

A company like Visa, however, doesn't see the value of its shares drop by 25% for no reason. The American senator, Dick Durbin, proposed a legislative amendment regarding transaction fees charged for debit cards. He is spearheading this movement (as though the banks won't be able to find other fees to strike back). In my humble opinion, Mr. Durbin would have another opinion towards all of this if he came to Canada to see if the higher regulatory environment here ever helped lower banking fees for consumers...

Regardless, it is therefore highly likely that the profits for Visa in 2012 will be 10% lower than what we initially anticipated. So, instead of earning almost $6 per share, we have lowered our estimate to $5.40. A P/E of 20x for this business seems totally justified in our opinion, even given the political risk, and we view this stock as undervalued at its current price.

Five-year Post-mortem: 2005

Like we do every year, we go through a five-year port-mortem analysis. We believe that studying our decisions in a systematic manner, and with some hindsight, enables us to learn from both our achievements and our errors. In 2005, we had acquired shares in two extremely high quality American companies: Wal-Mart and Disney.

Wal-Mart (WMT, $54)

We acquired shares in Wal-Mart in March of 2005 for about $50, which was equivalent to 18 times its profit at the time (the same P/E as the market back then). We had anticipated annual EPS growth of 12% which meant that the stock deserved its valuation—even a premium to the S&P.

From 2005 to 2010, EPS grew at 9% annually (including 11% in 2010). This compares favorably to the 2% annually earned by the S&P 500 over the same period. The company has outperformed the vast majority of businesses during very difficult economic times. But this 9% growth translated itself into only 2% growth in the company's stock value. The P/E is lower today than it was in 2005—it now has a discount of 12% relative to the market.

This has not been a very rewarding investment since, including dividends, our total annual return has been approximately 4%. In hindsight, we should have been more conservative with our growth expectations and/or allowed ourselves to have a greater margin of safety at the time of purchase.

But we must look ahead. If the company continues to grow at annual rates of 9% and adds a dividend of 2%, we're talking about an annual return of 11% in the intrinsic value of the company. And if the P/E ratio rises, at last, to a more reasonable level, then we could have a return in line with our objectives. For example, if by 2015, the P/E rises from 13x to 17x, the return on the stock would be around 16% annually from today onward.

Disney (DIS, $38)

Disney grew its EPS by 19% this year to $2.28 ($2.07 for the fiscal year ending in September). This is a record profit for Disney and represents a 71% increase (11% annualized) since we became shareholders again in September 2005—the day when Bob Iger became CEO. There are few leaders we admire as much.

Disney had several blockbusters in 2010. "Toy Story 3" broke sales records at the box office for animated films and "Alice in Wonderland" crossed the billion dollar mark at the box office.

"Alice in Wonderland" was a remake of an animated film from 1951 which was, at that time, a huge success for Disney. The modern version of the Tim Burton remake of this film was a great cinematographic achievement for Disney and, once again, the company greatly benefited from this film. Disney's business model is truly extraordinary. A movie like "Alice in Wonderland" is a little like having a giant oil well and pumping out all of its content… and then finding this well again 60 years later and pumping out even more oil, without any additional maintenance or extraction costs. The stars at Disney, like Mickey Mouse and Alice, are also immortal—without the need for capital and especially WITHOUT AN AGENT.

Few people know that "Alice in Wonderland" wasn't the second version of this film for Disney, but its third. At the age of 20, in 1922, Walt Disney had launched his first animated film business: Laugh-O-Gram Studio. In 1923, he went on to create a film based on the Lewis Carroll classic, but the company went bankrupt during that year and the production of this film was halted.

But Disney was a difficult man to discourage. He started a new animation studio and created his first star: "Oswalt the Lucky Rabbit" in 1927. His distributor in New York decided to continue the Oswalt series without Disney, taking with him the character and much of Disney's staff. Returning from New York on the train, back to square one, Disney drafted out a new character—a mouse. Disney's initial idea was to call the mouse "Mortimer" until his wife said: "why not Mickey?"

In 2006, the Walt Disney Company acquired all the rights to the character of Oswalt, then property of NBC Universal. No less than 78 years after Disney had created him.

Walt Disney was not only a fearless visionary but also a man with unmatched tenacity. Without the latter, we would have never heard of the former.





Mistake "du jour"

"Only those who are asleep make no mistakes"

- Ingvar Kamprad (founder of IKEA)

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2010. It is with a constructive attitude, in order to always become better investors, that we provide this detailed analysis. As is often the case with stocks, errors from omission (non-purchases) are often more costly than errors from commission (purchases). This year's list gave me shivers.

Bronze Medal: Coach

We bought a small amount of stock in Coach, the famous maker of luxury handbags, three years ago. It is not quite Louis Vuitton or Dolce & Gabbana but still a very solid brand. Coach is also very popular in Asia where the company has experienced rapid growth.

In 2007, while I was in Omaha for the Berkshire Hathaway shareholder meeting, I asked my girlfriend what I could bring back for her as a souvenir (I had in mind a pink Warren Buffett t-shirt or a box of

See's Candies). She answered, with enthusiasm, that she wanted a small bag from Coach (I had told her that I had visited a store as part of my research process). This is when I realized how many women held this brand in high regard.

Upon reading their annual report, I realized that Coach had impressive growth rates, along with exceptional profitability and a shareholder-friendly management team.

The company had belonged to Sara Lee for a number of years. In a restructuring of its finances in 2000, Sara Lee decided to distribute its ownership in Coach to its shareholders. As is often the case, this enabled the newly-independent Coach to considerably improve its profitability. In 2007, the stock had dropped from $51 to $35 and the company was trading at 15 times its profits, while companies such as Burberry, PPR (owner of Gucci) and LVMH (Louis Vuitton), were all trading at 20 times their earnings. Given the strength of these brands, such valuations were justified. But I would have preferred a better valuation so I only bought a small position in Coach, thinking that I might have a better valuation down the road…

And I had my chance. During the financial crisis, at its low, the stock had tumbled to $12. The company had $800 million in cash—equivalent to $2.50 per share. The stock market was effectively assigning a valuation of $9.50 per share for the business—and the company was still earning around $2 per share. We could buy one of the world greatest brands for five times its profit!!! But, worried that the recession would further hit the luxury goods industry, I passed on my chance. Even worse, when the stock bounced off its lows, I sold our few shares.

Today, the stock is trading at $54. Given that the Coach should earn $3 per share this year and that it has $3 per share in cash, the current valuation is still reasonable. Imagine it at $12.

Silver Medal: Google

Google went public in 2004 at $85 a share. We were naturally skeptical at the company's ability to continue dominating the search business on the Internet—a universe which historically evolved so quickly with market leaders changing just as quickly. Further, the stock was trading at about 50 times its profits at the time. We were, however, very impressed by the Shareholder Manual that that had been written by the company (inspired by the one written by Warren Buffett for Berkshire Hathaway). Google was definitely on our radar screen.

In 2005, when the stock was trading at $280, I was interviewed by La Presse and asked about Google. I actually described the company as a "Miracle of Capitalism" (difficult to have been more enthusiastic!) But I was not consistent in carrying out this admiration for Google into actually buying shares in the company. The stock continued to climb, reaching $700 in 2007.

During the big dip of 2008-09, the stock dropped to less than $300. At the time, the stock was trading at 15 times its profits. We decided to slowly begin buying shares in Google. The stock then quickly bounced back to $600.

The rise in the price of Google is totally justified. The company has become almost immovable in its leading position in the web search market (its moat is as big as it comes). YouTube is a worldwide success and its Smartphone operating system, Android, is a blockbuster. The company's EPS has grown from $1.50 in 2004 to more than $25 in 2010. Moreover, the company has accumulated $33 billion in cash in just a few years.

During the summer of 2010, the stock fell to $450 for no apparent reason—corresponding to a P/E of 15x. Jean-Philippe Bouchard, Vice-President at Giverny Capital, pleaded with me to wake up and buy shares in this unique business. But I wanted an even better prices and I decided to wait. The stock almost immediately bounced back to $600.

Gold Medal: Intuitive Surgical

About five years ago, my longtime friend Bernard Mooney talked to me about a company making revolutionary medical products: Intuitive Surgical (IS). IS had invented a robotic surgery system called "Da Vinci". This robotic system converted the movements of a surgeon into micro movements by the robotic tools inside a patient. In a few years, revenues at IS surged from $100 million to $1 billion. The beauty of the system is that the company earns more revenue from specialized accessories than from the robot itself (similar to Gillette with its razor blades). In fact, each surgery costs about $2000 in accessories. The company has little competition and its products have quickly become very popular with surgeons in a number of different specialties (such as prostate surgeries and hysterectomies).

Such innovative companies, with outstanding profitability and excellent growth prospects, seldom trade at bargain prices. Despite this, I followed this business closely. During the crisis of 2008-09, the stock dropped from a high of $350 in 2008 to a low of $85 at the beginning of 2009. The company had no debt and roughly $13 per share in cash, and had earnings per share in excess of $5. So, it was possible to buy one of the most promising businesses in the universe of stocks that we follow for about 14 times its profits. I bought a small starting position and waited for a better price (are you started to see a trend?)

After a quarter of lower profits, growth has come back with a vengeance. In 2010, revenues grew by 60% relative to 2008. EPS has climbed from $5 to almost $9 in two years. And the stock has quadrupled, reaching $345.

We should have bought shares in this company: we had front row seats and fully understood its business and the strengths of its model.

What is the lesson from our 2008-2009 errors?

Of course, many other stocks aside from Google and Intuitive Surgical were just as undervalued during the bottom of March 2009. We were fully invested since there was no shortage of bargains. In order to buy Google, we would have had to sell another stock—most likely one that was also undervalued.

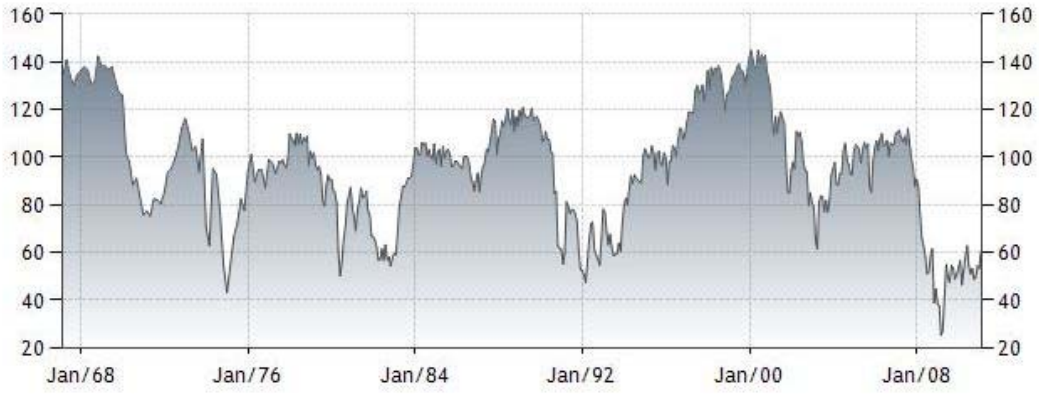
We did, however, have more conservative holdings in our portfolio, such as Wal-Mart, Procter & Gamble and Johnson & Johnson, that had not decline as much as the market. Relative to other stocks, these holdings were less undervalued and should have been sold. We would have certainly added several percentage points of performance to our returns for 2009 and 2010.

The conclusion: one should not hesitate to sell stocks trading at 60 cents to the dollar to buy stocks trading a 40 cents to the dollar!

Conclusion: the wall of fear

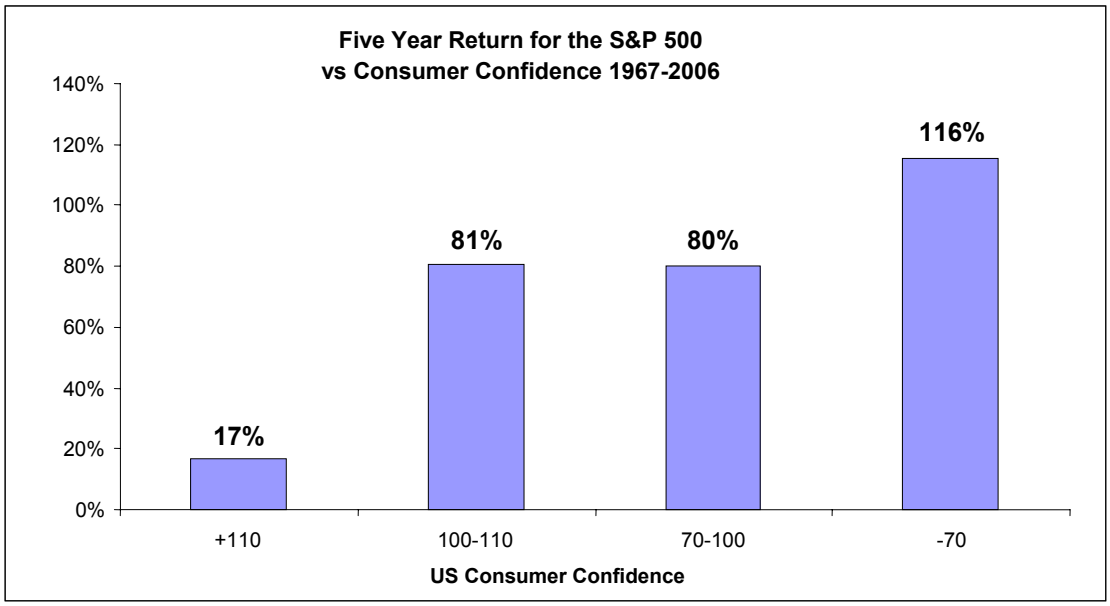
During my most recent interview with La Presse newspaper, I spoke about the "wall of fear" when referring to the continuous rise of the market. The ambient pessimism is still very high these days: people were highly distressed by the crisis and remain skeptical.

One way to measure the pulse of the population is to follow the level of consumer confidence in the US. If I were a macroeconomic strategist and wanted to receive only one piece of economic data per year in order to predict the market in the short or medium term, this would be it! It's no doubt simplistic, but when consumers are pessimistic, the market is low and there are numerous opportunities to create wealth. When consumers are optimistic, the market is high and a pause is likely to come.



US consumer confidence from 1967 to 2010 (Source: TradingEconomics.com and Conference Board)

A normalized confidence level is 100. The level at the end of the year was 53. This level remains quite low despite that it was higher than the level from the beginning of 2009. In fact, the level is still as low as it was during the recessions of 1974, 1982 and 1992.



Five years forward total return of the S&P 500 depending of the level of US consumer confidence (1967-2006)

Historically, when the level of consumer confidence was high (such as during 1999-2000), the return of the S&P 500 during the following five years ends up being quite modest. And when the level of consumer confidence was low, the return of the S&P 500 during the following five years was high. The more the population is pessimistic, the greater the potential for stocks in the medium term. As indicated in the chart above, when the level of consumer confidence dropped below 70, the return for the S&P 500 in the following five years was 116% (or 17% on annualized basis).

So, we still see great potential for the market for the years to come, especially in more undervalued sectors of the market. Even more importantly, however, is that the companies in our portfolio are in excellent financial health and trade at compelling valuation.

We also want you to know that we are fully aware and grateful for your vote of confidence. It is imperative for us to not only select outstanding companies for our portfolios, but to also remain outstanding stewards of your capital.

We wish a great 2011 to all our partners.



François Rochon and the Giverny Capital team

APPENDIX 1

Investment philosophy

In 2010, we saw a large increase in the number of Giverny Capital partners (the term we use for a client). With all these new comers, it is imperative that we write again (and again) about our investment philosophy.

Here the key points:

- We believe that over the long run, stocks are the best class of investments.
- It is futile to predict when it will be the best time to begin buying (or selling) stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity).
- We choose companies that have (sustainable) high margins and high returns on equity, good long term prospects and that are managed by brilliant, honest, dedicated and altruist people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be grossly assessed.
- The stock market is dominated by participants that perceive stocks as casino chips. With that knowledge, we can then buy great businesses sometimes well bellow their intrinsic value.
- There can be quite some time before the market recognizes the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

This discrepancy between the market quotes of a business and its underlying intrinsic value and the high volatility of the securities market are perceived by many participants as disadvantages. It's the other way around: market imbalances and fluctuations are our allies in our noble quest for wealth. In fact, the more irrational the stock market, the higher our chances are to attain our financial objectives.

But there is one important point: Owning a few undervalued securities (around 20) over many years doesn't yield linear returns. To stare at a freshly planted tree does not make it grow faster. Our approach is to judge the quality of an investment over a minimum **five years period.**

So patience – ours AND those of the partners – becomes the key ingredient for success.

Real patience is neither easy nor that common. That is why many investors pray in those words: "Dear God, could you gratify me with patience? And if it is at all possible, RIGHT NOW"

The Rule of Three

In conjunction with our investment philosophy, I've added a stock market rule that I called : The Rule of Three. This three parts rule comes from historical observations: it is not a scientific process that has come to its enunciation but an empirical one.

- One year out of three, the stock market will go down at least 10%.
- One stock out of three that we buy will be a disappointment.
- One year out of three, we will underperform the index.

The judgment that you – as partners – pose on our work should be in line with these parameters.

APPENDIX 2

Notes on the returns of the Giverny portfolios

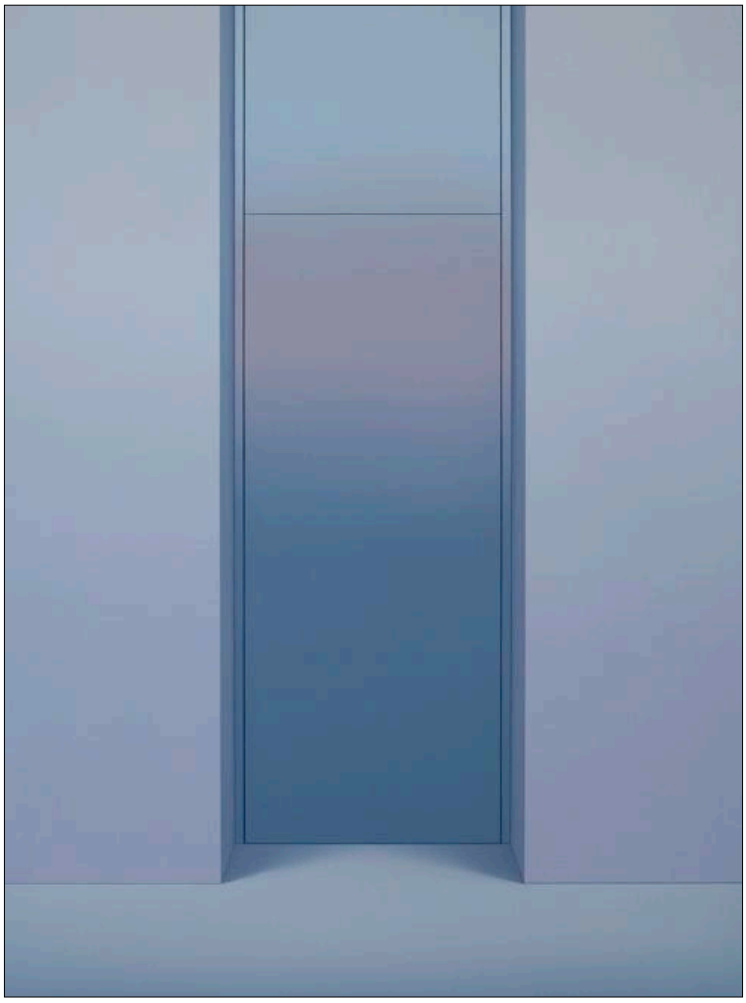
- The Giverny portfolio is a private family group of accounts managed by François Rochon since 1993. The returns of the period from 1993 to 1999 were realized before registration of Giverny Capital Inc. at the AMF in June of 2000.
- The returns indicated include trading commissions, dividends and other income but do not include management fees.
- The Giverny portfolio serves as a model for Giverny Capital's clients. But returns from one client to the other can vary depending on a multitude of factors, as for example the timing of their arrival.
- Past results do not guarantee future results.
- The index benchmark group is selected at the beginning of the year and tends to be a good reflection of the asset composition of the portfolio. In 2010 :

    - Giverny Global Portfolio: TSX 14% Russell 2000 39% S&P 500 39% MSCI EAFE 8%
    - Giverny US Portfolio : S&P 500 100%
    - Giverny Canada Portfolio : S&P / TSX 100%

- The returns are audited by Price Waterhouse Coopers (PWC) at the end of each year for each portfolio. PWC has audited all yearly results since 1993.
- The PWC data are those given by the fiduciary TD Waterhouse.
- The returns calculated by PWC are in compliance with ***generally accepted accounting norms in Canada.***
- The PWC report is available upon request.

Giverny Capital Inc.

Annual Letter to our Partners
2011



Pierre Dorion
Gate II - 2011
Giverny Capital Collection

Giverny Capital Inc. – 2011 Annual Letter ©

For the year ending December 31st 2011, our portfolio's return was +7.8% versus a loss of 1.1% for our benchmark. Our return, including a gain of approximately 2% due to fluctuations in the Canadian currency, therefore outperformed our benchmark by 8.9%.

Since our inception, on July 1st 1993, our compounded annual growth rate has been +13.6% versus +6.6% for our weighed benchmark, or an annualized outperformance of 6.9% over this period. When we exclude the effect caused by the appreciating Canadian currency since our inception, which represents an annualized increase of 1.2% since 1993, our portfolio has returned +15.0% annually versus +7.9% for our benchmark. Our long-term (and ambitious) objective is to maintain an annual return that is 5% higher than our benchmark.

The Artwork on Our Letter

We have illustrated the cover of our letter with a copy of an artwork from our corporate collection since 2004. This year, we selected a work by the Quebecois artist Pierre Dorion entitled "Gate II (22nd Street)".

The Giverny Portfolio (in Canadian dollars): Returns Since July 1st 1993

Return *	Giverny	Index **	+ / -	$ US/Can	S&P 500	+ / -	Giverny ***	Index ***	+ / -
1993 (Q3-Q4)	37.0%	9.5%	27.6%	3.3%	8.4%	28.6%	34.4%	7.4%	27.0%
1994	16.5%	3.7%	12.7%	6.0%	7.3%	9.2%	12.0%	-0.3%	12.3%
1995	41.2%	24.0%	17.2%	-2.7%	32.9%	8.3%	43.8%	26.3%	17.5%
1996	28.0%	22.8%	5.2%	0.3%	22.7%	5.3%	27.7%	22.5%	5.2%
1997	37.8%	28.6%	9.2%	4.3%	36.7%	1.0%	33.4%	24.5%	8.9%
1998	20.6%	18.8%	1.8%	7.1%	37.7%	-17.0%	14.5%	12.8%	1.7%
1999	15.1%	16.3%	-1.2%	-5.7%	14.1%	1.0%	20.6%	21.9%	-1.3%
2000	13.4%	3.2%	10.2%	3.9%	-4.6%	18.0%	9.7%	-0.2%	9.9%
2001	15.1%	-0.4%	15.5%	6.2%	-5.7%	20.8%	9.4%	-5.3%	14.7%
2002	-2.8%	-18.3%	15.6%	-0.8%	-22.0%	19.3%	-2.0%	-17.7%	15.7%
2003	13.6%	14.0%	-0.4%	-17.7%	5.7%	7.9%	33.7%	34.1%	-0.5%
2004	1.6%	6.2%	-4.5%	-7.3%	2.8%	-1.1%	8.3%	13.1%	-4.8%
2005	11.5%	3.6%	7.9%	-3.3%	1.5%	10.0%	14.5%	6.7%	7.8%
2006	3.5%	17.0%	-13.5%	0.2%	15.7%	-12.1%	3.3%	16.8%	-13.5%
2007	-14.4%	-11.6%	-2.8%	-14.9%	-10.0%	-4.2%	-0.3%	2.2%	-2.5%
2008	-5.5%	-22.0%	16.5%	22.9%	-22.2%	16.7%	-21.5%	-35.4%	13.9%
2009	11.8%	12.2%	-0.4%	-13.7%	9.6%	2.2%	27.7%	27.7%	0.1%
2010	16.1%	13.8%	2.3%	-5.3%	9.0%	7.1%	21.7%	19.3%	2.5%
2011	7.8%	-1.1%	8.9%	2.3%	4.4%	3.4%	5.8%	-2.9%	8.7%
Total	954.7%	229.0%	725.7%	-20.7%	217.7%	737.1%	1222.2%	308.5%	913.7%
Annualized	13.6%	6.6%	6.9%	-1.2%	6.4%	7.1%	15.0%	7.9%	7.1%

* Green section: all returns are adjusted to Canadian dollars
** Index is a hybrid index (S&P/TSX, S&P 500, MSCI EAFE, Russell 2000) which reflects the weight of the underlying assets
*** Estimated without the effect of currency
Note: Asset appraisal of the Giverny Global Portfolio performed by PricewaterhouseCoopers, in Canadian dollars.

The Giverny US Portfolio

We have been publishing the returns of the Giverny US Portfolio, which is entirely denominated in US dollars, since 2003. The Giverny US Portfolio corresponds to the American portion of the Giverny Portfolio. In 2011, the Giverny US Portfolio realized a return of +5.0% compared to +2.1% for our benchmark, the S&P 500. The Giverny US Portfolio therefore outperformed our benchmark by 2.9%

Since its inception in 1993, the Giverny US Portfolio has returned +1056.4%, or +14.1% on an annualized basis. During this same period, the S&P 500 has returned +298.9%, or +7.8% on an annualized basis. Our added value has therefore been 6.4% annually.

Year	Giverny US	S&P 500	+/-
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	37.6%	17.2%
1996	27.0%	23.0%	4.1%
1997	32.9%	33.4%	-0.4%
1998	11.0%	28.6%	-17.6%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-9.1%	20.4%
2001	8.1%	-11.9%	20.0%
2002	-4.4%	-22.1%	17.7%
2003	31.6%	28.7%	2.9%
2004	9.3%	10.9%	-1.6%
2005	12.5%	4.9%	7.5%
2006	3.3%	15.8%	-12.4%
2007	-1.7%	5.5%	-7.2%
2008	-24.3%	-37.0%	12.7%
2009	28.7%	26.5%	2.3%
2010	21.9%	15.1%	6.9%
2011	5.0%	2.1%	2.9%
Total	1056.4%	298.9%	757.5%
Annualized	14.1%	7.8%	6.4%

Note: Asset appraisal of the Giverny US Portfolio performed by PricewaterhouseCoopers
S&P 500 returns provided by Standard & Poors

We outperformed the S&P 500 for a fourth consecutive year, led by strong performances from companies such as Fastenal, Bank of the Ozarks, Buffalo Wild Wings, Visa and O'Reilly Automotive.

Giverny Canada Portfolio

We introduced a portfolio that is 100% focused on Canadian equities in 2007. This corresponds closely to the Canadian portion of the Giverny Portfolio. In 2011, the Giverny Canada Portfolio returned +13.5% versus a loss of 8.7% for our benchmark (the S&P/TSX), therefore outperforming our benchmark by 22.2%.

Since 2007, the Giverny Canada Portfolio has returned +66.4%, or +10.7% on an annualized basis. During this same period, our benchmark had a gain of +5.2%, or a gain of +1.0% on an annualized basis. Our annual added value was therefore 9.7%.

Year	Giverny Canada	S&P/TSX	+/-
2007	19.7%	9.8%	9.9%
2008	-24.6%	-32.9%	8.3%
2009	28.2%	33.1%	-4.9%
2010	26.7%	17.6%	9.1%
2011	13.5%	-8.7%	22.2%
Total	66.4%	5.2%	61.2%
Annualized	10.7%	1.0%	9.7%

Note: Asset appraisal of the Giverny Canada performed by PricewaterhouseCoopers

Our Canadian stocks performed very well in 2011. The all-star in our portfolio was Dollarama which rose 55%. MTY Foods and Computer Modelling Group also had solid years. As a result, we were able to outperform the TSX. Our Giverny Canada Portfolio has nearly no correlation with the TSX and, as the legendary John Templeton was fond of saying, "It is impossible to do better than the average without doing something different from the average."

2011: A Year in Review

The European financial crisis affected stock markets throughout the world, with nearly every major market outside of the US finishing the year in the red. For example, the Chinese market which is perceived as a bastion of economic growth, dropped nearly 20%. The Shanghai market reached a high of 6092 on October 16, 2007 and closed 2011 at 2199—a 64% decline in four years.

The TSX in Canada lost 8.7% in 2011—an underperformance of 10.8% relative to the S&P 500 in the US (actually a 13.1% difference if we consider the appreciating value of the US Dollar during the year). Last year, we wrote that US markets offered brighter prospects than the Canadian markets. We believe this to still be the case.

We are investors, not economic strategists or other soothsayers. From this perspective, 2011 was a "Grand Cru" year. Our companies, as a whole, had exceptional financial results and their stock prices resisted the widespread slump of many equity markets.

The Irony of Treasuries

2011 was a year when the media, and many people with savings (note that the word "investor" is not used), continued their near obsession with the debt problems of Western governments. But I will not engage in the easy game of social criticism. It's like in hockey: from the stands, everything seems so simple to fix.

During these times, corporations have managed their finances in a rational manner (at least for the most part). These companies don't have the luxury of dealing in large long-term liabilities while running short-term deficits. Ironically, corporate securities (stocks) are shunned in favor of governmental debt securities (treasuries)—and this has been the case for many years now. This has therefore created a rare situation where we observe a wide disparity between the valuation of stocks, with the S&P 500 trading at 12 times its earning power (corresponding to a earning yield of 8%), and the valuation of 10-year Treasury notes, which are trading at 50 times their interest payment (or a yield of 2%). During 2011, and despite this disparity, the majority of people sold their equity funds to put their savings into funds holding Treasuries.

The ultimate irony is that these "investors" are avoiding stocks for the simplistic reason that governmental debt is too high. They are ranting against government debt but yet buy more government debt at measly interest rates with their hard-earned dollars. They stand against indebted governments by lending them more money. And they do this with no additional reward to compensate for the inflation risk they assume. To the contrary, a 10-year note yielding 2% annually is almost certain to lose its real value over time. An annual inflation rate of 3% would create a loss of purchasing power of 10% over ten years, even after pocketing the interest.

The ultimate argument by buyers of government debt is that their investment is guaranteed. It is in fact a guarantee…. a guarantee of impoverishment.

Profiting from Pessimism

In August and September, the market was heading for another bear market (a drop of 20% of more). The majority of market participants, still feeling the sting from the crisis of 2008-2009, became drastically pessimistic (in a way that doesn't happen very often historically). From my experience over the last 20 years, I have never seen such a wide disparity between the perception of the market and its underlying economic reality.

We decided to profit from the many bargains that could be found at the time. Though we typically trade very little (with an average holding period of five years), we had a number of buys and sells in 2011. We increased our holdings in existing positions that seemed even more undervalued and also purchased new positions (see subsequent section). We also sold holdings that had less potential. In other words, we sold holdings that were trading at 60% of their intrinsic value (according to our estimate) to buy holdings trading at 40% of their intrinsic value.

A (Rare) Prediction in 2011

> *"I think the future of equities will be roughly the same as their past; in particular, common stock purchases will prove satisfactory when made at appropriate price levels. It may be objected that it is far too cursory and superficial a conclusion; that it fails to take into account the new factors and problems that have entered the economic picture in recent years – especially those of the movement toward less consumption and zero growth. Perhaps I should add to the list the widespread public mistrust of Wall Street as a whole, engendered by its well-night scandalous behavior during recent years in the areas of ethics, financial practices of all sorts, and plain business sense."*

These words perfectly summarize the overall sentiment towards the market these days. These words, however, were spoken by Benjamin Graham during a speech in 1974.[1] In 1973-74, the market had tumbled 50% and pessimism ran high. Western economies were sapped by the parasitic force of soaring inflation. The skyrocketing price of oil, fueled by war in the Middle East, permanently altered the North American model for transportation. Many at the time, with the fall of Saigon in 1975, believed that the end of the American capitalistic hegemony was near.

$10,000 invested in the Dow in 1974 would be worth more than $500,000 today (including the reinvestment of dividends). Over 37 years, the annual return has been 11%, which is pretty much in

[1] Published in *Financial Analyst Journal*, September/October, 1974

line with the 10% historical return of stocks. The prediction of Warren Buffett's mentor proved unquestionably accurate.

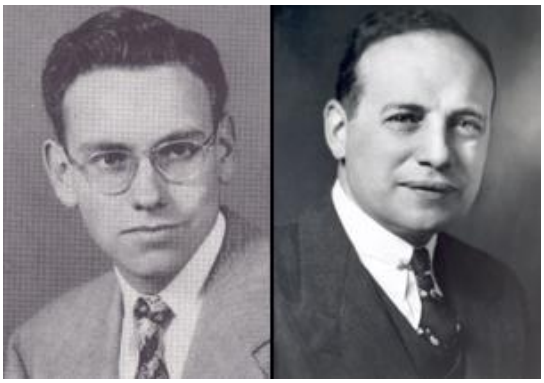


Figure 1: Warren Buffett as a student and Professor Ben Graham
(Source: Columbia University; circa 1951)

I also made a prediction this year which was published in the Montreal Gazette newspaper on August 30th (I have a bi-weekly column since January of 2011). During the panic of August/September, I predicted that within five years (by 2016), the Dow would rise to 17,000. My prediction isn't based on some fancy formula, but rather, by assuming corporate earnings would grow at an annual rate of 6.5% between 2011 and 2016 and then applying a P/E multiple of 15 to those earnings. Including dividends, this translates into an annual return of more than 10%.

Many experts, and many lesser experts, predict all sorts of things without facing their audience once their prediction are proven far-fetched (as they often do). At Giverny Capital, we don't play this game of predictions without a post-mortem assessment. We look forward to revisiting this prediction in the 2016 Annual Letter to our partners.

A Memorable Meeting in February 2011

It's not often you have the opportunity to meet one of your childhood heroes. Twenty years ago, fresh out of university, I started to get interested in the market. In November 1992, after juggling with all sorts of investing approaches, I read "One Up on Wall Street" by Peter Lynch.

Afterwards, I read everything I could find about Mr. Lynch and subsequently, on Warren Buffett (since Mr. Lynch had said that he was the best investor of all). These readings engraved the investment philosophy that has been behind the management of our portfolios since.

Last February, we received a very special invitation: Peter and his wife Carolyn invited us to their apartment in Boston to discuss about the stock market. Nicolas, Jean-Philippe and I had the chance to meet this legendary investor.

Mr. Lynch hasn't been involved in the management of mutual funds for several years now, but he does continue to manage a few portfolios with the same enthusiasm that has always been part of his approach. We talked about our favorite ideas, particularly within the retail and restaurant industries—a sector that Mr. Lynch has always enjoyed following.

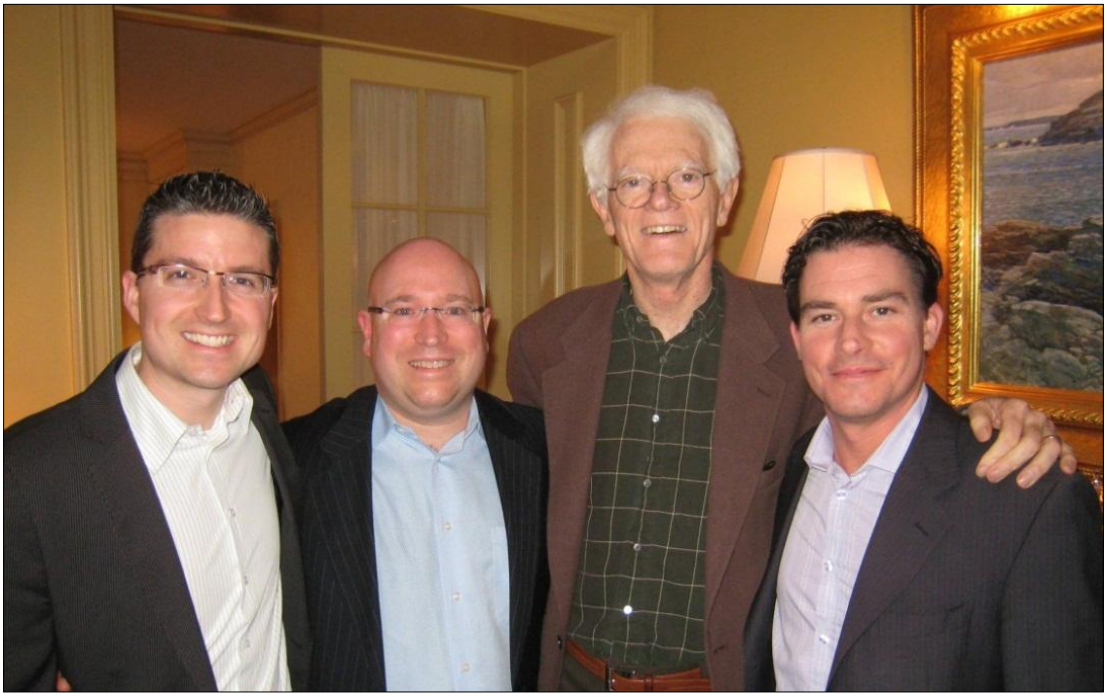


Figure 2 : Jean-Philippe, François, Peter and Nicolas

The Flavor of the Day for 2011

Each year, we elect our "flavor of the day" for the year. In other words, what is popular (and what will eventually likely yield little financial reward). In the last three Annual Letters, I have named the following "flavors": bonds, Canadian real estate and gold. These assets continue to remain popular.

I would dare to say that the "flavor of the day" is to detest stocks and the markets (the "Occupy Wall Street" movement embodies this quite well). Since our premise is to advocate caution and to not let ourselves be charmed by the "flavor of the day", the little sympathy garnered by stocks these days only reinforces our enthusiasm. Our enthusiasm is, of course, tied to the compelling market valuations of the stocks we own. But it is amplified (if not confirmed) by the negativity of most market participants.

Owner's Earnings

At Giverny Capital, we do not evaluate the quality of an investment by the short-term fluctuations in its stock price. Our wiring is such that we consider ourselves owners of the companies in which we invest. Consequently, we study the growth in earnings of our companies and their long-term outlook. Since 1996, we have presented a chart depicting the growth in the intrinsic value of our companies using a measurement developed by Warren Buffett: "owner's earnings". We arrive at our estimate of the increase in intrinsic value of our companies by adding the growth in earnings per share (EPS) and the average dividend yield of our portfolio. This analysis is not exactly precise but approximately correct. In the non-scientific world of the market, and as Keynes said: "it is better to be roughly right than precisely wrong."

This year, the intrinsic value of our companies, as a whole, rose by 17% (16% from the growth in earnings and 1% from the average dividend). Despite changes to our portfolio during the year, we consider this growth in earnings to appropriately reflect the economic reality of our group of companies. The stocks of our companies rose 6% (without the effect of currency), which can only

mean one thing: our companies are more undervalued at the current moment than they were at the beginning of the year. And it was the same story for the S&P 500: the underlying earnings growth of its companies was 17% and the index only rose by 2%.

	Giverny			S&P 500		
Year ***	Value *	Stock **	Difference	Value *	Stock **	Difference
1996	14%	29%	15%	13%	23%	10%
1997	17%	35%	18%	11%	33%	22%
1998	11%	12%	1%	-1%	29%	30%
1999	16%	12%	-4%	17%	21%	4%
2000	19%	10%	-9%	9%	-9%	-18%
2001	-9%	10%	19%	-18%	-12%	6%
2002	19%	-2%	-21%	11%	-22%	-33%
2003	31%	34%	3%	15%	29%	14%
2004	21%	8%	-12%	21%	11%	-10%
2005	14%	15%	0%	13%	5%	-8%
2006	14%	3%	-11%	15%	16%	1%
2007	10%	0%	-10%	-4%	5%	9%
2008	-3%	-22%	-19%	-30%	-37%	-7%
2009	0%	28%	28%	3%	26%	23%
2010	22%	22%	0%	45%	15%	-30%
2011	17%	6%	-11%	17%	2%	-15%
Total	594%	474%	-120%	206%	172%	-34%
Annualized	12.9%	11.5%	-1.3%	7.2%	6.5%	-0.8%

* Estimated growth in earnings plus dividend yield
** Market performance, inclusive of dividends
*** Results estimated without currency effects

Since 1996, our companies have increased their intrinsic value by 594%, or about a sevenfold increase. Meanwhile, the value of their stocks has increased 474% (without currency effect). During this same period, the companies comprising the S&P 500 increased their aggregated intrinsic value by 206% and saw their stock prices rise by 172%. Market performance and corporate performance are rarely synchronized over the course of a calendar year. But as more time passes, the synchronization between the two begins to reveal itself.

Over 16 years, our portfolio has realized a return that is 5% higher than the S&P 500 for the simple reason that the underlying companies in our portfolio have increased their intrinsic value at a rate that is 5% higher than the average.

Five-year Post-mortem: 2006

Like we do every year, we go through a five-year post-mortem analysis. We believe that studying our decisions in a systematic manner, and with the benefit of hindsight, enables us to learn from both our achievements and our errors. 2006 was a difficult year for our investment style and we had our worst year relative to market indices. Our reaction was to remain loyal to our philosophy. *"If we are on right path, the only thing left to do is to keep walking"* is what we wrote in the beginning of our Annual Letter that year. Many companies in our portfolio saw their stock prices decline despite their

EPS increasing. Fastenal's stock, for example, declined 8% even though its earnings increasing by 21%. Fastenal's stock price has doubled since… because its EPS has doubled.
Over the course of the five years since 2006, our holdings have returned +5.1% annually versus an annual loss of 0.4% for the indices (without considering the effect of currency). During the economic tempest of the last years, the ship built from our portfolio companies held fast and our capital was adequately protected. We are back on the path to reach our ambitious goal of outperforming the indices by 5% on an annual basis.

In 2006, in the "flavor of the day" section, we discussed Canadian banks. Canadian banking stocks were climbing 15% annually at the time and many investors were in love with them. I explained that stocks such as Scotiabank and the Bank of Montreal had done well primarily because their P/E multiples had expanded from 8x in 2000 to 14x in 2006. I added that *"In the long run, in a Canadian economy which grows at 5% per year, it seems to be unrealistic to believe that all the players of the banking industry will be able to do much better than this growth rate."* Since then, over the last five years, the stock of the Bank of Montreal has gone from $69 to $56, while Scotiabank's stock threaded water—going from $52 to $51.

Significant Buys from 2006

In 2006, we bought shares in two new companies: Mohawk Industries located in Georgia, and Bank of the Ozarks located in Arkansas.

Mohawk is the largest floor covering company in the US (includes carpeting, wood flooring, and tiles). I've always admired its CEO, Jeff Lorberbaum. In 2006, the stock dropped and I saw an opportunity to buy shares at $75. Today, the stock is trading around $64. Therefore, this has not been a good investment so far. The company was heavily affected by the depression in residential construction in the US. We were aware at the time that this sector was experiencing some difficulty, but since this segment was only 15% of the company's revenue, we were confident that the company's prospects remained bright. But the recession of 2008-09 affected the company's earning power more than anticipated and—as a result—its stock price followed suit.

EPS dropped from $7.31 in 2006 to $2.53 in 2009, and then bounced back to $3.77 in 2011. The company is still a long ways from the profitability level it enjoyed before the crisis. Despite this, we still like the company's management and are convinced that a rebound in this industry is around the corner.

Bank of the Ozarks has been a more rewarding investment. We bought this stock at the end of 2006 and it doubled over the next five years.

Bank of the Ozarks is a bank in Arkansas (the Ozarks is a region in the north of this state). Although Bank of the Ozarks has existed since 1903, it wasn't until 1979 that the company started to shine, when 25-year old George Gleason took control of the bank. The company only had $28 million in assets at the time. It now has more than $3.8 billion in assets. The company went public in 1997 at $2 per share (adjusted for stock splits) and the company's stock price has increased fifteen fold since (an annualized return of 21%).

I met Mr. Gleason in November 2006 at their headquarters in Little Rock. I was very impressed by his easygoing manner and that of his upper management (about fifteen VPs welcomed me that day). I had the feeling that Mr. Gleason knew each loan on the bank's books. Nothing exotic (or esoteric), no subprime mortgages, no incomprehensible derivative products: only traditional banking activities. The

company had a low cost structure and very few bad loans. Its conservatism enabled the bank to not only survive the financial crisis of 2008-2009, but to also make excellent acquisitions at very compelling prices in the aftermath.

In fact, Ozarks was able to increase its assets by 50% due to the crisis (thanks to many acquisitions made at bargain prices and aided by the FDIC[2]). We bought shares in 2006 at $15, when the company was earning $.95 per share. We paid a premium to the typical P/E multiple we would pay for a bank but believed it deserved such a premium.

While the majority of banks are earning less in 2011 than they did in 2006, Ozarks has doubled its EPS over five years—and the stock price has followed suit. More interestingly is that Ozarks, with its prudent management, is probably one of the least risky banks in the US. Despite the widespread stereotype, risk and reward don't necessarily always go hand in hand.



Graph 1: Shares of Bank of the Ozarks from 2006 to 2011

Market volatility is a whole other thing. Two years after buying Ozarks, the stock dropped by 50%. If you have a good memory, you will remember that in the quarterly letter from June 2008 (when we were answering questions from our partners), we had this question: *"What explains the crumbling stock of Bank of the Ozarks? In today's trading session alone, for example, the stock lost another 10%."* I responded that nothing explained this drop and that the fundamentals of the bank seemed intact and that we should not let ourselves by affected by short-term market fluctuations.

[2] The Federal Deposit Insurance Corporation (FDIC) is a governmental entity guaranteeing banking deposits in the US and that can, when necessary, take temporary control of struggling banks.

Our Companies

"Wealth is the product of Man's capacity to think."

- Ayn Rand

American Express (AXP, $47)

Amex had an excellent year: revenues climbed 9%, cards issued rose 7%, and EPS increased 22% to $4.09. The average amount spent by cardholders was $14,881—12% higher than in 2010. This figure is about five times more than Visa or MasterCard. But the best news was that the level of write-offs for bad loans has been gradually declining from 4.3% at the end of 2010 to 2.3% during the last quarter of 2011.

Amex earned 21% more in profits than in 2007—the year before the financial crisis. Strangely, its stock price has decreased from $65 to $47: the P/E multiple has therefore been tumbling from 19x to 11x. The financial crisis was a benefit for Amex. The company was able to adopt the structure of bank and lower its borrowing costs (by being able to pay less interest on its deposits). The company was also able to gain market share relative to other card issuers. Above all, Amex demonstrated that it was able to navigate through one of the worst financial crises in history and that its business model (which is more integrated than that of Visa or MasterCard) was intact.

We consider American Express one of the strongest brands worldwide and we believe this company is worth far more than 11 times earnings.

Bank of the Ozarks (OZRK, $30)

For 2011, shares of Bank of the Ozarks rose 17%. Non-performing loans decreased from 1.72% in 2010 to 1.17% in 2011. EPS climbed by 56%, to $2.94, though there were some non-recurring items. I estimate that its earning power is about $2 per share.

Berkshire Hathaway (BRK.B, $76)

The company led by the legendary Warren Buffett was very active in 2011. Berkshire made several significant acquisitions (the largest of which was the $9 billion purchase of Lubrizol). The company also made massive purchases in its stock portfolio and announced a share buyback (see the conclusion of this letter). A second co-manager, Ted Weschler, was hired to potentially succeed Warren Buffett. The financial titan of Omaha is stronger than ever.

With its stock price threading water, Wall Street remains myopic to the company's intrinsic value and its long-term potential (it is still trading for 20% less than it did in 2007). That's just fine with us: we bought more shares throughout the year at very good prices.

Buffalo Wild Wings (BWLD, $68)

We bought shares in this interesting American restaurant chain two years ago. As its name suggests, this company specializes in selling chicken wings and a number of accompanying sauces. The theme of the restaurant is one of a sports bar (a bit like the "Cage aux Sports" which we know quite well here in Quebec). The company is growing quickly and now has 824 restaurants (with 519 operating as franchises). Revenues for 2011 grew by 28% and EPS rose 32%. The company maintains a return on equity of 20% which is excellent for the restaurant industry. From 2007 to 2010, the restaurant

industry experienced four consecutive negative years of comparable sales. Buffalo Wild Wings, however, maintained an average organic growth rate of 3%. In 2011, their organic growth rate was 5% while the industry overall grew at only 1%.

Of course, like any company that relies on cloning its concept (for a restaurant or a retail store), there is a maturity plateau that eventually needs to be reckoned with. We believe that the company can at least double its restaurant base before reaching such a saturation point. The company even now has four restaurants in Canada and is aiming to open 16 new locations here in 2012 and hopes to reach 100 restaurants within a couple of years.

Carmax (KMX, $31)

The fiscal year at Carmax ends on the last day of February. We are anticipating EPS and sales growth of 10% for fiscal 2011-2012. The company now has 107 stores in the US but still only has 3% of the used car market. Carmax is planning on opening 10 to 16 stores per year for the next five years (or about a 60% increase in the size of its current retail footprint).

We have been shareholders in Carmax since 2007. Although it hasn't been an easy time for American consumers, Carmax still managed to double its earnings per share since our purchase and the stock has risen by 50%. Few companies have an annual growth potential of 15% for the next decade and when we have the opportunity to buy such a company at less than 15 times earnings (like we did during the year), we become even more enthusiastic.

5N Plus (VNP-T, $5)

2011 was a transformative year for 5N Plus. The company quadrupled in size by acquiring the Belgian company, MCP Group SA. The latter is world's largest producer and distributor of bismuth (with 50% of the market), gallium, indium, selenium, and tellurium. 5N Plus paid $317m for this business by using cash, selling debt and issuing more shares. This allowed 5N Plus to reduce its dependency on the American firm First Solar and on solar energy in general—which experienced a horrible 2011!

Since the acquisition, the company's shares have slid from $8 to $5 due to the falling prices of a number of metals that the 5N Plus sells. The company is the leader in the markets for bismuth and cadmium telluride (used in solar panels) and we believe that the company will be able to maintain attractive margins despite fluctuations in base metal prices. The company adds value through its purification activities. The company is trading at nine times its 2012 estimated earnings and seems undervalued.

Disney (DIS, $38)

Disney had an excellent 2011. Earnings rose by 17% and ESPN continued to spearhead the company's strong earnings. Strong theatrical releases (such as Cars 2, Pirates of the Caribbean 4 and Thor) also contributed significantly. The number of subscribers to the Disney Channel reached 100 million and the company started construction of its theme park in Shanghai.

Bob Iger remains, in my opinion, one of the best CEOs in the US. For 2012, we are estimating EPS of more than $3. The stock is therefore trading at only 13 times estimated earnings.

Dollarama (DOL-T, $45)

Two years ago, we were thrilled by the IPO of a company we had long admired: Dollarama. The reason for this admiration is simple: for us the company's founder and CEO, Larry Rossy, is one of the best businessmen in Canada. We bought shares after the IPO and the stock has done very well—doubling in value since.



Figure 3: Larry Rossy, CEO of Dollarama (Photo: Globe and Mail)

After the first three quarters of 2011 (its fiscal year ends on January 31), revenues rose by 12%, same-store sales increase 4.4%, and EPS surged 46%. We knew that net margin could expand but the performance of 2011 exceeded our expectations. EPS should reach $2.45 in 2012 and the stock seems reasonably valued at the current level. We are keeping our shares with enthusiasm.

Fastenal (FAST, $44)

Fastenal hit a grand slam in 2011. Revenues rose by 22% and EPS climbed by 34%. This company from Winona (Minnesota) opened 122 new stores (selling nuts and bolts) in 2011—the company now operates 2585 stores.

We bought Fastenal in 1998 and it has been our most rewarding investment to date. This company has everything: a most boring primary business activity, a profitability level unrivaled in the industry, and a unique culture. Above all, the company is led by a management team dedicated to creating value with a long-term time horizon while always taking to heart its customers, employees and shareholders.

M&T Bank (MTB, $76)

M&T Bank had a good year. After extraordinary items, we estimate 2011 earnings per share of $6.74 which is 15% higher than 2010. Like Ozarks and Wells Fargo, bad loans are decreasing while profitability is increasing. M&T's return on its assets is about 1.2%. We believe that its return on asset could reach 1.5% in the long term, meaning that EPS could reach $11 in a few years.

MTY Food Group (MTY-T, $15)

MTY continued to acquire more brands in the quick service restaurant industry (with its restaurants primarily located in retail malls). In 2011, the company acquired:

- Koryo Korean BBQ (20 restaurants)
- Mr. Submarine (338)
- Jugo Juice (136)



Figure 4: Stanley Ma, CEO of MTY (Source: Canadian Business; Photo: Sylvain Dumas)

MTY now operates 2263 restaurants throughout Canada. In 2011, revenues rose by 17% and EPS increased 9%. Although the company significantly increased its operating expenses (after the acquisition of a production facility), we believe that these lower margins are temporary.

We remain admirers of Stanley Ma, the CEO of MTY, and we believe that the company's long-term prospects are very bright. The company also distributes now roughly a quarter of its profits in dividends.

Omnicom (OMC, $45)

Omnicom, the largest advertising firm in the world, had an excellent year in 2011. Revenues rose by 11% and EPS by 24% (partly boosted by the company buying back 7% of its shares outstanding during the year). Omnicom also raised its dividend by 25%.

We have been shareholders in Omnicom since 2008 and have earned a good return since. The stock is only trading at 12 times earnings. So, it seems to us that its potential for appreciation is excellent.

O'Reilly Automotive (ORLY, $80)

In 2011, O'Reilly continues to reap the benefits of its courageous acquisition of 1492 CSK stores in 2007-2008 (courageous because this acquisition was completed in an environment of great pessimism towards the retail sector). In four years, the number of stores has increased from 1830 to 3707 and

sales have risen from $2.5b to $5.8b. Above all, EPS has climbed from $1.67 to $3.81. In 2011, sales rose by 10%, with 5% coming from same-store sales. EPS increased by 22%.

Since our purchase in the summer for 2004, the total growth in earnings has been 350% (or 20% annually). The stock has quadrupled.

Resmed (RMD, $26)

2011 was a difficult year for Resmed. Revenues rose 12% and EPS increased about 7%. These results are good but we are beginning to see a significant slowdown in the company's growth. Since we bought shares in this Australian company back in 2004, it has grown its revenue from $340m to $1.2b—an annualized growth rate of 20%. It has been a satisfactory investment.

We decreased our position in this company during 2011. The company's growth rate, as mentioned, has been slowing over the last couple of years (while its valuation by the market remained fairly high). The company's founder, Peter Farrell, has also been looking for a successor for some time now—without much success. We would consider increasing our position if we see a clear path to returned growth.

Stryker (SYK, $50)

Sales at Stryker rose by 11% in 2011, to $8.3b, while EPS increased by 14%. The most significant news of the year was Stryker's purchase of the neurovascular division of Boston Scientific. This acquisition enabled Stryker to grow its neurology revenue by 49%. This segment now represents 17% of the company's revenue and Stryker continues to diversify its medical products portfolio.

We anticipate another 10%+ increase in earnings for 2012. In 2013, however, the company will have to begin paying a new 2.3% medical products tax for its US revenue (about two thirds of its business). This will have a minor impact on Stryker and the company, with its excess cash, should be able to acquire new sources of revenue.

Visa (V, $102)

Visa's 2011 revenue and EPS increased by 14% and 24%, respectively. The stock rose from $70 to $102 as the worry about the Durbin financial reforms began to dissipate. Regulations regarding debit card transaction charges turned out to be less harsh than initially anticipated.

Our purchase of Visa, which occurred last year when its shares dropped precipitously, has so far been quite rewarding. The company also benefited from its shares dropping at the time by buying back 43 million shares of its stock at an average price of $75 (effectively returning $3.2b to shareholders). Despite the lower debit card transaction fees anticipated for 2012, Visa estimates that EPS will grow 15% or more during the current fiscal year.

Wells Fargo (WFC, $28)

Wells Fargo had an excellent year. EPS climbed to $2.82—a new record. Deposits increased from $838b to $912b, (with an average interest rate of .22%). Non-performing assets (bad loans) continued to drop during the year and the bank's return on assets continued to increase. Wells Fargo's Tier 1 ratio (an indicator of its financial strength) rose from 8.3% last year to 9.5% at the end of 2011.

We expect EPS of $3.35 for 2012. We therefore continue to believe that the stock is highly undervalued. It's trading at 10% less than what it did at the same time last year even though we think that its earning power has increased by 20%.

New investments for 2011

Google (GOOG, $646)

We bought a position in Google, as we wrote in our quarterly letter from last June. We are generally not fond of technology companies. We have observed over the course of several years a number of technological shifts that rendered obsolete once outrageously dominant companies.

But in our eyes, Google isn't really a tech company. It is first and foremost a service provider with the type of dominant brand we have seldom seen in our careers. Using Google to find something on the Internet has become the norm and has now even become a verb in our language (to "google"). We love these types of dominant brands because they are so well entrenched and because they cannot just be attacked by money and are not as prone to fad.

We bought our shares when the company's stock experienced a market correction during the year.

Valeant Pharmaceuticals (VRX.T, $47)

We have followed the pharmaceutical industry for some years and have owned shares in a diverse group of companies in this space at various times over the last 19 years. For some time now, the economic model of this industry—based on the constant discovery and marketing of new drugs—hasn't been working as well as it once did. A former consultant from McKinsey, Michael Pearson, proposed a new model for the industry. Armed with a pro-shareholder attitude and a value investing mindset, Pearson took over at the helm of Valeant in 2008.

Since then, due to numerous acquisitions coupled with disciplined resource optimization, revenues at Valeant have increased from $872m to more than $2.5b. Operating margins have risen from 19% to 35%. Mr. Pearson seems to be an exceptional CEO, despite the inherent complexity of this industry, and he has our vote of confidence to continue creating shareholder value. When the stock price had a correction last fall, the company bought back its own shares (and Mr. Pearson himself also increased his ownership). We did the same: we first bought shares in Valeant at the beginning of the summer and doubled our position during the fall.

Due to its merger with Biovail, Valeant became a Canadian corporation. Despite the company's excellent performance on the market (tripling in two years), we believe that this stock is still undervalued. With our estimated profit of $4 per share for 2012, the stock's P/E is still only 12 times.

IBM (IBM, $184)

In 1995, I wrote an article for the Journal Les Affaires entitled *"IBM's Turnaround Largely Goes Unnoticed by Wall Street"*. For those who might remember, the company had some very serious problems a couple of years prior. In 1993, Louis V. Gerstner became CEO and orchestrated one of the greatest turnarounds in corporate history. At the beginning, Wall Street—still licking its wounds with the company—avoided the stock. IBM was trading at $20 (adjusted for splits) at the time, which was eight times its EPS. I considered this a very a very compelling valuation. For some odd reason, I only bought shares for one partner (who is still with us today and who must recognize himself) and I only

kept those shares for a brief period of time. I don't really have an explanation for not buying more shares aside that I must have found other even more appealing companies at the time.

But I continued to follow the work of Mr. Gerstner until his retirement in 2002. The stock had risen from $20 in 1995 to $135 in 2000 (at the top of the tech bubble) and then tumbled back to $60 in 2002. I continued to follow the company under the new management team. EPS went from $2.76 in 1995 to $6.01 in 2006 (a 7% annual growth rate). Then, in the five years that followed, EPS more than doubled and topped $13 in 2011 (a 17% annual growth rate). The company's accelerating earnings growth during the last years is the fruit of an optimal (and exemplary) use of its corporate and financial resources. Aside from brilliantly managing its operating activities, IBM also aggressively bought back its own shares.

In 2011, I finally stepped on my pride and we decided to buy shares in IBM, after comparing it with other blue chips we owned in our portfolio. It seemed to us that IBM was better managed while its market valuation was just as compelling as the other companies.

It is worth noting that, aside from 1995-1996 and 2008-2009, IBM's P/E has never been as low as it is now (12 times). It seems to us that Wall Street still hasn't fully realized the extent of the company's performance.

The Podium of Errors

"A life spent making mistakes is not only more honorable, but more useful than a life spent doing nothing."

- George Bernard Shaw

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2011 (or from past years). It is with a constructive attitude, in order to always improve as investors, that we provide this detailed analysis. As is often the case with stocks, errors from omission (non-purchases) are often more costly than errors from commission (purchases)… even if we don't see those on our statements.

Bronze Medal: Hansen Natural (now Monster Beverage)

About five years ago, a longtime friend, Jean-Louis Gauvreau, spoke to me with great enthusiasm about Hansen Natural. The company manufactures and markets an energy drink called Monster. The company's products are very popular and Hansen is highly profitable. Although Red Bull is the leader in this market, there seems to be ample space for other beverages in this industry. Jean-Philippe and I decided to push our research beyond its financial statements: we drank this beverage. After finding the taste rather strange, we just couldn't see the appeal of the product. But we decided to continue to study the company anyway!

In 2008, Hansen ran into a couple of tough quarters but managed to reinvigorate its growth due to, among other things, a distribution deal with Anheuser-Bush from 2007 and the introduction of new products. I knew that the deal with the behemoth behind Budweiser would prove highly beneficial and Hansen's plummeting stock price (which cratered from $34 to $11) offered an excellent occasion for us to buy. But I decided to pass.

In 2011, the company is twice as profitable as it was four years before. The stock has recently reached $50—about four times the price at which I had considered buying. I should have drank more of their product to stay awake!

Silver Medal: Healthcare Services Group

This error has been a long time in the making. In 1994, I discovered this interesting business: Healthcare Services Group. HSG is a provider of cleaning and janitorial services primarily for hospitals and healthcare facilities. It is difficult to find a more boring business. No one on Wall Street followed this company. But the company had terrific potential with little competition and a very reasonable valuation (with a P/E of 14x). The company had solid sales growth but its margins were low (and weakening). Its return on equity was therefore modest (return on equity is a key criteria at Giverny Capital). I lost interest.

HSG recently appeared in Value Line and I noticed the progress the company had made during the 16 years after I stopped following it. During many years, margins continued to weaken (reaching a low of 2% in 2000) and EPS went nowhere. Starting in 2001, however, the company started to grow again and EPS increased fivefold over the next 10 years. Even better, the company started paying a dividend in 2003 and has increased its payment every year since. Today, all of the company's earnings are actually paid out in dividends. For a company to continue to grow while no capital is retained is quite an accomplishment.

Over 10 years, revenues have risen from $284m to $865m and EPS rose from $.13 to $.60. The stock has risen from $1.40 to $19—a 1200% increase. The current market valuation is high (27 times its estimated earnings for 2012) but the dividend payment helps maintain such a rich valuation. High tech companies generating lots of cash and not giving any of it back to shareholders would have a lot to learn by looking at the Value Line report on HSG.

What was my error? It was to stop following this company. Starting in 2005, it would have been obvious that the company was significantly improving its business model. I would have missed the first wave of appreciation in the stock but we still would have tripled our investment in six years. Not counting an average dividend payment of 3%.

Gold Medal: Restaurant Companies in 2008

At the beginning of 2008, all sectors linked to consumer spending in the US (retail chains, restaurants, etc.) were depressed. Wall Street was worried—with reason—about a deep recession caused by the high debt levels of American families. Stocks in these sectors had dropped significantly.

In February 2008, well before the great market decline from the fall of that year, restaurant stocks seemed attractively priced and I went ahead and made a list of three potential candidates. The list was published in an article in the Journal Les Affaires about the restaurant sector. I was quoted as saying: *"Mr. Rochon believes that the worry concerning consumer spending will create purchasing opportunities in the US. He likes Cheesecake Factory, Buffalo Wild Wings and Panera Bread. Their concepts are working well and they can open many more locations."*

I knew Cheesecake Factory well. It's a chain I discovered while I was in Kansas City in 2004 (during my trip to Missouri to visit O'Reilly Automotive). I had also been a fan of Panera Bread for many years. Here is the performance of these three stocks relative to the S&P 500 (since the date that the article in Journal Les Affaires was published almost three years ago):

Stock	Feb 15, 2008	Dec 31, 2011	Gain *
Buffalo Wild Wings Inc.	$25.0	$67.5	170%
Cheesecake Factory	$20.5	$29.4	43%
Panera Bread	$38.3	$141.5	269%
Average			161%
S&P 500	1350	1258	-7%

* market returns not including dividends

These three stocks have, on average, risen 161% over 46 months. This is a phenomenal performance, especially when compared to the S&P 500 which decreased 7% during the same period (not inclusive of dividends). Sadly, we only slightly benefited from this surge by buying Buffalo Wild Wings in 2009 at $40—and then only putting to work a very modest sum of capital (about 2% our portfolio).

I knew that it was a perfect occasion to buy these high growth companies at good prices. But unfortunately, I remained seated in the bleachers and didn't act on my enthusiasm.

Conclusion: the First Share Buyback for Warren Buffett in 47 years!

The financial crisis of 2008-09 created the opportunity for Mr. Buffett to make billions of dollars by making sound investments at good prices and shareholders in Berkshire Hathaway profited enormously from these purchases. The value of these investments has already been realized in some cases (such as preferred shares he already resold in 2011), and others are still being realized. Regardless, the assets recently purchased at well below their intrinsic values will be a source of great financial reward in the years to come.

Strangely, the market has yet to adequately reflect the growth in intrinsic value at Berkshire Hathaway since 2008. During last September, the stock was trading near the level of $70. At that time, we increased our position in Berkshire by 50% and we consider this perhaps one of the best occasions to have bought this stock in our lifetime. If Mr. Buffett was a few years younger, we probably would have bought even more.

Warren Buffett also announced at the time that Berkshire Hathaway would be buying back some of its own shares. The reason he provided was very simple: "the stock seems undervalued". Mr. Buffett had announced a buyback in March of 2000 but the stock proceeded to climb so quickly that he was never able to carry out his announcement. This time around, we were a bit more "lucky": the stock didn't rise much and the company was able to buy back a good portion of its stock for the first time since Mr. Buffett became president in 1965. This should prove very rewarding to us.

To Our Partners

The rigor of our investment selection process enabled us to get past the great crisis of 2008-09 and also through the market correction of last summer. Our companies have the balance sheets and management teams in place to not only survive these types of crises, but to also increase their market share and competitiveness during these difficult times. The outlook for our companies is excellent and we believe that this is an opportune time to invest should you have excess capital.

We also want you to know that we are fully aware and grateful for your vote of confidence. It is imperative for us to not only select outstanding companies for our portfolios, but to also remain outstanding stewards of your capital.

The entire team at Giverny Capital thanks you.

We wish a great 2012 to all our partners.



François Rochon and the Giverny Capital team

APPENDIX 1

Investment philosophy

Note: This section is repeated from prior annual letters and is aimed at new partners.

In 2011, we saw a large increase in the number of Giverny Capital partners (the term we use for our clients). With all these newcomers, it is imperative that we write again (and again) about our investment philosophy.

Here are the key points:

- We believe that over the long run, stocks are the best class of investments.
- It is futile to predict when it will be the best time to begin buying (or selling) stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity).
- We choose companies that have high (and sustainable) margins and high returns on equity, good long term prospects and are managed by brilliant, honest, dedicated and altruistic people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be approximately assessed.
- The stock market is dominated by participants that perceive stocks as casino chips. With that knowledge, we can then sometimes buy great businesses well below their intrinsic values.
- There can be quite some time before the market recognizes the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

Experience and common sense teach us that an investment philosophy based on buying shares in companies that are undervalued, and holding these companies for several years, will not generate linear returns. Some years, our portfolio will have a return that is below average. This is a certainty that we must accept.

Another important point: the significant volatility of the market is often perceived negatively by many investors. It's actually the contrary. When we see stock prices as *"what other people believe the company is worth"* rather than the real value (at least in the short term), these fluctuations become our allies in our noble quest for creating wealth. Instead of fearing them, we can profit from them by acquiring superb businesses at attractive prices. The more that markets (the "other" participants) are irrational, the more likely we are to reach our ambitious performance objectives.

Benjamin Graham liked to say that the irrationality of the market was an extraordinary advantage to the intelligent investor. The person, however, who becomes affected by short-term market fluctuations (less than 5 years) and who take decisions based on them transforms this advantage into a disadvantage. His or her own perception of stock quotes becomes their own worst enemy. Our approach at Giverny Capital is to judge the quality of an investment over a long period of time.

So patience – ours AND that of our partners – becomes the keystone for success.

APPENDIX 2

Notes on the returns of the Giverny portfolios

- The Giverny portfolio is a private family group of accounts managed by François Rochon since 1993. The returns of the period from 1993 to 1999 were realized before registration of Giverny Capital Inc. at the AMF in June of 2000.
- The Giverny portfolio serves as a model for Giverny Capital's clients. But returns from one client to the other can vary depending on a multitude of factors, such as the timing of the opening and funding of a client's account.
- Past results do not guarantee future results.
- The returns indicated include trading commissions, dividends and other income but do not include management fees.
- The index benchmark group is selected at the beginning of the year and tends to be a good reflection of the asset composition of the portfolio. In 2010 :

    - Giverny Global Portfolio: TSX 14% Russell 2000 39% S&P 500 39% MSCI EAFE 8%
    - Giverny US Portfolio : S&P 500 100%
    - Giverny Canada Portfolio : S&P/TSX 100%

- An asset appraisal of the three portfolios is performed by PricewaterhouseCoopers (PwC) at the end of each year for each portfolio. PwC has audited all yearly statements since 1993.
- The PwC data are those provided by our custodian TD Waterhouse.
- An appraisal of each portfolio under management is sent by TD Waterhouse on a monthly basis.
- The PwC reports are available upon request.
- For more information, please see the "returns" section of our website.

Giverny Capital Inc.

Annual Letter to our Partners 2012



Lynne Cohen
Untitled (smiling couch) - 2011
Giverny Capital Collection

Giverny Capital Inc. – 2012 Annual Letter ©

For the year ending December 31st 2012, our portfolio's return was 21.5% versus 12.5% for our benchmark. Our return, including a loss of approximately 2% due to fluctuations in the Canadian currency, therefore outperformed our benchmark by 9.0%.

Since our inception, on July 1st 1993, our compounded annual growth rate has been 14.0% versus 7.0% for our weighted benchmark, representing an annualized outperformance of 7.0% over this period. When we exclude the effect caused by the appreciating Canadian currency since our inception, which represents an annualized increase of 1.3% since 1993, our portfolio has returned 15.4% annually versus 8.3% for our benchmark. Our long-term (and ambitious) objective is to maintain an annual return that is 5% higher than our benchmark.

The Artwork on Our Letter

Since 2004, we have illustrated the cover of our letter with a copy of an artwork from our corporate collection. This year we selected a photographic artwork by Lynne Cohen entitled "Untitled (smiling couch)".

The Giverny Portfolio (in Canadian dollars): Returns Since July 1st 1993

Return *	Giverny	Index **	+ / -	$ US/Can	Giverny ***	Index ***	+ / -
1993 (Q3-Q4)	37.0%	9.5%	27.6%	3.3%	34.4%	7.4%	27.0%
1994	16.5%	3.7%	12.7%	6.0%	12.0%	-0.3%	12.3%
1995	41.2%	24.0%	17.2%	-2.7%	43.8%	26.3%	17.5%
1996	28.0%	22.8%	5.2%	0.3%	27.7%	22.5%	5.2%
1997	37.8%	28.6%	9.2%	4.3%	33.4%	24.5%	8.9%
1998	20.6%	18.8%	1.8%	7.1%	14.5%	12.8%	1.7%
1999	15.1%	16.3%	-1.2%	-5.7%	20.6%	21.9%	-1.3%
2000	13.4%	3.2%	10.2%	3.9%	9.7%	-0.2%	9.9%
2001	15.1%	-0.4%	15.5%	6.2%	9.4%	-5.3%	14.7%
2002	-2.8%	-18.3%	15.6%	-0.9%	-2.0%	-17.7%	15.7%
2003	13.6%	14.0%	-0.4%	-17.8%	33.9%	34.3%	-0.5%
2004	1.6%	6.2%	-4.5%	-7.3%	8.3%	13.1%	-4.8%
2005	11.5%	3.6%	7.9%	-3.2%	14.5%	6.7%	7.8%
2006	3.5%	17.3%	-13.8%	0.2%	3.3%	17.1%	-13.8%
2007	-14.4%	-11.9%	-2.5%	-14.9%	-0.3%	2.4%	-2.7%
2008	-5.5%	-22.4%	16.9%	22.9%	-21.5%	-35.6%	13.9%
2009	11.8%	12.8%	-1.0%	-13.7%	27.7%	28.2%	-0.5%
2010	16.1%	13.9%	2.2%	-5.4%	21.7%	19.5%	2.2%
2011	7.8%	-1.0%	8.8%	2.3%	5.8%	-2.8%	8.6%
2012	21.5%	12.5%	9.0%	-2.2%	23.7%	14.6%	9.1%
Total	**1182.2%**	**270.8%**	**911.4%**	**-22.4%**	**1536.1%**	**371.5%**	**1164.6%**
Annualized	**14.0%**	**7.0%**	**7.0%**	**-1.3%**	**15.4%**	**8.3%**	**7.1%**

* Green section: all returns are adjusted to Canadian dollars
** Index is a hybrid index (S&P/TSX, S&P 500, MSCI EAFE, Russell 2000) which reflects the weight of the underlying assets
*** Estimated without the effect of currency

Note: Please refer to Appendix B for disclosure statements on the Giverny portfolios and their corresponding indices.

The Giverny US Portfolio

We have been publishing the returns of the Giverny US Portfolio, which is entirely denominated in US dollars, since 2003. The Giverny US Portfolio corresponds to the American portion of the Giverny Portfolio. In 2012, the Giverny US Portfolio realized a return of 22.8% compared to 16.0% for our benchmark, the S&P 500. The Giverny US Portfolio therefore outperformed our benchmark by 6.8%

Since its inception in 1993, the Giverny US Portfolio has returned 1318.7%, or 14.6% on an annualized basis. During this same period, the S&P 500 has returned 362.8%, or 8.2% on an annualized basis. Our added value has therefore been 6.4% annually.

Year	Giverny US	S&P 500	+/-
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	37.6%	17.2%
1996	27.0%	23.0%	4.1%
1997	32.9%	33.4%	-0.4%
1998	11.0%	28.6%	-17.6%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-9.1%	20.4%
2001	8.1%	-11.9%	20.0%
2002	-4.4%	-22.1%	17.7%
2003	31.6%	28.7%	2.9%
2004	9.3%	10.9%	-1.6%
2005	12.5%	4.9%	7.5%
2006	3.3%	15.8%	-12.4%
2007	-1.7%	5.5%	-7.2%
2008	-24.3%	-37.0%	12.7%
2009	28.7%	26.5%	2.3%
2010	21.9%	15.1%	6.9%
2011	4.9%	2.1%	2.8%
2012	22.8%	16.0%	6.8%
Total	**1318.7%**	**362.8%**	**955.9%**
Annualized	**14.6%**	**8.2%**	**6.4%**

Note: Please refer to Appendix B for disclosure statements on the Giverny portfolios and their corresponding indices.

We outperformed the S&P 500 for a fifth consecutive year. No single stock was a factor to this outperformance and, when we looked to our performance attribution for 2012, we noted that nine out of our top ten holdings outperformed the S&P 500.

Giverny Canada Portfolio

We introduced a portfolio that is 100% focused on Canadian equities in 2007. This corresponds closely to the Canadian portion of the Giverny Portfolio. In 2012, the Giverny Canada Portfolio returned 24.2% versus 7.2% for the S&P/TSX, therefore outperforming the index by 17.0%.

Since 2007, the Giverny Canada Portfolio has returned 106.6%, or 12.9% on an annualized basis. During this same period, our benchmark had a gain of 14.4%, or a gain of 2.3% on an annualized basis. Our annual added value was therefore 10.6%.

Year	Giverny Canada	S&P/TSX	+/-
2007	19.7%	9.8%	9.9%
2008	-24.6%	-33.0%	8.4%
2009	28.2%	35.1%	-6.9%
2010	26.7%	17.6%	9.1%
2011	13.5%	-8.7%	22.2%
2012	24.2%	7.2%	17.0%
Total	106.6%	14.4%	92.2%
Annualized	12.9%	2.3%	10.6%

Note: Please refer to Appendix B for disclosure statements on the Giverny portfolios and their corresponding indices.

Our primary Canadian holdings performed very well in 2012. The all-star in our portfolio was MTY Foods, which rose 45%. Dollarama (+33%) and Valeant Pharmaceuticals (+28%) also performed well.

For five out of the last six years, the Giverny Canada Portfolio outperformed the TSX. It is also worth repeating that our Canadian portfolio is very concentrated and has little correlation to the TSX. So the relative performance, whether positive or negative, will therefore often be high.

2012: A Year in Review

Our portfolio companies, despite slowing Western and to some extent Eastern economies, continued to grow their profits and intrinsic values at a very satisfying pace. The market also adequately reflected this wealth creation in the case of the majority of our companies. We thought that 2012 was the "year of the stock picker" (in market astrology) and many investors who favor a diligent and rational method for selecting holdings for their portfolios were rewarded.

In the US, the residential real estate market has finally begun to show signs of a rebound, after six years of misery. And, despite a deep rooted skepticism from many people, the S&P 500 posted a total return of 16% for the year. The old adage about the market climbing a wall of fear (even a fiscal wall) never seems to have been more true.

The situation is different in Canada as companies linked to natural resources had a difficult year. Furthermore, the Canadian real estate market is showing signs that it is beginning to run out of steam. The S&P/TSX index only climbed 7% in 2012 and is still 13% lower than what it was in April 2011.

The economic situation in China plays an increasingly important role in the global arena. Yet, it is difficult to get a clear idea of the exact situation. Despite excellent GDP growth announced by the government, stock market investors in China have not been rewarded: in 2012, the Shanghai Stock Exchange (SSE Composite) was flat and it is still down 63% from its October 2007 high.

Looking towards Europe, several countries are mired in problems that will likely take years to resolve. In the case of some of these countries, the problems seem more cultural rather than economic. Moreover, the use of a common currency further complicates the situation. Yet, this does not prevent

us from admiring several European companies located in countries such as the United Kingdom, Sweden, Denmark, Italy, etc. Quality has no nationality.

An Energy Revolution in the US

Media outlets are quick to present us with one crisis after another, along with constant economic and political worries. With the help of the Internet and many television stations, bad news circles the planet in no time. With the right twist, plain old bad news begins to look more and more like an imminent catastrophe and for many investors, the perfect reason to sell their stocks! Good news, on the other hand, remains largely unnoticed since it seems to represent a less valuable source for ratings and clicks.

One piece of good news, which could have major consequences for several decades to come, is what we could call the American energy revolution. Five years ago, when oil was selling for $140 a barrel, a significant problem in the US was its trade deficit in global energy markets. The country's high energy demand couldn't be met by domestic supply which resulted in massive energy imports. The problem was also exacerbated by China's growing demand for energy resources. But the economic crisis of 2008-2009 reset the supply and demand equation. New oil reserves in the US have also been developed to the point where for each barrel produced between 2007 and 2009, there was 1.6 barrels of new reserves added. Oil prices collapsed to $40 in 2008 and have recently bounced back to $91—still quite a bit lower from its high just a few years prior.

Meanwhile, as supply and demand for oil has found a new equilibrium on a global level, new discoveries of oil and gas reserves in the American west (and the ability to extract it from shale), has the potential to completely change the energy balance in the US. In 2012, the US produced 6.4 million barrels of crude oil, an increase of 760,000 barrels from the prior year (a 14% increase). And the estimates predict an additional 25% increase within the next two years. As for natural gas, the amount of new reserves is simply astronomical. The International Energy Agency, in a report released last November, now predicts that the US will be energy independent by 2035.

So the US seems destined to significantly change the dynamics of its trade balance for energy. A decrease in its trade deficit (relative to GDP) will likely be the most important consequence. This should bolster the value of the US dollar and foster continued growth in states like Wyoming, North Dakota, and Montana.

Despite the optimistic tone of this section, none of this changes the fact that the energy industry is – to us – difficult to predict. The fact that it has changed so much since 2007 (and we did not foresee it) serves as evidence. This simply means that companies that operate in the energy industry are difficult for us to evaluate. We are quite disciplined in sticking within the boundaries of our circle of competence. On the other hand, we believe that we can indirectly benefit from this US energy boom through our investments in companies such as Union Pacific and Burlington Northern Santa Fe (now a part of Berkshire Hathaway).

Owner's Earnings

At Giverny Capital, we do not evaluate the quality of an investment by the short-term fluctuations in its stock price. Our wiring is such that we consider ourselves <u>owners</u> of the companies in which we invest. Consequently, we study the growth in earnings of our companies and their long-term outlook.

Since 1996, we have presented a chart depicting the growth in the intrinsic value of our companies using a measurement developed by Warren Buffett: "owner's earnings". We arrive at our estimate of the increase in intrinsic value of our companies by adding the growth in earnings per share (EPS) and the average dividend yield of the portfolio. This analysis is not exactly precise but, we believe, approximately correct. In the non-scientific world of the stock market, and as Keynes would have said: "It is better to be roughly right than precisely wrong."

This year, the intrinsic value of our companies, as a whole, rose by 19% (18% from the growth in earnings and 1% from the average dividend). Despite changes to our portfolio during the year, we consider this growth in earnings to appropriately reflect economic reality. The stocks of our companies rose approximately 23% (without the effect of currency). As for the S&P 500, the underlying earnings growth of its companies was 5% (8% including dividends) and the total return of the index was 16%.

	Giverny			S&P 500		
Year ***	Value *	Market **	Difference	Value *	Market **	Difference
1996	14%	29%	15%	13%	23%	10%
1997	17%	35%	18%	11%	33%	22%
1998	11%	12%	1%	-1%	29%	30%
1999	16%	12%	-4%	17%	21%	4%
2000	19%	10%	-9%	9%	-9%	-18%
2001	-9%	10%	19%	-18%	-12%	6%
2002	19%	-2%	-21%	11%	-22%	-33%
2003	31%	34%	3%	15%	29%	14%
2004	21%	8%	-12%	21%	11%	-10%
2005	14%	15%	0%	13%	5%	-8%
2006	14%	3%	-11%	15%	16%	1%
2007	10%	0%	-10%	-4%	5%	9%
2008	-3%	-22%	-19%	-30%	-37%	-7%
2009	0%	28%	28%	3%	26%	23%
2010	22%	22%	0%	45%	15%	-30%
2011	17%	6%	-11%	17%	2%	-15%
2012	19%	23%	4%	8%	16%	8%
Total	726%	606%	-120%	229%	216%	-13%
Annualized	13.2%	12.2%	-1.0%	7.3%	7.0%	-0.3%

* Estimated growth in earnings plus dividend yield
** Market performance, inclusive of dividends
*** Results estimated without currency effects

Since 1996, our companies have increased their intrinsic value by 726%, or about an eightfold increase. Meanwhile, the value of their stocks has increased 606% (including dividends but without currency effects). During this same period, the companies comprising the S&P 500 increased their aggregated intrinsic value by 229% and saw their stock prices rise by 216%. Market performance and corporate performance are rarely synchronized over the course of a calendar year. But as more time passes, the synchronization between the two inevitably begins to reveal itself.

Over 17 years, our portfolio has realized a return that is 5% higher than the S&P 500 for the simple reason that the underlying companies in our portfolio have increased their intrinsic value at a rate that

is 5% higher than the average. This is how we plan on continuing to reach our performance objectives in the future, rather than trying to speculate on the highs and lows of the market or trying to read the tea leaves of economic or political trends.

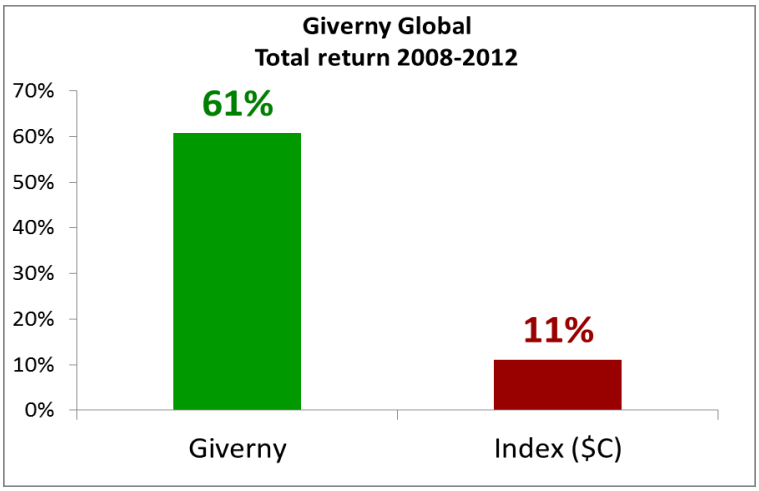
Five-year Post-mortem: 2007

Like we do every year, we go through a five-year post-mortem analysis. We believe that studying our decisions in a systematic manner, and with the benefit of hindsight, enables us to learn from both our achievements and our errors.

2007 was a very difficult year for our investment style. The soaring Canadian dollar weighed heavily on our portfolio returns that year. Furthermore, our holdings underperformed the index (it was difficult to outperform that year if you didn't own companies focused on natural resources). We wrote in our 2007 letter that the headwinds facings our companies seemed temporary in nature and that the next five years should bode well for our portfolios.

We added the following to the end of our 2007 letter: *"If there is a recession in 2008, we are ready. Historically, recessions in North America have been temporary. Our businesses have good balance sheets and they will profit from slowdowns by taking market share from weaker competitors or by making acquisitions at good prices."*

There was quite a recession in 2008-2009 and, as we had hoped, our companies weathered the storm and—in many cases—benefited by making advantageous acquisitions at bargain prices. Our portfolio has performed well since the beginning of 2008: the Giverny Global Portfolio has had a total return of 61% while its benchmark returned 11% (in Canadian dollars).



Note: Please refer to Appendix B for disclosure statements on the Giverny portfolios and their corresponding indices.

The Flavor of the Day for 2012

Each year, we select our "flavor of the day" for the year. In other words, we look for what is (too) popular and will eventually yield little financial reward. In the last three Annual Letters, we named bonds, Canadian real estate and gold as posing risks to fellow investors. While we remain confident that these asset classes will disappoint many, we don't see any other segments of the market that seem to suffer from exaggerated popularity these days.

A New Book on Benjamin Graham

We had a nice surprise this year: a new book on the father of value investing, Benjamin Graham. Joe Carlen's "The Einstein of Money" is an exceptional biography of Warren Buffett's mentor. I am convinced that all fans of value investing will find this book a fascinating read.

Our Companies

"Quality is never an accident; it is always the result of intelligent effort."

- John Ruskin

American Express (AXP, $58)

Amex had an excellent year: revenues climbed 5% and earnings per share (EPS) increased 8% to $4.40. The company also repurchased $4 billion worth of its own shares during the year. We consider American Express an exceptionally high quality international business. The stock also seems reasonably priced, trading at 12 times the company's estimated earnings for 2013.

Bank of the Ozarks (OZRK, $34)

2012 was yet another exceptional year for Bank of the Ozarks. Our bank, based in Little Rock, had EPS of $2.21. The profits from last year had a number of non-recurring items, making them more difficult to interpret comparatively. What is significant for 2012, however, is the bank posting a solid return on assets of 2.04% and an efficiency ratio (a measure of the bank's cost structure) of 46.6%. Its balance sheet also remains strong: the bank increased its equity to assets ratio from 10% to 12%.

We consider Ozarks to be one of the best banks in the US. Since 2006, EPS have risen from $0.95 to $2.21, an annualized increase of 15%. Very few banks can brag about having that kind of performance within the difficult economic climate of the last few years.

Berkshire Hathaway (BRK.B, $90)

The company led by the legendary Warren Buffett had an excellent 2012. The uptick in residential construction helped many of Berkshire's holding companies. We remain confident that Wall Street is still nearsighted about the intrinsic value of Berkshire and its long term potential. That's good news for us (since we're regular buyers) and we were happy to see the company continue to buy back its own shares at very compelling prices.

Buffalo Wild Wings (BWLD, $73)

Buffalo Wild Wings (BWW) is a chain of sports-oriented restaurants which, as its name suggests, specializes in selling chicken wings. We have been shareholders for three years and the company is growing very quickly, with the number of restaurants increasing from 493 at the end of 2007 to 891 at the end of 2012. The company is aiming for 1700 restaurants within a few years.

Revenues for 2011 grew by 33% but EPS rose by only 12%. Rising prices of chicken wings gnawed away at the company's margins. We are confident that BWW's long-term business model is sound and that margins should stabilize despite year to year fluctuations.

Carmax (KMX, $38)

The fiscal year at Carmax ends on the last day of February. For fiscal 2012-2013, we are anticipating sales and EPS growth of 10% and 7%, respectively. The company now has 117 stores in the US but still only has 3% of the used car market (and only 6% share in existing markets). The company is also launching smaller concept retail stores.

Carmax is planning on opening 10 to 15 units per year for the foreseeable future and aims to reach 160 stores in three years.

Disney (DIS, $50)

Disney had another excellent year in 2012. Earnings rose by 17% and the company's stock price rose by 32%. The film "Wreck-It Ralph" was a blockbuster, becoming the 75th film by Disney to gross more than $100 million. But the biggest news of the year was Disney's acquisition of *Lucas Film*, the famed studio started by George Lucas, the creator of the Star Wars empire. Disney plans to launch "Star Wars Episode 7" in 2015. This seems like a terrific acquisition for Disney and, vice versa, we think that George Lucas couldn't have found a better home to ensure the perpetuity of his work.



Bob Iger and George Lucas (Source: Disney)

We bought our first shares in Disney in September 2005 (the day that Bob Iger was named CEO). Since then, EPS has climbed 135% (an annualized growth rate of 13%) and the stock has risen from $24 to $50 (or 108%).

Dollarama (DOL-T, $59)

Three years ago, we were thrilled by the IPO of a company we had long admired: Dollarama. The reason our admiration is simple: for us the company's founder and CEO, Larry Rossy, is one of the best businessmen in Canada. We bought shares immediately and the stock has done very well, tripling in value since.

In 2012, Dollarama introduced two new fixed price levels for its goods: $2.50 and $3.00. This enabled the company to vastly expand its product offering.

The company's performance in 2012 exceeded our expectation. After the first three quarters of 2012 (the company's fiscal year ends January 31st), revenues increased 14%, same-store sales increased 7%, and EPS surged 33%. The company also increased its dividend and started buying back shares.

With EPS possibly reaching $3.50 in 2013, the stock seems reasonably valued at the current level.

Fastenal (FAST, $47)

Fastenal had another good year in 2012. Revenues rose by 13% and EPS climbed by 17%. One of the primary areas of growth for the company has come from the installation of vending machines at client sites. The number of vending machines has increased from 7,453 at the end of 2011 to 21,095 at the end of 2012.

The other factor to the company's growth in recent years has been significant productivity improvements at its existing stores. During the last quarter of 2012, sales per store reached $83,098, compared to $78,781 per store for the same quarter in 2011. The company's operating margins have increased from 20.2% to 20.9%.

We bought Fastenal in 1998 and it has been a very rewarding investment, even if the stock seemed on many occasions richly valued (trading at 30 times its earnings). For the last ten years, the annualized growth rate of Fastenal's earnings has been a whopping 19%. It may not be the latest technological craze of the day, but Fastenal sure knows how to sell nuts and bolts while delivering top notch customer service!

Google (GOOG, $707)

Google had a good year in 2012. Revenues rose 34% and EPS (according to our estimate) increased by 8%. The company continues its dominance of the search engine market, while its mobile operating system, Android, is rapidly taking market share from other competitors.

Google is a small position in our portfolio because we believe that the company could be a better allocator of excess cash flows (such as IBM, for example). Aside from this, we consider Google an exceptional company.

IBM (IBM, $192)

IBM had flat revenues in 2012 (without currency effect). EPS still rose by 10% for the year. This dominant information services company does a brilliant job at managing its capital, which is the primary reason why we are shareholders. It's so rare!

LKQ Corp (LKQ, $21)

LKQ is a new purchase. The company is the North American leader in the manufacturing and distribution of refurbished auto parts. The acronym for the company's name stands for "Like Kind and Quality", referring to the high quality of its recycled products.

Before buying shares in LKQ, I wanted to meet with the CEO at their offices in Chicago. His assistant explained to me that he was seldom at the headquarters and that he preferred being on-site at the company's other locations. I was curious to know more and eventually met the management team at a conference in New York. I was impressed with its quality and the growth outlook for this business, along with the prospect of industry consolidation, which made a compelling case to own shares in this company. The company has also just expanded overseas with a significant acquisition in the UK.

LKQ is growing very quickly: from 2007 to 2012, revenues rose from $1.1 billion to $4.1 billion. EPS has climbed from $0.27 to $0.84 (a 25% compounded annual growth rate). We estimate EPS for 2013 to come in around $1.05.

M&T Bank (MTB, $99)

M&T Bank had a phenomenal year. Net interest revenues rose 9% and reserves for bad debt dropped by 24%. Return on assets rose from 1.26% to 1.40% and its efficiency ratio dropped to 56%. EPS climbed by 20% to $7.88—a record level for our Buffalo-based bank.

M&T also completed another significant acquisition: Hudson City Bancorp. HCB has branches in New Jersey, Connecticut, Long Island, and regions north of New York City. This bank has a good track record, but had a very difficult year in 2011. We think the integration of HCB within M&T should go smoothly as M&T has done a great job at this for 30 years.



M&T Bank was rated one of the best banks for 2012 by Money Magazine

We bought shares for the second time in M&T Bank in 2009 for about $38 and the stock has performed well since. We had previously been shareholders between 1998 and 2007 for one single reason: we had deep admiration for the bank's CEO, Robert Wilmers. In 2007, Mr. Wilmers decided to retire and we sold. During the crisis of 2008, he decided to return to take back the helm at M&T Bank so we decided to buy again. Mr. Wilmers is now 78 and we hope he can stay another decade at M&T Bank.

MTY Food Group (MTY-T, $22)

MTY Food is an operator and franchisor of multiple quick service restaurant concepts. We have been shareholders in this superb Montreal-based company since 2007. MTY grew rapidly in 2012, with revenues rising 31% while EPS climbed 33%. The company acquired the "Mr. Souvlaki" chain in 2012 and also began signing international development agreements in places such as the UK, Lebanon, the UAE, and Saudi Arabia.

We continue to deeply admire the company's CEO, Stanley Ma, and remain confident in the company's future prospects.

Omnicom (OMC, $50)

Omnicom, one of the largest advertising firms in the world, saw revenues rise by 3% in 2012. EPS increased by 9%, with the company increasing its dividend and actively buying back roughly 5% of its shares. Omnicom remains a very stable player in this industry and its stock valuation is attractive.

O'Reilly Automotive (ORLY, $89)

O'Reilly had an excellent year, with revenue climbing 7% and net income increasing 15%. EPS surged 25% due to the company aggressively buying back its own shares. By returning excess cash flows to shareholders through its share buyback, the company was able to greatly improve its return on equity. The company's ROE topped 20% for the first time in its history.

Since our purchase in the summer for 2004, the total growth in earnings has been 324%, or 20% annually, and the stock has quadrupled. Who says that "buy and hold" no longer works?

Resmed (RMD, $42)

After a difficult 2011, Resmed had an exceptional 2012. This leader in medical equipment used for sleep disorders saw its revenues rise by 10% and its EPS surge by 34%. Since 2008, Resmed has maintained a revenue growth rate in excess of 14% annually. Since our first purchase in 2004, EPS has grown by 367% (or 21% annually).

We decreased our position in this company in 2011 when the company's founder, Peter Farrell, retired and the company was looking for a successor. To this day, the company has proved us wrong on this decision by continuing to grow its profits at admirable rates of return.

Union Pacific (UNP, $126)

At the end of 2009, Berkshire Hathaway acquired Burlington Northern Santa Fe (BNSF). This allowed us to exchange parts of our existing shares in BNSF for additional shares in Berkshire. But we still like the industry fundamentals for railroad companies.

Last summer, we met with the CEO of a very successful Los Angeles based business. This brilliant businessman had had dinner the night before with the CEO of BNSF, Matthew Rose, and he further convinced us of the outstanding economics of the rail industry. He explained how Union Pacific and BNSF became dominant in the western part of the US to the point where there is now a quasi-duopoly in this region. With the energy boom in this area, in particular with shale oil, these two companies are benefiting from an increase in rail cargo. So we decided to buy shares in Union Pacific after returning from California. We see a bright future for the company.

Valeant Pharmaceuticals (VRX, $60)

Valeant is a bit different from the typical business we are drawn to at Giverny Capital. Based in the Montreal region, Valeant has become a sizable pharmaceutical company on a global level. However its accounting isn't simple and the company has a vast array of different products.

The reason we decided to invest in Valeant is our admiration for its CEO, Michael Pearson. The company's results for 2012 were impressive. Sales reached $3.6 billion—double the sales from three years ago. EPS followed suit, rising 57% to $4.14.

The most important acquisition of the year for Valeant was Medicis Corp, a leader in dermatological drugs. In 2008, Valeant was in 11th place in the dermatology segment in the US. With the Medicis acquisition, Valeant is now in first place, with more than twice the revenue than its closest competitor.

Visa (V, $152)

Visa had a terrific year in 2012: operating revenues increased 15% and EPS rose 24%. Visa returned the majority of its profit back to shareholders, with dividends and share buybacks to the tune of $3 billion. It's difficult to ask for more.

We bought Visa two years ago, when the stock fell by 25%. The Durbin reforms from the US congress and the potential impact on transaction fees for debit cards was a great worry on Wall Street. But, as we had thought, the impact of these reforms turned out to be modest and the stock has doubled since.

Wells Fargo (WFC, $34)

Wells Fargo continued to improve its profitability in 2012: the bank's return on asset rose from 1.25% to 1.41% while its return on equity reached 13%. EPS increased by 19% to $3.36. The company also increased its dividend by 83% and bought back 120 million of its shares—equivalent to a non-taxable dividend of $3.9 billion.

We expect EPS of $3.75 for 2013. We think that Wells Fargo is one of the best large banks in the US and its stock is still trading well below its intrinsic value.

The Podium of Errors

"Mistakes are the usual bridge between inexperience and wisdom."

- Phyllis Theroux

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2012 (or from past years). It is with a constructive attitude, in order to always improve as investors, that we provide this detailed analysis. As is often the case with stocks, errors from omission (non-purchases) are often more costly than errors from commission (purchases)… even if we don't see those on our statements.

Bronze Medal: JP Morgan

Here is a recent error with opportunity costs that were quick to materialize. We've followed JP Morgan for some time and are fans of its CEO, James Dimon. This summer, the bank announced an unexpected loss of a couple of billion dollars. JP Morgan found itself at the center of an exaggerated media frenzy that is oh-so-typical of our era. The stock quickly tumbled from $44 to $32—this represented a decrease of $40 billion in the bank's market valuation and seemed out of line with a loss realistically assessed in the $4-5 billion range.

The stock seemed undervalued to us before the drop, so imagine afterwards: at $32, the PE ratio for JP Morgan was now seven. Given that JP Morgan is one of the top banks in the US and it was now possible to buy shares at prices that had an earnings yield of more than 15%.

I even went ahead and enthusiastically recommended the stock on television and in the Montreal Gazette newspaper. But with our own money, I stayed on the sidelines. It was difficult to choose which of our other holdings to sell and I thought that we already had a large exposure to financial services in our current portfolio. But such an opportunity is rare and these excuses are regrettable.

Wall Street's worry quickly ebbed and the stock went back to trading at its levels from last Spring. As I write this paragraph, the stock is trading at $48. We therefore missed out on a 50% rise. And the stock is still trading an only 9 times the estimated earnings for 2013. When a stock rises by 50% in just a few months and is still attractively priced, there isn't much more that needs to be said about how deeply discounted this stock was when it was at its low.

Silver Medal: Lumber Liquidators

The sale of Lumber Liquidators (LL) in 2011 was one of the worst mistakes in recent years. We bought shares in the company in 2010, after visiting the company in Toano, Virginia. This is probably one of the most out-of-the-way places we've visited in our noble goal to realize good returns on our capital. We were very impressed by this company which sells hardwood floors and other flooring products directly to customers. LL has a low cost structure and is able to offer more value to its customers than if they made their purchase at a retailer such as Lowe's of Home Depot. LL has been growing very quickly but in 2010, the company implemented a new IT system that affected it profitability. The stock dropped in price as a result of this and we jumped at the chance to become shareholders at around $25.

In 2011, the company continued to have some difficulties and same-store sales fell significantly (by 7% in the second quarter). EPS were flat for a second consecutive year, while operating margins fell from 8.9% in 2009 to 7.4% in 2011. Further, the CEO decided to leave his post. We were surprised by this news and decided to sell since the original investment thesis no longer seemed valid.

The company has, just opposite to our errant prognosticating, turned itself around. Sales rose 17% in 2012 and EPS surged from $0.94 to $1.61, while operating margins reached 9.5%. And as for its share price? Since our sale at around $17, the stock has more than tripled, to $60 (as of February 2013). Analysts expect more than $2 in EPS this year (twice the level of 2010). While the stock is hardly a bargain (now trading at 30 times estimated profits), we have stomped on our pride and continue to follow the company closely. But I have to admit that this goes to show that I showed a flagrant lack of patience on this one.

Gold Medal: Stericycle

About a decade ago, a fellow portfolio manager spoke to me, with great enthusiasm, about a company called Stericycle. The company is a leader in the collection of medical waste and thereby absolutely being my kind of business: unexciting, tending not to attract competition, and not affected by technological change. While the business isn't exciting, its financial results most definitely are. Over ten years, annual revenues have increased from $400 million to nearly $2 billion. EPS has risen from $0.55 to $3.30 this year, with an annualized growth rate of 20%. The stock has risen from $16 to $92.

You might have noticed − given your usual perceptiveness − that the stock's P/E ratio was 29 times in 2002 and is still 28 times at the current moment. The stock has always traded at lofty P/E ratios. I have therefore made an error that I have, unfortunately, made many times: avoiding a high quality enterprise due to a valuation that seemed higher than what I would have liked to pay. I waited in vain for a better price… for a decade. It's very difficult to find a company that can maintain an annual growth rate of more than 20% over a long period of time. When we find one and we have confidence that the future outlook is promising, refusing to pay a slight premium relative to average companies often becomes a very costly mistake. It was an error of almost 500% in this case.

Conclusion: The Current Potential for Stocks

In recent years, we have regularly emphasized our enthusiasm for the stock market and, even more specifically, for our businesses. We don't have a crystal ball, but we know that the potential for the appreciation of stocks is inversely proportional to the valuation assessment reflected by the market. From this perspective, the news is good: the S&P 500 is trading at only 13-14 times the earnings estimate for 2013.

The other ingredient, which is often associated with low valuations, is the pessimism of the financial community. On this level, we could not ask for better news. Since 2008, investors have been fleeing the stock market. Indeed, over the last five years, they sold half a trillion ($500 billion) worth of equities and injected a trillion dollars into bond funds.

Furthermore, the consumer confidence index in the United States (my favorite contrarian indicator) ended the year at 67 (normal is 100) and even dropped to 59 in January. This level is usually found during a recession.

This tendency towards pessimism for stock is not limited to individual investors. Many institutional investors have also reduced their allocation to equity markets, in favor of bonds and "alternative" investments (real estate, private equity, commodities, etc.) For example, the endowment funds at the top American universities (those with more than a billion under management) have reduced their exposure to equities to 27% from 45% ten years ago, while their exposure to "alternatives" is now 61%.

We believe that equities will be the best asset class in the coming years for the simple reason that it seems to be the most undervalued.

To Our Partners

Using rationality, along with our unwavering optimism, we trust that the companies we own are exceptional, led by top-notch people, and destined for a great future. They should continue to prudently navigate the often troubled waters of the global economy. Furthermore, the valuation assigned by the market to these outstanding companies is very similar to the valuation of an average company in S&P 500, despite the fact that our companies have better growth prospects than average. Therefore we consider the appreciation potential for our portfolio, both in absolute and relative terms, to be excellent.

We also want you to know that we are fully aware of and grateful for your votes of confidence. It is imperative for us to not only select outstanding companies for our portfolios, but to also remain outstanding stewards of your capital. We certainly like to achieve good returns, but it must not come at the cost of taking undue risk. Our philosophy to favor companies with solid balance sheets and dominant business models, along with purchasing these companies at reasonable valuations, is central to the risk management of our portfolios.

We wish a great 2013 to all our partners.



François Rochon and the Giverny Capital team

APPENDIX A

Investment philosophy

Note: This section is repeated from prior annual letters and is aimed at new partners.

In 2012, we saw a large increase in the number of Giverny Capital partners (the term we use for our clients). With all these newcomers, it is imperative that we write again (and again) about our investment philosophy.

Here are the key points:

- We believe that over the long run, stocks are the best class of investments.
- It is futile to predict when it will be the best time to begin buying (or selling) stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity).
- We choose companies that have high (and sustainable) margins and high returns on equity, good long term prospects and are managed by brilliant, honest, dedicated and altruistic people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be approximately assessed.
- The stock market is dominated by participants that perceive stocks as casino chips. With that knowledge, we can then sometimes buy great businesses well below their intrinsic values.
- There can be quite some time before the market recognizes the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

Experience and common sense teach us that an investment philosophy based on buying shares in companies that are undervalued, and holding these companies for several years, will not generate linear returns. Some years, our portfolio will have a return that is below average. This is a certainty that we must accept.

Another important point: the significant volatility of the market is often perceived negatively by many investors. It's actually the contrary. When we see stock prices as *"what other people believe the company is worth"* rather than the real value (at least in the short term), these fluctuations become our allies in our noble quest for creating wealth. Instead of fearing them, we can profit from them by acquiring superb businesses at attractive prices. The more that markets (the "other" participants) are irrational, the more likely we are to reach our ambitious performance objectives.

Benjamin Graham liked to say that the irrationality of the market was an extraordinary advantage to the intelligent investor. The person, however, who becomes affected by short-term market fluctuations (less than 5 years) and who take decisions based on them transforms this advantage into a disadvantage. His or her own perception of stock quotes becomes their own worst enemy. Our approach at Giverny Capital is to judge the quality of an investment over a long period of time.

So patience – ours AND that of our partners – becomes the keystone for success.

APPENDIX B

Notes on the returns of the Giverny portfolios

- The Giverny portfolio is a private family group of accounts managed by François Rochon since 1993. The returns of the period from 1993 to 1999 were realized before registration of Giverny Capital Inc. at the AMF in June of 2000.
- The Giverny portfolios serve as a model for Giverny Capital's clients, but returns from one client to the other can vary depending on a multitude of factors, such as the timing of the opening and funding of a client's account.
- Past results do not guarantee future results.
- The Giverny Canada and Giverny US portfolios are parts of the Giverny Global portfolio.
- The returns indicated include trading commissions, dividends (including foreign withholding income taxes) and other income but do not include management fees.
- The index benchmark group is selected at the beginning of the year and tends to be a good reflection of the asset composition of the portfolio. In 2012 :

    - Giverny Global Portfolio: TSX 18% Russell 2000 40% S&P 500 40% MSCI EAFE 2%
    - Giverny US Portfolio : S&P 500 100%
    - Giverny Canada Portfolio : S&P/TSX 100%

- The returns for the S&P 500 (in $USD) are provided by Standard & Poors.
- The returns for the various indices used for comparable purposes are deemed reliable by Giverny Capital. It should be noted that currency effects and the impact of dividends on the returns for indices are estimated. Despite its best effort, Giverny Capital cannot guarantee that this information is accurate and complete at all times.
- The custodian of our client portfolio is TD Waterhouse in Canada and TD Ameritrade Institutional in the US.
- The financial statements of the three portfolios are audited by PricewaterhouseCoopers (PwC) at the end of each year. The PwC data are those provided by our custodian TD Waterhouse. The PwC reports are available upon request.
- For more information, please see the "returns" section of our website.

GIVERNY CAPITAL

Annual Letter to our Partners 2013

20th Anniversary of the Giverny portfolio



Gabor Szilasi
Giverny - 1998
Giverny Capital Collection

For the year ending December 31st 2013, our portfolio's return was 50.2% versus 38.9% for our benchmark. Both returns include a gain of approximately 8% due to fluctuations in the Canadian currency. So in 2013, we have outperformed our benchmark by 11.3%.

Since our inception on July 1st 1993, our compounded annual growth rate has been 15.5% versus 8.3% for our weighted benchmark, representing an annualized outperformance of 7.2% over this period. When we exclude the effect caused by the appreciating Canadian currency since our inception, which represents an annualized increase of 0.9% since 1993, our portfolio has returned 16.6% annually versus 9.3% for our benchmark. Our long-term and ambitious objective is to maintain an annual return that is 5% higher than our benchmark.

The Artwork on Our Letter

Since 2004, we have illustrated the cover of our letter with a copy of an artwork from our corporate collection. This year we selected a photographic artwork by Gabor Szilasi entitled "Giverny".

The Giverny Portfolio (in Canadian dollars): Returns Since July 1st 1993

Return *	Giverny	Index **	+ / -	$ US/Can	Giverny ***	Index ***	+ / -
1993 (Q3-Q4)	37.0%	9.5%	27.6%	3.3%	34.4%	7.4%	27.0%
1994	16.5%	3.7%	12.7%	6.0%	12.0%	-0.3%	12.3%
1995	41.2%	24.0%	17.2%	-2.7%	43.8%	26.3%	17.5%
1996	28.0%	22.8%	5.2%	0.3%	27.7%	22.5%	5.2%
1997	37.8%	28.6%	9.2%	4.3%	33.4%	24.5%	8.9%
1998	20.6%	18.8%	1.8%	7.1%	14.5%	12.8%	1.7%
1999	15.1%	16.3%	-1.2%	-5.7%	20.6%	21.9%	-1.3%
2000	13.4%	3.2%	10.2%	3.9%	9.7%	-0.2%	9.9%
2001	15.1%	-0.4%	15.5%	6.2%	9.4%	-5.3%	14.7%
2002	-2.8%	-18.3%	15.6%	-0.8%	-2.0%	-17.7%	15.7%
2003	13.6%	14.0%	-0.4%	-17.7%	33.7%	34.1%	-0.5%
2004	1.6%	6.2%	-4.5%	-7.3%	8.3%	13.1%	-4.8%
2005	11.5%	3.6%	7.9%	-3.3%	14.5%	6.7%	7.8%
2006	3.5%	17.0%	-13.5%	0.2%	3.3%	16.8%	-13.5%
2007	-14.4%	-11.6%	-2.8%	-14.9%	-0.3%	2.2%	-2.5%
2008	-5.5%	-22.0%	16.5%	22.9%	-21.5%	-35.4%	13.9%
2009	11.8%	12.2%	-0.4%	-13.7%	27.7%	27.7%	0.1%
2010	16.1%	13.8%	2.3%	-5.3%	21.7%	19.3%	2.5%
2011	7.6%	-1.1%	8.7%	2.2%	5.5%	-2.9%	8.4%
2012	21.2%	12.5%	8.7%	-2.2%	23.4%	14.6%	8.8%
2013	50.2%	38.9%	11.3%	6.9%	42.2%	31.3%	10.9%
Total	1825.9%	415.2%	1410.7%	-17.0%	2226.1%	519.0%	1707.1%
Annualized	15.5%	8.3%	7.2%	-0.9%	16.6%	9.3%	7.3%

* Green section: all returns are adjusted to Canadian dollars
** Index is a hybrid index (S&P/TSX, S&P 500, MSCI EAFE, Russell 2000) which reflects the weight of the underlying assets
*** Estimated without the effect of currency

Note: Refer to Appendix C for disclosure statements on the Giverny portfolios and their corresponding indices.

The Giverny US Portfolio

We have been publishing the returns of the Giverny US Portfolio, which is entirely denominated in US dollars, since 2003. The Giverny US Portfolio corresponds to the American portion of the Giverny Portfolio. In 2013, it realized a return of 40.6% compared to 32.4% for our benchmark, the S&P 500. The Giverny US Portfolio therefore outperformed our benchmark by 8.2%

Since its inception in 1993, the Giverny US Portfolio has returned 1893.7%, or 15.7% on an annualized basis. During this same period, the S&P 500 has returned 512.7%, or 9.2% on an annualized basis. Our added value has therefore been 6.5% annually.

Year	Giverny US	S&P 500	+/-
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	37.6%	17.2%
1996	27.0%	23.0%	4.1%
1997	32.9%	33.4%	-0.4%
1998	11.0%	28.6%	-17.6%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-9.1%	20.4%
2001	8.1%	-11.9%	20.0%
2002	-4.4%	-22.1%	17.7%
2003	31.6%	28.7%	2.9%
2004	9.3%	10.9%	-1.6%
2005	12.5%	4.9%	7.5%
2006	3.3%	15.8%	-12.4%
2007	-1.7%	5.5%	-7.2%
2008	-24.3%	-37.0%	12.7%
2009	28.7%	26.5%	2.3%
2010	21.9%	15.1%	6.9%
2011	4.7%	2.1%	2.6%
2012	22.3%	16.0%	6.3%
2013	40.6%	32.4%	8.2%
Total	**1893.7%**	**512.7%**	**1381.1%**
Annualized	**15.7%**	**9.2%**	**6.5%**

Note: Please refer to Appendix C for disclosure statements on the Giverny portfolios and their corresponding indices.

We outperformed the S&P 500 for a sixth consecutive year. No single stock alone was a factor for this outperformance and, when we looked to our performance attribution for 2013, we noted that seven out of our top ten holdings outperformed the S&P 500.

Giverny Canada Portfolio

We introduced a portfolio that is 100% focused on Canadian equities in 2007. This corresponds closely to the Canadian portion of the Giverny Portfolio. In 2013, the Giverny Canada Portfolio returned 49.4% versus 13.0% for the S&P/TSX, therefore outperforming the index by 36.4%.

Since 2007, the Giverny Canada Portfolio has returned 208.6%, or 17.5% on an annualized basis. During this same period, our benchmark had a gain of 29.3%, or a gain of 3.7% on an annualized basis. Our annual added value was therefore 13.7%.

Year	Giverny Canada	S&P/TSX	+/-
2007	19.7%	9.8%	9.9%
2008	-24.6%	-32.9%	8.3%
2009	28.2%	33.1%	-4.9%
2010	26.7%	17.6%	9.1%
2011	13.5%	-8.7%	22.2%
2012	24.0%	7.2%	16.8%
2013	49.4%	13.0%	36.4%
Total	208.6%	29.3%	179.3%
Annualized	17.5%	3.7%	13.7%

Note: Please refer to Appendix C for disclosure statements on the Giverny portfolios and their corresponding indices.

Our primary Canadian holdings performed very well in 2013. The all-star in our portfolio was Valeant Pharmaceuticals, which rose 96%. Dollarama (+50%) and MTY Foods (+54%) also excelled.

For six out of the last seven years, the Giverny Canada Portfolio outperformed the TSX. It is also worth repeating that our Canadian portfolio is very concentrated and has little correlation to the TSX. So the relative performance, whether positive or negative, will therefore often be high.

2013: The year of the "triple play"

Legendary investor Peter Lynch always emphasized the importance of being patient: "Frequently, years of patience are rewarded in a single year". The year 2013 was such a year. We could qualify it with the baseball term: "triple play". Our 50% return includes three components:

- An earnings growth rate of 15% for our companies with an additional 1% from dividends
- An increase of the average Price to Earnings ratio (P/E) of our stocks from 14x to 17x
- A currency gain of 8% linked to the drop of the Canadian dollar from 0.99$ to 0.94$.

We believe our return for 2013 was justified. It reflects a return to a more normal valuation level for our holdings. We went through a period from 2006 to 2009 where we had to cope with a P/E compression for our stocks and a huge rise in the Canadian currency. As we stipulated in our annual letters during those years, we believed those events were temporary in nature and were not justified by our long term fundamental analysis.

Yet, it would be unrealistic to extrapolate our 2013 return into the future. In the the long run, the number one factor influencing a portfolio's return is the overall intrinsic value increase of the companies owned. But we believe that our stocks are still undervalued and that the Canadian dollar is still overpriced by 10 to 16%. So the next few years could also bring additional rewards to the intrinsic value of our holdings, but not at the same level as this year.

Since 1993, the cornerstone of our investment philosophy is based on Benjamin Graham's book "The Intelligent Investor", first published in 1949. In it, Graham wrote: "In the short term, the stock market reflects the irrationality and unpredictability of human investors. But in the long term, it reflects adequately the intrinsic value of companies".

Over the last two decades, we have been witnesses to strange market movements and numerous irrational behaviors from investors (the list would be too long to mention here). But in the end, the strangeness cleared up and common sense prevailed. If there is one thing that we have learned since 1993 is that market fads come and go but fundamental principles endure.

Twenty years of the Giverny Portfolio

I started to manage the Giverny portfolio in July 1993. So we celebrate our twenty year anniversary with this letter. Results over those two decades have been more than satisfactory. But most important, I've learned some valuable lessons which should be useful in enhancing portfolio values going forward. Last summer, I wrote in my Gazette column an article highlighting the ten most important lessons learned since 1993. You will find the article in Appendix A at the end of this letter.

I would like to emphasize the most important lesson of the last twenty years: <u>It is futile to try to predict the stock market over the short run</u>. All previous lessons are useless if you try to predict the stock market over the short run. I have heard people say hundreds of times that they were waiting to buy great companies because they had negative views on the short-term direction of the stock market. Owning great businesses, managed by great people and acquired at reasonable prices is the winning recipe. The rest is just noise.

The stock market and Bridge

Investing in the stock market has similarities with the game of bridge. As you probably know, a member of the Giverny Capital team, Nicolas L'Écuyer, is a great bridge player. He was Canadian champion six times. To succeed in bridge, you have to be able to combine logic and rationality. Another important point: in duplicate bridge, the points are never given in absolute terms but relative to what others have done with the same hand being played. As with the stock market, what counts is the result relative to the average.

Nicolas likes to say that two things are important in bridge: to have a plan to play the hand and always favor the play that has the best chance of success. The fact that a particular decision has worked or not at a particular time is irrelevant if the thought process was correct. In other words, if a play has a 75% chance to be the right one, do not blame yourself when it does not work (which will be one time out of four times). In addition, when playing in a bridge club where players of various levels of play are present, it is interesting to look at the results at the end of the evening. Very often, the best team plays for 60% and the worse one for 40%. The difference is not that large.

An analogy applies to the stock market: managing a portfolio of equities requires a specific plan (a philosophy of securities selection) and a decision-making process that favors the better odds. If we look at the history of the stock market in the long run, stocks have returned 10% per year compared to roughly 5% for bonds and 3% for treasury bills. So to be 100% invested in equities is the most favorable statistical approach. Some will tell you that a portfolio thus formed will be more volatile and more "risky". Obviously, it is true that an equity portfolio will fluctuate, sometimes widely as we saw in 2008-2009. But it is not really "risky" if its owner is patient and allows enough time for the odds to play out in their favor.

As important, we have to accept the 60-40 rule. To be wrong (or not totally right) 40% of the time can produce excellent results in arenas such as bridge and the stock market. In fact, we stipulated many years ago in our "Rule of three" that we have to accept that one year out of three, we will underperform the index and that one stock purchased out of three will not perform as expected. If one studies the

table of the Giverny portfolio since 1994 (excluding the half-year of 1993), we observe that our portfolio has underperformed the S&P 500 six years out of twenty, the equivalent of 30% of the time. To be aware of this fact is vital so we can be psychologically prepared for the inevitable periods when we will have results that are worse than average. We have to accept from the start that it is impossible to be always the best in that field even if one is competent and loaded with motivation and efforts.

It is important to realize that our "Rule of three" is not linear and totally unpredictable. Some of our partners would love to know in advance the years we will underperform so that they can wait on the sidelines. In the long run, the stock market will eventually reflects the intrinsic values of the companies owned. But all temporal parameters are unknown. Few investors, professional or not, can do better than the average. In our opinion, one simple but crucial quality is needed: humility. Humility is needed to recognize that we can't predict the economy and the stock market (and why even try with politics?) Humility is needed to recognize that, even with our own stocks, we can't know in advance which ones will do well and when they are going to do well.

Nicolas would add that one key to succeed in bridge is to play often so odds can eventually win over luck. Persistence eventually trumps luck!

The Flavor of the Day for 2013

Many of the financial (and less financial) assets that we labelled "flavor of the day" in the last years have turned sour in 2013. Bonds lost value as interest rates increased. The price of gold is down 34% since its 2011 high. The Canadian Dollar has started to fall to a level closer to its Purchasing Power Parity or PPP (as evaluated by the OECD). Even housing prices in Canada show signs of getting back to more reasonable levels.

So where are we seeing popularity (and consequently danger)? Recently, we have observed the popularity of some new names in the technology field. A dozen or so years have passed since the tech bubble crash of 2000-2002. A new generation of young investors, and some older ones with "young memory", have become infatuated with outstanding companies with a great potential future but that trade at high P/Es in the stock market. Facebook and LinkedIn are good examples but we could also add Netflix and Tesla Motors, the terrific electrical car manufacturer.

These are all outstanding companies with great CEOs. But in the stock market, it does not guarantee outstanding investment results if one pays a too high price for them. With an average P/E of more than 100 times for these four stocks, we would advise prudence.

Here is a little table on the new "Fantastic Four"

Company	**Quote**[1]	**EPS 2014**	**P/E 14**
Facebook	68 $	1,25 $	55
Netflix	446 $	4,10 $	109
LinkedIn	204 $	1,58 $	129
Tesla Motors	245 $	1,90 $	129
Average			**105**

We could add a few words on Twitter, which came public last November. The stock quickly flew away (!) and now has a $30 billion dollar market value[1]. The company is not yet profitable so we could not include it in the preceding table. Analysts estimate that the company will have $1.2 billion in revenues

[1] As of February 28th 2014

in 2014. So theoretically, if the company had a 25% net margin level that would translate into $300 million dollars in profits. At its present level, the P/E would then be the equivalent of 100 times this hypothetical scenario. As for the four other securities mentioned, we would advise caution.

Owner's Earnings

At Giverny Capital, we do not evaluate the quality of an investment by the short-term fluctuations in its stock price. Our wiring is such that we consider ourselves owners of the companies in which we invest. Consequently, we study the growth in earnings of our companies and their long-term outlook.

Since 1996, we have presented a chart depicting the growth in the intrinsic value of our companies using a measurement developed by Warren Buffett: "owner's earnings". We arrive at our estimate of the increase in intrinsic value of our companies by adding the growth in earnings per share (EPS) and the average dividend yield of the portfolio. This analysis is not exactly precise but, we believe, approximately correct. In the non-scientific world of the stock market, and as Keynes would have said: "It is better to be roughly right than precisely wrong."

This year, the intrinsic value of our companies, as a whole, rose by 16% (15% from the growth in earnings and 1% from the average dividend). Despite changes to our portfolio during the year, we consider this growth in earnings to appropriately reflect economic reality. The stocks of our companies rose approximately 42% (without the effect of currency). As for the S&P 500, the underlying earnings growth of its companies was 7% (9% including dividends) and the total return of the index was 32%.

	Giverny			S&P 500		
Year ***	Value *	Market **	Difference	Value *	Market **	Difference
1996	14%	29%	15%	13%	23%	10%
1997	17%	35%	18%	11%	33%	22%
1998	11%	12%	1%	-1%	29%	30%
1999	16%	12%	-4%	17%	21%	4%
2000	19%	10%	-9%	9%	-9%	-18%
2001	-9%	10%	19%	-18%	-12%	6%
2002	19%	-2%	-21%	11%	-22%	-33%
2003	31%	34%	3%	15%	29%	14%
2004	21%	8%	-12%	21%	11%	-10%
2005	14%	15%	0%	13%	5%	-8%
2006	14%	3%	-11%	15%	16%	1%
2007	10%	0%	-10%	-4%	5%	9%
2008	-3%	-22%	-19%	-30%	-37%	-7%
2009	0%	28%	28%	3%	26%	23%
2010	22%	22%	0%	45%	15%	-30%
2011	17%	6%	-11%	17%	2%	-15%
2012	19%	23%	4%	7%	16%	9%
2013	16%	42%	26%	9%	32%	23%
Total	867%	903%	45%	259%	317%	58%
Annualized	13.4%	13.7%	0.3%	7.4%	8.3%	0.9%

* Estimated growth in earnings plus dividend yield
** Market performance, inclusive of dividends
*** Results estimated without currency effects

Since 1996, our companies have increased their intrinsic value by 867%, or about a tenfold increase. Meanwhile, the value of their stocks has increased 903% (including dividends but without currency

effects). On an annualized basis, our companies increased their intrinsic value by 13.4% and our stock returned 13.7% per year. The similarity between those two numbers is not a coincidence. During this same period, the companies comprising the S&P 500 increased their aggregated intrinsic value by 259% and saw their stock prices rise by 317%. Market performance and corporate performance are rarely synchronized over the course of a calendar year. But as more time passes, the synchronization between the two inevitably begins to reveal itself.

Over 18 years, our portfolio has realized a return that is 5% higher than the S&P 500 primarily because the underlying companies in our portfolio have increased their intrinsic value at a rate that is 5% higher than the average. This is how we plan on continuing to reach our performance objectives in the future, rather than trying to speculate on the highs and lows of the market or trying to read the tea leaves of economic or political trends.

Five-year Post-mortem: 2008

Like we do every year, we go through a five-year post-mortem analysis. We believe that studying our decisions in a systematic manner, and with the benefit of hindsight, enables us to learn from both our achievements and our errors.

The year 2008 was tumultuous, which is an understatement. We have never seen so much pessimism as in late 2008 and early 2009—to a point that many questioned the very survival of capitalism. Peter Lynch liked to say that the most important organ in the stock market is not the brain but the stomach. To have the right temperament toward stock quotes was vital during the 2008-09 crisis. We witnessed incredibly irrational behaviors on the part of many investors, even from seasoned investors.

At Giverny Capital, we did not panic. We stayed 100% invested in stocks and we made new purchases to the best of our capabilities. We also tried, with little success, to rally investors to our noble cause. I was interviewed in the Montreal newspaper "La Presse" on February 14th 2009 and I labelled the market environment as the "Opportunity of a generation" (in French, it is a little more poetic since it rhymes). We even set up a web site to encourage stock purchases and organized conferences (www.occasiongeneration.com). It was so popular that we had to cancel many conferences because of a lack of registration.

New buy in 2008: Omnicom

We bought shares of Omnicom in 2008 at $24. The big ad firm was on our radar for more than 15 years (yes, we are patient people). In 2008, we bought shares at approximately seven time normalized earnings, a level we believed to be at least a third of its intrinsic value. We held on to the stock for five years and sold it this year at $64 after it announced its merger with Publicis. We had a return of 167% for an investment that we believed had very low risk. In fact, we believe the stock is still undervalued today but we chose to invest our capital in another company that we believed to be even more undervalued.

Mistakes of 2008

In 2008-09, there were lots of great bargains. Many outstanding companies were trading at a third – even a fourth – of their fair value. Some of our own stocks like Carmax, Disney, American Express and Wells Fargo, went down to such attractive levels. We made additional share purchases but not to a level we should have. We would have shown fortitude if we had sold some our then more stable blue chips like Johnson & Johnson, Wal-Mart and Procter & Gamble to cash in on such opportunities. To

sell a stock that trades at 66 cents on the dollar to buy a similar stock that trades at 33 cents on the dollar is an intelligent transaction. It is pointless to be too severe in castigating ourselves. But we could conclude that our lack of opportunism has cost us something like 10% of missed returns over the last few years.

Our total return since 2008

The good news, however, is that the Giverny Global portfolio had a total return of 141% since January of 2008 (*before* the start of the great bear market of 2008-2009), which compares to a total return of 54% for our benchmark.

Our Companies

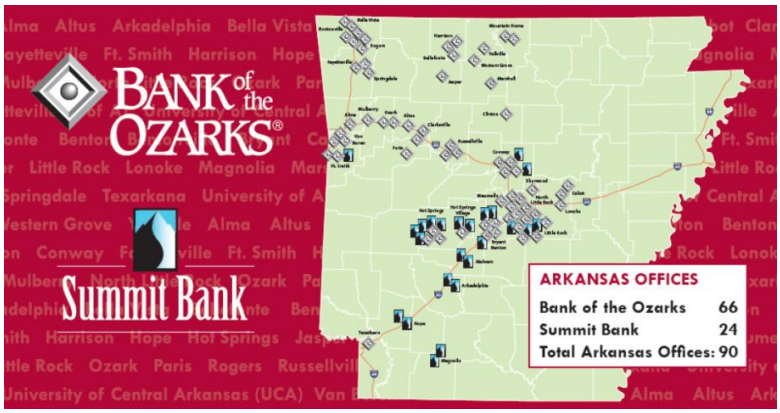
> "In my books, I've always placed the emphasis on the importance of the management team in selecting companies… and yet, I didn't do it enough"
>
> - Philip A. Fisher

Bank of the Ozarks (OZRK, $57)

2013, yet again, was an exceptional year for Bank of the Ozarks, our bank from Little Rock, Arkansas. The company generated a 9% growth in EPS, reaching $2.41. Here are the highlights from 2013:

- The bank's efficiency ratio (a measure of its cost structure), was an impressive 46%.
- Return on Assets reached 2.04%
- Non-performing loans fell from .57% to .43%.
- The bank's balance sheet continues to strengthen with returns on equity of 13%.
- Ozarks completed its acquisition of First National Bank of Shelby, based in North Carolina.
- In December, Ozarks acquired Bancshares, a Houston-based bank.
- Deposits increased by 20% to $3.7 billion.
- Total assets grew by 18.5% to $4.8 billion.

The company also announced its acquisition of Summit Bancorp at the end of January 2014. This bank has $1.2 billion in assets and 24 branches in Arkansas. After this announcement, Bank of the Ozarks now operates 90 branches in this state (see map below). Given these acquisitions, Bank of the Ozarks now has $6.3 billion in assets.



Since our purchase in 2006, EPS has increased by 154%, or a 14% compounded annual return. Few banks can tout this kind of performance given the difficult economic context of the past years. For the third year in a row, Bank of the Ozarks has been named the best performing bank in the U.S. by *Bank Director* magazine. We remain optimistic about the company's prospect for continued growth.

Berkshire Hathaway (BRK.B, $119)

The company led by the legendary Warren Buffett had another excellent year in 2013. It's difficult to precisely measure the growth in the company's intrinsic value for the year, but we estimate it close to the 18% mark, which in line with their growth in book value.

The greatest asset for Berkshire is its float on insurance premiums which now tops $77 billion. This is the amount of funds set aside to pay for future insurance liabilities. Since the company has a profitable insurance business (with an underwriting ratio of less than 100%), this float is acquired for free. What could be better than having nearly $80 billion in interest-free dollars in the hands of the greatest investor in the history of capitalism? If Mr. Buffett can achieve a 10% return on this capital, this translates itself in $8 billion in annual pre-tax profit that is generated for shareholders. In our opinion, this business activity alone is worth roughly $80 billion, or $34 per share.

We continue to consider shares in Berkshire as undervalued by the market. Mr. Buffett's advanced age certainly plays into the equation. We believe that the company has become the strongest company in the world and is prepared to survive the genius who composed the symphony of capitalism which is Berkshire (though, like Mr. Buffett, we hope that this day is far into the future). We have no idea when this will happen but we see this stock someday trading at a price more representative of its intrinsic value.

Buffalo Wild Wings (BWLD, $147)

Buffalo Wild Wings (BWW) is a sports-oriented restaurant chain which primarily serves chicken wings, as its name reveals. We have been shareholders in the BWW for four years and have been handsomely rewarded for our ownership in this company. The company grew revenue by 22% in 2013 and its EPS climbed by 24%. In the beginning of 2014, the company surpassed 1000 restaurants (with 560 operating as franchises). We continue to see a bright outlook for this concept.

Cabela's (CAB, $67)

We bought shares in Cabela's during the year. This company operates a large chain of retail stores serving the hunting, fishing and outdoor apparel market. While it's been around for 50 years, Cabela's became a public company about 10 years ago. Jean-Philippe, an avid hunter and fisherman, and I have followed the company since.

The company recently adopted a more high-performing business model which grabbed our attention. By reducing the square footage of its new stores, Cabela's was able to significantly improve its return on equity. Profits per square foot are 62% higher in its newer stores relative to its older and larger ones. The company has gone ahead and put in place an ambitious expansion program to expand the number of smaller footprint stores. Cabela's only has a 3.6% market share and could double or triple this figure over the course of the next decade.



The Cabela's store in Louisville, Kentucky

Same-store sales increased almost 4% in 2013, while revenues grew by 16% to $3.6 billion. EPS increased by 22% to $3.32. We believe that Cabela's has an excellent brand and has a bright long-term future.

Carmax (KMX, $47)

Carmax's fiscal year ends in February. We estimate that sales and EPS will grow by 15%. While the company operates 124 stores in the US, it only has roughly 3% of the used car market. Carmax is planning on opening between 10 and 15 stores annually within the coming years.

We have been shareholders since 2007, when we purchased the stock for $21. The stock subsequently tumbled by 67% during the crisis (such things happen in the market). Yet, Carmax remained profitable during 2008 and 2009. Our patience was rewarded and the company generated earnings in 2013 that were more than twice that of 2007 (or an annualized growth rate of 18%). And the stock followed suit by rising in a commensurate manner to its EPS growth.

Disney (DIS, $76)

Disney had an excellent 2013, with EPS climbing 16% and the stock appreciating by 50%. Bob Iger remains in our judgment one of the best CEOs in the US. We bought shares in Disney the very day Bob Iger was named CEO in September of 2005. Since his arrival at the helm of Disney, the company's stock has increased by 200%, or 150% more than the performance of the S&P 500 over the course of the same period. The difference to shareholders is an added value of $70 billion (yes, I should repeat this one: 70 billion dollars). It's not even worth mentioning what a bargain Bob Iger has been for shareholders of Disney. We welcome the news from the company that Iger was going to postpone his retirement by 18 months. He will remain in his position until June 2016. Sigh of relief!



Dollarama (DOL-T, $88)

Four years ago, we were thrilled to see one of the company's we had always admired go public: Dollarama. The reason for this admiration is simple: we think that Larry Rossy, the company's founder and CEO, is one of the best businessmen in Canada. The stock has quadrupled since its IPO.

After its first three quarters of 2013 (the company's fiscal year ends on January 31st), revenues have risen by 14% and same-store sales has increased by 5%. EPS has climbed 22%. December was a bit difficult for the company due to inclement weather. The depreciation of the Canadian dollar could also have a minor impact on the company's gross margins for 2014. Dollarama now has more than 800 stores in Canada and is preparing for international expansion. We believe that the company's outlook is excellent and we are happy to continue owning our shares.

Fastenal (FAST, $47)

Fastenal had a more challenging year, with revenue and EPS only increasing by 6%. The good news is that most of Fastenal's growth was organic, since its store count only increased by 1%. After a few good years of solid growth, the number of new vending machines installed decreased relative to 2012.

We have been shareholders in Fastenal for more than 15 years and have been handsomely rewarded. In 2013, EPS was eight times higher than they were in 1998—equivalent to an annualized growth rate of 15%. We continue to admire the company's culture and management team.

Google (GOOG, $1121)

Google had a great 2013, with revenues climbing 19% and adjusted EPS rising by 12%. The company seems to have succeeded in stabilizing its margins and the transition from revenue derived from traditional Internet towards mobile seems to be occurring harmoniously.

The company dominates the search engine market and its mobile operating system, Android, continues to gain market share. Google continues to be a smaller weight in our portfolio as we would appreciate a better allocation of excess cash flows.

IBM (IBM, $188)

Although IBM's revenue slightly declined (using a constant currency) in 2013, the company's EPS grew by 12%. The company's hardware revenue continues to represent a smaller and smaller portion of its overall revenue—IBM announced the sale of its x86 server division to Lenovo at the beginning of 2014.

This company which dominates information services does a brilliant job at managing its capital. This is a primary reason why we are shareholders. On top of it, the stock is trading at roughly 10 times its estimated earnings for 2014 which seems to us as highly undervalued.

LKQ Corp (LKQ, $33)

We invested in LKQ in 2012. This Chicago-based company refurbishes used automotive parts. The company became the leader in its industry by offering very compelling prices relative to new parts (which pleases the insurance companies) along with an unrivaled distribution network. LKQ has

diversified in Europe over the last years by making some acquisitions in the United Kingdom, Belgium, France and the Netherlands.

Revenues grew at an annualized rate of 22% from 2008 to 2013, from less than $2 billion to more than $5 billion. In 2013, EPS rose by 22% relative to last year and we see a bright future for the company's growth prospects.

M&T Bank (MTB, $116)

EPS at M&T Bank grew by 10% in 2013, to $8.66. The bank's return on asset reached 1.5% and its return on equity was 18%. The merger with Hudson City Bancorp, however, is taking a bit more time than anticipated. Once complete, we believe this acquisition will be highly beneficial to M&T.

Robert Wilmers has led M&T since 1983 and has done a phenomenal job and, despite being 79, we hope he'll remain as CEO of this Buffalo-based bank for years to come. I would also be remiss to not add that I often travel to Buffalo and I can say firsthand that M&T plays an outstanding role in its community.

Mohawk Industries (MHK, $149)

When we speak of phenomenal CEOs, we would have to include Jeffrey S. Lorberbaum of Mohawk in this same league. He has led this company, a leader in floor covering based in Georgia, with great skill and agility through the residential real estate crisis of 2006-2011. The company improved its balance sheet, made good acquisitions at compelling prices, and substantially improved its cost structure.

2013 was an exceptional year, with revenues rising 27% and adjusted EPS surging by 45% to $6.90. The acquisition of Marazzi, Pergo and Spano contributed significantly to this growth. We had to remain patient with Mohawk but we were finally rewarded, with the stock doubling since our first purchase more than six years ago.

MTY Food Group (MTY-T, $34)

MTY grew its adjusted EPS by 15% in 2013. The company also completed some important acquisitions, with Extreme Brandz the most significant. This company has roughly 235 Extreme Pita and more than 70 Mucho Burrito restaurants in Canada and the US. The 40 location in the US are the first foray by MTY on American soil. MTY begins its much-anticipated American expansion.



The Mucho Burrito at the *Bay Adelaide Centre* in Toronto

We have been shareholders in MTY for six years. From 2007 to 2013, adjusted EPS increased from $.51 to $1.50—a growth of nearly 200%. We are great admirers of Stanley Ma, the company's CEO, and we continue to see a bright future for the company.

O'Reilly Automotive (ORLY, $129)

O'Reilly had another excellent year in 2013, with revenues climbing 8%, same-store sales rising by 4% and EPS increasing by 27%. O'Reilly's surge in EPS was amplified by the fact that the company bought back approximately 10% of its shares outstanding in 2013.

Since our purchase in the summer of 2004, EPS has quintupled (equivalent to a 21% annualized growth rate) and the stock has gone up six fold. It's difficult to not be highly satisfied from this investment.

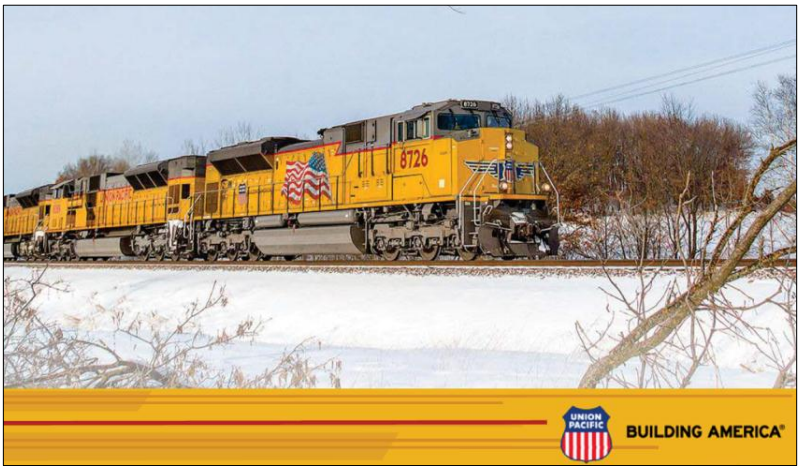
Precision Castparts (PCP, $269)

Precision Castparts manufactures complex metal composite parts sold primarily to the aerospace industry. The company is a leader in this market and benefits from highly durable competitive advantages which enable it to generate net margins of 18%. This is an exceptional level for an industrial company.

2013 was an excellent year, with EPS rising by 26%. We estimate that 2014 revenues will be $11 billion and that net income will come in at $2 billion (or roughly $14 per share). We would like for the stock to have a more compelling P/E multiple which is the reason why we don't have a greater allocation to PCP in our portfolios!

Union Pacific (UNP, $168)

Union Pacific had an excellent year. EPS rose by 14% in 2013 and we anticipate a similar growth for 2014. The most important factor for shareholders of Union Pacific is the company's capacity to increase its prices. The company increased its prices by 3.75% in 2013—surpassing inflation and exceeding the company's rise in its own costs (of less than 1%). The company's operating cost ratio decreased from 67.8% in 2012 to 66.1%, with company aiming for 65% in the near term. The company also increased its dividend by 19% and bought back $2 billion of its own shares. So everything is rolling along (!) for our railroad company based out of Omaha.



Valeant Pharmaceuticals (VRX, $117)

It was another year of solid growth for our Laval-based pharmaceutical. The company completed many acquisitions, with the purchase of Bausch & Lomb the most significant. Valeant has complex accounting but we believe that adjusted EPS will be $6.24 in 2013 compared to $4.51 for the prior year (a 38% increase). 2014 also looks promising, with a growth rate estimated to surpass 30%. The stock has nearly tripled since our purchase two years ago.

The pharmaceutical industry is not easy to predict and analyze. The reason behind this investment is simple: we greatly admire Valeant's CEO, Michael Pearson.

Visa (V, $222)

Visa had another exceptional year. Revenues increased by 13% and EPS climbed by 21% (this EPS growth is magnified by the company buying back 5% of its shares). Our purchase of Visa three years ago, after a sharp decline in the stock, has proven to be very rewarding with the stock tripling since.

Wells Fargo (WFC, $45)

Wells Fargo had another very solid year. EPS rose by 16% to $3.89—a record level. We estimate that the adjusted EPS for Wells Fargo, while compensating for the amortization of intangible assets, reached $4.08. Chargeoffs related to non-performing loans also significantly decreased. The bank's return on asset was 1.51% and its return on equity was 13.9%. The company increased its dividend by 31% in 2013.

We estimate adjusted EPS of $4.45 for 2014 and continue to consider this stock as highly undervalued.

The Podium of Errors

"There's no way that you can live an adequate life without many mistakes.
In fact, one trick in life is to get so you can handle mistakes"

- Charlie Munger, Vice-Chairman of Berkshire Hathaway

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2012 (or from past years). It is with a constructive attitude, in order to always improve as investors, that we provide this detailed analysis. As is often the case with stocks, errors from omission (non-purchases) are often more costly than errors from commission (purchases)… even if we don't see them on our statements.

Bronze Medal: Tripadvisor

As you can imagine, I spend a great deal of the year on the road visiting companies, attending conferences and meeting partners. Having had all sorts of hotel experiences over the course of the past decades, I really like to be able to choose hotels which can make my travels more enjoyable. I discovered the website Tripadvisor a few years ago and became a loyal fan. To paraphrase an American Express advertising, I never leave home without vetting out my destination on Tripadvisor ahead of time. The company also owns another very useful site called webseatguru.com which helps you choose the best seat on any commercial flight.

Tripadvisor went public at the end of 2011 and I was very impressed with the company's financial performance after reading the prospectus. Unfortunately, the stock rapidly climbed to $45 and was trading at 30 times its earnings. Then, in the fall of 2012, the stock tumbled by 33% to $30 and I seriously thought about buying it. The P/E seemed reasonable (20x) for a company with a dominant brand that was growing at 20% a year. Yet, as often the case, I decided to wait for an even better price. And the stock surged by 180% in the following year and is now trading at $84. It's too bad that I didn't convert my admiration into profits as it would have paid for a few five star hotels…for both you and me.

Silver Medal: Buffalo Wild Wings

You are likely surprised to find Buffalo Wild Wings in this section about errors as we have quadrupled our money since becoming shareholders. Difficult to ask for more? Well, it could have been better.

In the middle of 2012, the company had a disappointed quarter due to a substantial increase in the price of chicken wings that weakened gross margins. True to its typical myopia, Wall Street punished the stock which dropped by 24% thereafter.

We had a 2% weight on this stock in our portfolio at that moment. We thought about doubling our holding, believing that these margin problems would be temporary. I decided to go to Minneapolis to meet the executive team at BWW to look into this. I was (yet again) highly impressed by their vision and game plan for the company. I came back convinced that we should not only keep our shares but that we should add to our position. But I didn't act on this conviction and when the stock started to climb, I waited on the sidelines. The stock doubled over the next 15 months. If we had had twice the weight in our portfolio, we would have been even more rewarded this year.

Gold Medal: Church & Dwight

Church & Dwight was first known for its Arm & Hammer brand, the baking soda often placed in our refrigerators to capture odors. About 15 years ago, the company decided to develop an ambitious growth plan by developing new products for Arm & Hammer and also by acquiring new brands. In 2001, the company purchased Carter-Wallace which has many brands including Trojan (the famous condoms), Nair (to remove superfluous body hair) and First Response (the pregnancy test).

As soon as 2003, I could observe the success of this strategy. In only five years, EPS increased from $.26 to $.62 and the stock was trading at $11 (or a P/E of 19x). I hoped that the stock would drop to a more interesting level which never really happened. In 2013, the company generated $2.89 in EPS, meaning that the company grew at an annualized rate of 17% over the course of the last decade. The stock is now trading at $61, a gain of 455% in 10 years (19% annually). And the P/E increased rather than decreased.

This was a great error because I understood the nature of the company's product and brands (allow me to make a juvenile joke by mentioning that *Trojan is an ideal repeat business*). Additionally, after following the company closely for five years, I also realized by 2003 that the company was led by a brilliant team dedicated to serving and creating wealth for its shareholders. I don't have any excuses to even mention and this error is certainly in the gold camp.

Conclusion: the Missing Gene Hypothesis!

We've repeated on numerous occasions throughout the years the importance of having a good attitude towards market fluctuations in order to realize returns that are above the average. We like to repeatedly cite the wise words of the great money manager John Templeton: "It is impossible to produce superior performance unless you do something different from the majority." This something different, in our opinion, is to be able to buy stocks without being affected by the opinions and behaviors of other investors.

Over the course of the last 20 years, we have noticed how few market participants actually achieve this. Warren Buffett even said a few years ago that the capacity to have a good attitude towards stock prices might be an innate trait not acquired with experience (or good arguments). This statement made us think about another way to look at things.

Clearly, the capacity to do better than average is not just linked to intelligence, work or financial resources (if this were the case, all the great financial institutions would achieve it). We came to the conclusion that those rare investors who are able to do better than average over a long period of time might have something that others do not have.

Actually, it's the contrary; they are actually missing something that is present in others: the hypothetical "tribal gene". Like animals, our genetic code was developed over hundreds of thousands of years, with the primary objective being survival. As humans, we learned early (more than 200,000 years ago) that living in a tribal unit offered protection. Following the tribe became a survival instinct well-entrenched in the core of our being. This unconscious instinct is extremely powerful, primarily in moments of crisis or when our survival is in jeopardy. So, when stocks tumble and those around you sell in a panic, it's almost impossible for someone with an intact genetic code to resist the tendency to follow the tribe towards a safe haven (in this case, towards the liquidity of cash).

From our empirical observations, it seems that some members of our species are immune to this call of the herd. They can go left when the rest of the tribe goes towards the right. Their attitude isn't influenced by the behavior of the tribe. Their genetic code seems to not have the "tribal gene". It's difficult to evaluate what percentage of humans have this particularity but it's a minority. And it's probably those who eventually become creators (artists, scientists, writers, entrepreneurs, etc), as the act of creation requires the capacity to make something new and to forge a new path different from others. To create is to go where there was nothing before. Creating is the antonym of following.

Such a theory, which is of course impossible to prove, probably sounds arrogant despite that not being our intent. We are simply on a quest for learning.

Subjectively, we believe that our team at Giverny Capital doesn't have this tribal gene. This line of thinking enables us to answer the question of why we didn't panic during the crisis of 2008-09 and remained optimistic while nearly all others sought refuge.

Many decades ago, Warren Buffett told a group of students: "To succeed in the market, be fearful when others are greedy and greedy when others are fearful." This simple phrase captures the essence of success in the market.

To Our Partners

Using rationality, along with our unwavering optimism, we trust that the companies we own are exceptional, led by top-notch people, and destined for a great future. They should continue to prudently navigate the often troubled waters of the global economy. Furthermore, the valuation assigned by the market to these outstanding companies is very similar to the valuation of an average company in the S&P 500, despite the fact that our companies have better growth prospects than average. Therefore we consider the appreciation potential for our portfolio, both in absolute and relative terms, to be well above average.

We also want you to know that we are fully aware of and grateful for your votes of confidence. It is imperative for us to not only select outstanding companies for our portfolios, but to also remain outstanding stewards of your capital. We certainly like to achieve good returns (and have developed a taste for it), but it must not come at the cost of taking undue risk. Our philosophy to favor companies with solid balance sheets and dominant business models, along with purchasing these companies at reasonable valuations, is central to the risk management of our portfolios.

We wish a great 2014 to all our partners.



François Rochon and the Giverny Capital team

APPENDIX A

The Gazette

Published on July 9th 2013

Twenty years of the Giverny Portfolio

By François Rochon

I started to manage the Giverny Portfolio in July 1993 (and have thoroughly measured results since). The results over twenty years are very satisfactory. More importantly, I have learned lots of lessons that should be useful going forward. Here are the top 10 things I have learned since 1993:

10- Investing in the stock market is not a game.

Investing in the stock market is about acquiring partial ownership in companies. It is not a game. Those who approach the market as if it were a casino end up with the results of gamblers.

9- Beating the market is harder than most people think

The vast majority of investors don't come close to beating the market. Even professional managers, as a whole, don't beat the market because they are the market. But some investors are able to do it. In my experience, it requires a total devotion to the art of investing in addition to the right temperament toward market fluctuations.

8- Short-term results can be caused by luck as much as by skill

Most great investors I know have, on average, underperformed the market one year out of three. Results over a few years don't mean much. But over the long term, chance evens out and sound investment principles prevail. So patience is a key quality to investment success.

7- The more an industry changes, the riskier it is to invest in

I am astonished to see that many leading tech companies of the nineties don't exist anymore (or have lost 80% of their values). Industries that change quickly can be good for customers but bad for shareholders. It applies to technology stocks as well as stocks in some medical fields or government regulated sectors. On the other hand, a company like Coca-Cola will still exists in 50 years!

6- Beware of IPOs

Initial Public Offerings are usually popular at the end of a bull market. When you hear about new exciting IPOs, raise your shields! Although some IPOs do very well (I did buy Dollarama when it

came public a few years back), the majority do poorly. The main reason is that the price set is rarely advantageous to the buyer.

5- Most people are wrong most of the time

I don't have much scientific data to explain this one. But my observations over the years have led me to believe that, in the stock market, most people are wrong most of the time. And the irony is that most people think they know more than the others!

4- Price and value are not the same thing

Price is what you pay, value is what you get. I have seen over the years many stocks sell at half what they were worth. And I've seen overvalued stocks by the bucket. A great business is not always a great stock. Although it is a mistake to solely focus on price, it is an important factor.

3- Look for a company with a competitive advantage

It is a ferociously competitive business world out there. Companies that do better than average - over many years - have a competitive advantage. Look for such advantages.

2- One key ingredient is the management

A great business model is one key ingredient. A great management team is the other one. Most of my big winners were linked to the fact that the management of the company was outstanding.

1- It is futile to try to predict the stock market over the short run

All the previous lessons are useless if you try to predict the stock market over the short run. I have heard people say hundreds of times that they are waiting to buy great companies because they had some views on the short-term direction of the stock market. Owning great businesses, managed by great people and acquired at reasonable prices is the winning recipe.

APPENDIX B

Investment philosophy

Note: This section is repeated from prior annual letters and is aimed at new partners.

In 2013, we saw a large increase in the number of Giverny Capital partners (the term we use for our clients). With all these newcomers, it is imperative that we write again (and again) about our investment philosophy.

Here are the key points:

- We believe that over the long run, stocks are the best class of investments.
- It is futile to predict when it will be the best time to begin buying (or selling) stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity).
- We choose companies that have high (and sustainable) margins and high returns on equity, good long term prospects and are managed by brilliant, honest, dedicated and altruistic people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be approximately assessed.
- The stock market is dominated by participants that perceive stocks as casino chips. With that knowledge, we can then sometimes buy great businesses well below their intrinsic values.
- There can be quite some time before the market recognizes the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

Experience and common sense teach us that an investment philosophy based on buying shares in companies that are undervalued, and holding these companies for several years, will not generate linear returns. Some years, our portfolio will have a return that is below average. This is a certainty that we must accept.

Another important point: the significant volatility of the market is often perceived negatively by many investors. It's actually the contrary. When we see stock prices as *"what other people believe the company is worth"* rather than the real value (at least in the short term), these fluctuations become our allies in our noble quest for creating wealth. Instead of fearing them, we can profit from them by acquiring superb businesses at attractive prices. The more that markets (the "other" participants) are irrational, the more likely we are to reach our ambitious performance objectives.

Benjamin Graham liked to say that the irrationality of the market was an extraordinary advantage to the intelligent investor. The person, however, who becomes affected by short-term market fluctuations (less than 5 years) and who take decisions based on them transforms this advantage into a disadvantage. His or her own perception of stock quotes becomes their own worst enemy. Our approach at Giverny Capital is to judge the quality of an investment over a long period of time.

So patience – ours AND that of our partners – becomes the keystone for success.

APPENDIX C

Notes on the returns of the Giverny portfolios

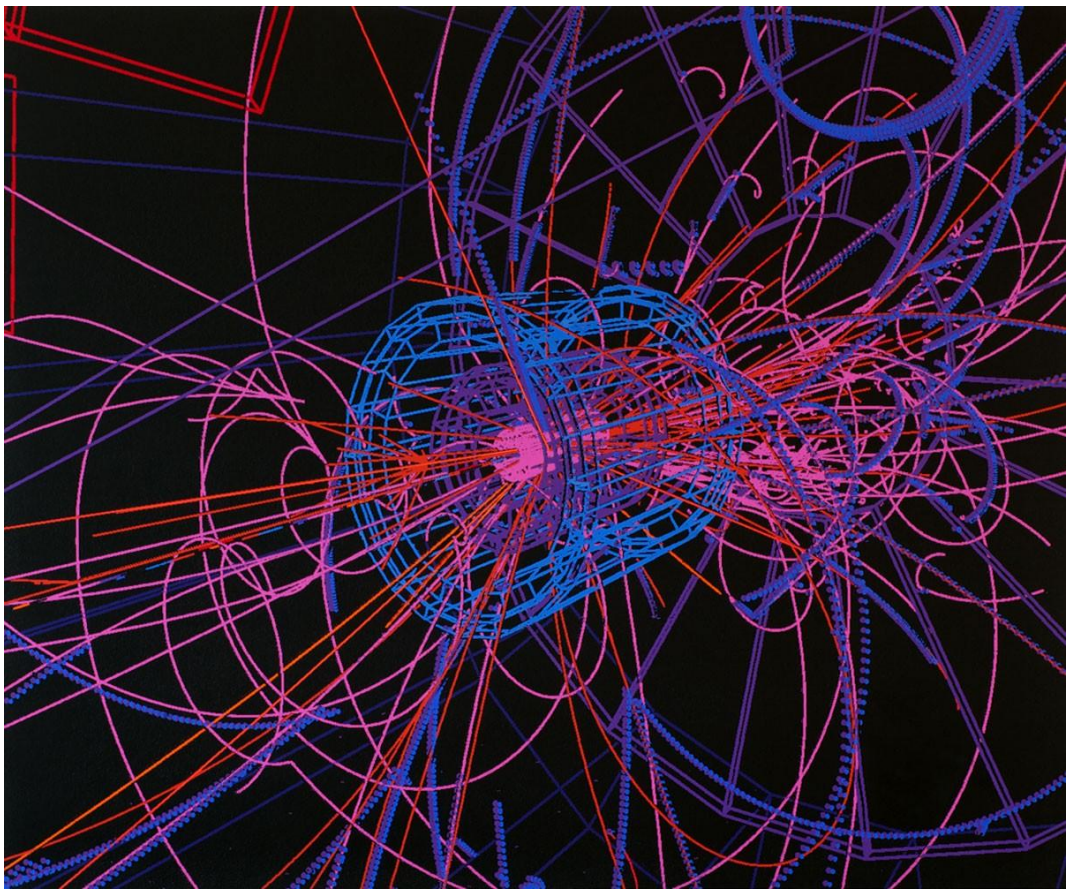
- The Giverny portfolio is a private family group of accounts managed by François Rochon since 1993. The returns of the period from 1993 to 1999 were realized before registration of Giverny Capital Inc. at the AMF in June of 2000.
- The Giverny portfolios serve as a model for Giverny Capital's clients, but returns from one client to the other can vary depending on a multitude of factors, such as the timing of the opening and funding of a client's account.
- Past results do not guarantee future results.
- The Giverny Canada and Giverny US portfolios are parts of the Giverny Global portfolio.
- The returns indicated include trading commissions, dividends (including foreign withholding income taxes) and other income but do not include management fees.
- The index benchmark group is selected at the beginning of the year and tends to be a good reflection of the asset composition of the portfolio. In 2013 :

    - Giverny Global Portfolio: TSX 18% Russell 2000 40% S&P 500 40% MSCI EAFE 2%
    - Giverny US Portfolio : S&P 500 100%
    - Giverny Canada Portfolio : S&P/TSX 100%

- The returns for the S&P 500 (in $USD) are provided by Standard & Poors.
- The returns for the various indices used for comparable purposes are deemed reliable by Giverny Capital. It should be noted that currency effects and the impact of dividends on the returns for indices are estimated. Despite its best effort, Giverny Capital cannot guarantee that this information is accurate and complete at all times.
- The custodian of our client portfolio is TD Waterhouse in Canada and TD Ameritrade Institutional in the US.
- The financial statements of the three portfolios are audited by PricewaterhouseCoopers (PwC) at the end of each year. The PwC data are those provided by our custodian TD Waterhouse. The PwC reports are available upon request.
- For more information, please see the "returns" section of our website.

GIVERNY CAPITAL

Annual Letter to our Partners 2014



Nicolas Baier
Production de masse, A08 – 2014
peinture/reproduction d'un graphique du CERN
Acrylic on Canvas
Giverny Capital Collection

Historical Summary

It has been more than two decades since I discovered the writings of Warren Buffett, Benjamin Graham, John Templeton, Philip Fisher and Peter Lynch. I then decided to begin managing a family portfolio based on an investment approach synthesized from these great money managers. By the end of 1998, after five years of satisfactory results, I decided to launch an investment management firm offering asset management services aligned with my own investment philosophy. Giverny Capital Inc. came into existence.

In 2002, Giverny hired its first employee: Jean-Philippe Bouchard (JP for those who know him well). A few years later, JP became a partner and participates actively in the investment selection process for the Giverny portfolio. In 2005, two new persons joined the firm who eventually became partners: Nicolas L' Écuyer and Karine Primeau. Finally, in 2009, we launched a US office in Princeton, New Jersey. The director of our Princeton office, Patrick Léger, shares in the culture and long-term time horizon inherent to Giverny.

We are Partners!

From the very first days of Giverny, the cornerstone of our portfolio management philosophy was to manage client portfolios in the same way that I was managing my own money. Thus, the family portfolio I've managed since 1993 (the "Rochon Global Portfolio") serves as a model for our client accounts. It is crucial to me that clients of Giverny and its portfolio managers are in the same boat! That is why we call our clients "partners".

The Purpose of our Annual Letter

The primary objective of this annual letter is to discuss the results of our portfolio companies over the course of the prior year. But even more importantly, our goal is to explain in detail the long-term investment philosophy behind the selection process for the companies in our portfolio. Our wish is for our partners to fully understand the nature of our investment process since long-term portfolio returns are the fruits of this philosophy. Over the short term, the stock market is irrational and unpredictable (though some may think otherwise). Over the long term, however, the market adequately reflects the intrinsic value of companies. If the stock selection process is sound and rational, investment returns will eventually follow. Through this letter, we give you the information required to understand this process. You will hopefully notice that we are transparent and comprehensive in our discussion. The reason for this is very simple: we treat you the way we would want to be treated if our roles were reversed.

The Artwork on Our 2014 Letter

Since 2004, we have illustrated the cover of our letter with a copy of an artwork from our corporate collection. This year we selected a recent work by the Quebec artist Nicolas Baier.

For the year ending December 31st 2014, the return for the Rochon Global Portfolio was 28.1% versus 17.8% for our benchmark, which represents an outperformance of 10.2%. The return of the Rochon Global Portfolio and the one of our benchmark include a gain of approximately 9% due to fluctuations in the Canadian currency.

Since our inception on July 1st 1993, our compounded annual growth rate has been 16.1% versus 8.7% for our weighted benchmark, representing an annualized outperformance of 7.3% over this period.

Our long-term and ambitious objective is to maintain an annual return that is 5% higher than our benchmark.

The Rochon Global Portfolio: Returns since July 1st 1993

Return *	Rochon	Index **	+ / -	$ US/Can ***
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	3.3%
1994	**16.5%**	3.7%	**12.7%**	6.0%
1995	**41.2%**	24.0%	**17.2%**	-2.7%
1996	**28.0%**	22.8%	**5.2%**	0.3%
1997	**37.8%**	28.6%	**9.2%**	4.3%
1998	**20.6%**	18.8%	**1.8%**	7.1%
1999	**15.1%**	16.3%	**-1.2%**	-5.7%
2000	**13.4%**	3.2%	**10.2%**	3.9%
2001	**15.1%**	-0.4%	**15.5%**	6.2%
2002	**-2.8%**	-18.3%	**15.6%**	-0.8%
2003	**13.6%**	14.0%	**-0.4%**	-17.7%
2004	**1.6%**	6.2%	**-4.5%**	-7.3%
2005	**11.5%**	3.6%	**7.9%**	-3.3%
2006	**3.5%**	17.0%	**-13.5%**	0.2%
2007	**-14.4%**	-11.6%	**-2.8%**	-14.9%
2008	**-5.5%**	-22.0%	**16.5%**	22.9%
2009	**11.8%**	12.2%	**-0.4%**	-13.7%
2010	**16.1%**	13.9%	**2.2%**	-5.4%
2011	**7.8%**	-1.0%	**8.8%**	2.3%
2012	**21.5%**	12.5%	**9.0%**	-2.2%
2013	**50.2%**	38.9%	**11.3%**	6.9%
2014	**28.1%**	17.8%	**10.2%**	9.1%
Total	**2366.3%**	**507.0%**	**1859.3%**	**-9.5%**
Annualized	**16.1%**	**8.7%**	**7.3%**	**-0.5%**

* All returns are adjusted to Canadian dollars
** Index is a hybrid index (S&P/TSX, S&P 500, MSCI EAFE, Russell 2000) which reflects the weight of the underlying assets
*** Variation of the US dollar compared to the Canadian dollar

Note: Refer to Appendix C for disclosure statements on the Rochon portfolios and their corresponding indices.

The Rochon US Portfolio

We have been publishing the returns of the Giverny US Portfolio, which is entirely denominated in US dollars, since 2003. The Giverny US Portfolio corresponds to the American portion of the Giverny Portfolio. In 2014, it realized a return of 18.0% compared to 13.7% for our benchmark, the S&P 500. The Giverny US Portfolio therefore outperformed our benchmark by 4.3%

Since its inception in 1993, the Giverny US Portfolio has returned 2253%, or 15.8% on an annualized basis. During this same period, the S&P 500 has returned 597%, or 9.4% on an annualized basis. Our added value has therefore been 6.4% annually.

Year	Rochon US	S&P 500	+/-
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	37.6%	17.2%
1996	27.0%	23.0%	4.1%
1997	32.9%	33.4%	-0.4%
1998	11.0%	28.6%	-17.6%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-9.1%	20.4%
2001	8.1%	-11.9%	20.0%
2002	-4.4%	-22.1%	17.7%
2003	31.6%	28.7%	2.9%
2004	9.3%	10.9%	-1.6%
2005	12.5%	4.9%	7.5%
2006	3.3%	15.8%	-12.4%
2007	-1.7%	5.5%	-7.2%
2008	-24.3%	-37.0%	12.7%
2009	28.7%	26.5%	2.3%
2010	21.9%	15.1%	6.8%
2011	4.9%	2.1%	2.8%
2012	22.8%	16.0%	6.8%
2013	40.6%	32.4%	8.2%
2014	18.0%	13.7%	4.3%
Total	**2252.5%**	**596.5%**	**1656.0%**
Annualized	**15.8%**	**9.4%**	**6.4%**

Note: Please refer to Appendix C for disclosure statements on the Rochon portfolios and their corresponding indices.

We outperformed the S&P 500 for a seventh consecutive year. Our objective is to outperform the S&P 500 over the long term. Over a long period of time, the vast majority of managers fail to beat the S&P 500 and those who do typically underperform one year out of three. You will notice that over the 21 years of its track record, our US portfolio has underperformed the S&P 500 on six occasions (or 29% of the time).

We accept the fact that we will sometimes underperform the index over the short term when our investment style or specific companies are out of favor with mainstream thinking. We welcome rewarding periods of portfolio performance with humility—and with joy. While it's not always easy, we try to remain unaffected by short term results, both good and bad.

Rochon Canada Portfolio

We introduced a portfolio that is 100% focused on Canadian equities in 2007. This corresponds roughly to the Canadian portion of the Giverny Portfolio. In 2014, the Giverny Canada Portfolio returned 20.3% versus 10.6% for the S&P/TSX, therefore outperforming the index by 9.7%.

Since 2007, the Rochon Canada Portfolio has returned 271%, or 17.8% on an annualized basis. During this same period, our benchmark had a gain of 43%, or 4.6% on an annualized basis. Our annual added value was therefore 13.2%.

Year	Giverny Canada	S&P/TSX	+/-
2007	19.7%	9.8%	9.9%
2008	-24.6%	-32.9%	8.3%
2009	28.2%	33.1%	-4.9%
2010	26.7%	17.6%	9.1%
2011	13.5%	-8.7%	22.2%
2012	24.1%	7.2%	16.9%
2013	49.4%	13.0%	36.5%
2014	20.3%	10.6%	9.7%
Total	271.0%	42.9%	228.1%
Annualized	17.8%	4.6%	13.2%

Note: Please refer to Appendix C for disclosure statements on the Rochon portfolios and their corresponding indices.

Our primary Canadian holdings performed very well in 2014. The all-star in our portfolio was Dollarama, which rose 35%. While it was a volatile year for Valeant, the stock still rose nearly 22%. Finally, our most recent purchase, Constellation Software, increased by approximately 27%.

For seven out of the last eight years, the Rochon Canada Portfolio outperformed the TSX. It is also worth repeating that our Canadian portfolio is very concentrated and has little correlation to the TSX. So the relative performance, whether positive or negative, will therefore often be high.

2014: The Year of the "Return to Normal"

2014 was another exceptional year for us. Our companies increased their intrinsic values by approximately 13% which is well above the average rate. Further, our portfolio again generated a market return that was higher than the aggregate increase in the intrinsic values of our portfolio companies. The reason is simple: it is the result of a recovery to more appropriate valuations based on the price-earnings ratios of our companies as well as a more appropriate valuation for the Canadian dollar.

The foundation of our investment approach is to consider stocks as if they represent a fractional ownership in real businesses. While this may seem obvious, the vast majority of market participants do not approach stocks in this manner (unconsciously or otherwise) and the predominant emphasis is almost entirely based on the price of stocks over the short term. From our perspective, we try to remain impervious to market fluctuations and focus our efforts on analyzing the intrinsic performance of our companies. We discuss this intrinsic performance in the "Owner Earnings" section of our Annual Letter.

Let's review the last decade for our portfolio as well as for the stock market in general. It's an interesting exercise because we can see two distinct periods by analyzing the intrinsic performance of our companies and stock market since the beginning of 2005.

The first period, from 2005 to 2011, was characterized by a weaker economy, a contraction of the price-earnings ratio (both for out stocks as well as the S&P 500) and a rising Canadian dollar (which further reduced the performance of our US stocks). For this period, our companies increased their intrinsic values approximately 98% or 10% on an annual basis. The stock prices of our companies, however, rose by only 54% or 6% annually (including dividends). Further, the stronger Canadian dollar reduced this return to 32% or 4% on an annual basis. During these years, we explained that we considered the underlying performance of our companies to be below their long-term economic potential. The compression of price-earnings ratios for our securities also seemed unjustified. Finally, the high Canadian dollar seemed artificially high to us. These three temporary factors impeded the performance of our portfolios during this period.

The period from 2012 to 2014 brought an equilibrium to these factors. Over these three years, our companies increased their intrinsic value by 56% or 16% on an annual basis. Our securities on the stock market rose by 108% or 28% on an annual basis. The Canadian dollar returned to Earth which amplified our performance denominated in Canadian currency by 137% or 33% on an annual basis.

Some might believe that our companies are trading at unsustainably high levels. We don't believe that this is the case and, according to our analysis, the last three years have only corrected an abnormal past imbalance. In other words, the stock market pendulum has simply returned to the middle. Indeed, if we look at the ten year period from 2005 to 2014, our companies have increased their intrinsic values by 209% or 12% on an annual basis. Our stocks have achieved a total return of 219% during this period and, when considering the effect of the Canadian currency, the return is about 214%. Here is a summary table of the past decade:

Period	Intrinsic	Market	In $C
2005-2011	98%	54%	32%
Annualized	**10%**	**6%**	**4%**
2012-2014	56%	108%	137%
Annualized	**16%**	**28%**	**33%**
2005-2014	209%	219%	214%
Annualized	**12%**	**12%**	**12%**

It is obviously important to compare these results with the overall experience of stock market investors. During the last decade, companies in the S&P 500 increased their intrinsic values by about 7% per year and the S&P 500 generated an annual return of 7.7%. In Canada, during the same period, the S&P/TSX Composite Index generated an approximate annual return of 7.4%. Relative to the indices, the portfolio has achieved an outperformance in the 4-5% range per year over the last decade which is in line with our objective.

The market data above also points out that North American stock markets generated returns below the historical average of 10% over the last decade. However, we must remember that the S&P 500 achieved an annual return of 12% from 1995 to 2004. So one could argue that the last decade has simply "normalized" the prior decade.

Benjamin Graham wrote in his 1949 book, "The Intelligent Investor", that the stock market often behaves like a voting machine over the short term—a machine that reflects the sometimes irrational "votes" of investors. But in the long term, the market behaves like a weighing machine that eventually properly reflects the fair value of companies.

The Drop in Oil Prices

We've received several questions regarding the drop in oil prices beginning in late 2014. We have repeatedly affirmed our agnosticism vis-à-vis the price of oil during its past increases and we have the same view regarding the price of oil when it tumbles. If there is one thing that seems clear to us is that the price of oil is highly unpredictable and depends on myriad parameters. Companies that are directly dependent on the price of oil are therefore difficult to value and therefore fall outside of our circle of competence.

On the other hand, we own shares in companies, such as Union Pacific and Precision Castparts, that have part of their business linked to companies operating in various part of the energy sector. We believe that over the long term, their business models are solid and have significant economic benefits allowing them to maintain above-average returns on equity. We do not believe that their long-term economic models are affected by the recent drop in oil prices.

Outlook for 2015

As you know, we have a minimalist attitude towards economic forecasts. The economic outlook for 2015 seems good to us for the United States and, at best, modest for Canada. At this point, it is difficult to measure the impact of the sharp fall in oil prices on the Canadian economy and the Bank of Canada has lowered its growth outlook for 2015 as well as its interest rates.

In the United States, the decline in oil prices could lower the profits of energy companies in the S&P 500 by 50% in 2015. The recent sharp rise in the US dollar should also affect earnings growth of US multinationals. Yet, the drop in gas prices will have a beneficial effect on consumer spending. The combined effect of these various economic drivers on the profits of the S&P 500 for 2015 could lead to a growth rate of only 3%.

As for our companies, the effect of the decline in oil prices should be minimal. Still, many of our US companies generate revenues from various countries, so the rise of the US dollar will affect their level of earnings growth. Nevertheless, we believe that our companies can increase their profits by about 10-13% in the coming year.

Owner's Earnings

At Giverny Capital, we do not evaluate the quality of an investment by the short-term fluctuations in its stock price. Our wiring is such that we consider ourselves <u>owners</u> of the companies in which we invest. Consequently, we study the growth in earnings of our companies and their long-term outlook.

Since 1996, we have presented a chart depicting the growth in the intrinsic value of our companies using a measurement developed by Warren Buffett: "owner's earnings". We arrive at our estimate of the increase in intrinsic value of our companies by adding the growth in earnings per share (EPS) and the average dividend yield of the portfolio. This analysis is not precise but, we believe, approximately correct. In the non-scientific world of the stock market, we believe in the old saying: "It is better to be roughly right than precisely wrong."

This year, the intrinsic value of our companies, as a whole, rose by 13% (12% from the growth in earnings and 1% from the average dividend). Despite changes to our portfolio during the year, we consider this growth in earnings to appropriately reflect economic reality. The stocks of our companies rose approximately 19% (without the effect of currency).

	Rochon Global Portfolio			S&P 500		
Year ***	Value *	Market **	Difference	Value *	Market **	Difference
1996	14%	29%	15%	13%	23%	10%
1997	17%	35%	18%	11%	33%	22%
1998	11%	12%	1%	-1%	29%	30%
1999	16%	12%	-4%	17%	21%	4%
2000	19%	10%	-9%	9%	-9%	-18%
2001	-9%	10%	19%	-18%	-12%	6%
2002	19%	-2%	-21%	11%	-22%	-33%
2003	31%	34%	3%	15%	29%	14%
2004	21%	8%	-12%	21%	11%	-10%
2005	14%	15%	0%	13%	5%	-8%
2006	14%	3%	-11%	15%	16%	1%
2007	10%	0%	-10%	-4%	5%	9%
2008	-3%	-22%	-19%	-30%	-37%	-7%
2009	0%	28%	28%	3%	26%	23%
2010	22%	22%	0%	45%	15%	-30%
2011	17%	6%	-11%	17%	2%	-15%
2012	19%	23%	4%	7%	16%	9%
2013	16%	42%	26%	9%	32%	23%
2014	13%	19%	6%	9%	14%	5%
Total	983%	1094%	111%	293%	375%	83%
Annualized	13.4%	13.9%	0.6%	7.5%	8.6%	1.1%

Since 1996, our companies have increased their intrinsic value by 983%, or close to an eleven fold increase. Meanwhile, the value of their stocks has increased 1094% (including dividends but without currency effects). On an annualized basis, our companies increased their intrinsic value by 13.4% and our stock returned 13.9% per year. The similarity between those two numbers is not a coincidence.

During this same period, the companies comprising the S&P 500 increased their aggregated intrinsic value by 293% and saw their stock prices rise by 375%, or 7.5% and 8.6% annually, respectively.

Market performance and corporate performance are rarely synchronized over the course of a calendar year (as seen in the chart above). In fact, the aggregate stock prices for our portfolio has only been within 1% of the change in aggregate intrinsic value for any given year on only three occasions. But as more time passes, the synchronization between the two inevitably begins to reveal itself.

Over 19 years, our portfolio has realized a return that is 5% higher than the S&P 500 primarily because the underlying companies in our portfolio have increased their intrinsic value at a rate that is 5% higher than the average. This is how we plan on continuing to reach our performance objectives in the future, rather than trying to speculate on the highs and lows of the market or trying to predict economic or political trends.

The Flavor of the Day for 2014

Nearly all areas where we've seen excesses for the last decade have returned to earth. The list of popular "flavors" during the past decade is long. One can think of income trusts in the mid-2000s, and the worldwide euphoria over natural resources (oil comes to mind) during 2006-2007 and then the gold fever of 2010-2011. As we discussed above, even the Canadian dollar is beginning to slowly return to its fair value after a trip to the stratosphere.

One economic segment that still seems flavorful in the eyes of many Canadians is residential real estate. We believe that Canadian home prices continue to be out of sync with historical valuation norms.

But if we had to choose one asset class to avoid it would be government bonds. It is hard to believe that a 10-year bond yielding less than 2% will cover the inflation to come over the next decade. This is even worse when we consider that tax is paid on interest income (inflation, despite being a real cost does not offer tax deductibility on interest received). Our view is that the only benefit to this type of asset is that its principal is guaranteed. We consider that there is another guaranty that comes with government bonds—one which is seldom discussed in advertising for such investments—a guaranty for impoverishment.

Five-year Post-mortem: 2009

Like we do every year, we go through a five-year post-mortem analysis. We believe that studying our decisions in a systematic manner, and with the benefit of hindsight, enables us to learn from both our achievements and our errors.

We experienced a stock market low of rare magnitude in March of 2009. Many believed no less that is was the end of capitalism! We did not panic and remained 100% invested in equities. We then called the stock market at the time as "The opportunity of a generation." I was interviewed in La Presse newspaper on February 14, 2009 and could not help my excitement at the many bargains available at the time (see Appendix A for a copy of this interview in French… time to dust of your French-English dictionary!) More than five years have passed since that interview and the Dow Jones Industrial Average has risen from 7,500 to 18,000 points (+136%). I also recommended in the interview two stocks: Wells Fargo at $17 (in late 2014, it was trading at $55, or +227%) and Walt Disney at $18 (in late 2014, at $94 or +422%). I also recommended avoiding gold—and the price of gold is trading at the same level as five years later.

Among new stocks from 2009, we purchased shares in Buffalo Wild Wings—a company that Jean-Philippe had enthusiastically recommended. The company operated a network of 560 sports-themed restaurants (you guessed it: their flagship product is their delicious chicken wings). Today, the number of BWW stores exceeds 1082 and the stock has soared 400% in five years. My only regret is not having bought more shares.

Errors from 2009

We didn't just pick good stocks in 2009—we also made some epic errors of omission (non-purchases). The first that comes to mind is Harley-Davidson. We owned a few shares in Harley-Davidson about ten years ago. I always found the brand to be without equal (do you know any other brands that people freely tattoo on their bodies?) I even visited the company's museum in 2008 in Milwaukee and was amazed by the solid history of the company. I thoroughly understood the strengths of this business.

We sold our few shares in 2006 after finding the stock a bit expensive. During the financial crisis, the stock tumbled from a high of $75 to less than $10 in February of 2009. Berkshire Hathaway announced that it would lend the company some capital at a 15% annual interest rate. I told myself at the time that I should buy shares in HD since I wholeheartedly believed that the company would survive the crisis and find its way back to high profitability. But I didn't act on this belief. Keith Wandell became CEO in May 2009 and has done exceptionally well in that role. The stock now trades around $70 and I have much remorse for having stayed on the sidelines.

The errors of omission for 2009 were not limited to securities that are not part of our portfolio. We had securities in our portfolio such as American Express, Carmax, Mohawk Industries and Wells Fargo, which all reached incredibly attractive valuation levels during the depths of the crisis. We knew this at the time. We could have sold shares of other holdings such as Wal-Mart, Procter & Gamble and Johnson & Johnson, all of which had better withstood the market decline, to increase our investments in our most attractively-valued stocks. To give you an idea of the additional potential that we could have realized, here is a picture of the market performance of the four companies between the trough in February 2009 and their price at the end of 2014.

	Feb. 2009	Dec. 2014	Return
American Express	$11.0	$93.0	746%
Carmax Inc.	$7.8	$65.7	742%
Mohawk Industries	$22.4	$168.3	651%
Wells-Fargo	$8.8	$54.6	519%
Average			**665%**
S&P 500	734	2059	**181%**

Our Companies

O'Reilly Automotive (ORLY, $193)

The year 2014 marked an important anniversary: we've owned O'Reilly Automotive for a decade. At the start of 2004, we studied a company that we considered well managed and highly profitable: Autozone. Our usual investment process led us to study the company's competitors which led us to O'Reilly. The latter seemed even more interesting to us than Autozone so I decided to go visit the company in Springfield, Missouri. I was highly impressed by the company's game plan, its extensive distribution network, and the company's management. We decided to invest in O'Reilly despite the fact that the company's P/E ratio was considerably higher than Autozone's.

In 2007, while the retail environment was greatly depressed in the United States, O'Reilly made the largest acquisition in its history: CSK Auto. The company expanded its retail footprint from 1830 to 3179 locations despite the general economic malaise of the time. Subsequently, O'Reilly has primarily used excess cash to aggressively buy back its own shares. We certainly enjoyed that too and over ten years, EPS grew from $1.12 to $7.34, at an annualized growth rate of 21%.

O'Reilly had another outstanding year in 2014, with revenues climbing 9%, same-store sales rising by 6%, and net income increasing by 16%. The rise in earnings per share (EPS) was also boosted by the repurchase of approximately 5% of the company's outstanding shares in 2014. EPS therefore

increased by 22%. Here is a graph of the stock for the ten years since our first purchase in August of 2004.



Source: BigCharts.com

As you can see, we were not immediately rewarded and the stock went sideways for a couple of years. But in the end, the stock followed the increase in the intrinsic value of the business. It's difficult to not be highly satisfied from this investment.

Bank of the Ozarks (OZRK, $38)

2014 was an exceptional year for Bank of the Ozarks, our bank from Little Rock, Arkansas. The company generated a 26% growth in EPS, reaching $1.52. Here are the highlights from 2014:

- The bank's efficiency ratio (a measure of its cost structure), was an impressive 45%.
- Return on Assets reached 2.01%
- The bank's balance sheet continues to strengthen with returns on equity of 13.4%.
- In March, Bank of the Ozarks completed its acquisition of OMNIBANK Bank, based in Texas.
- In May, Ozarks acquired Summit Bank, based in Arizona.
- After New York City in 2013, Ozarks opened a branch in Los Angeles in 2014.
- Deposits increased by 48% to $5.5 billion.
- Total assets grew by 41% to $6.8 billion.

Since our purchase in 2006, EPS has increased by 217%, or a 15% compounded annual return. Few banks can tout this kind of performance given the difficult economic context of the past years. We anticipate a solid increase in EPS in 2015 and we remain optimistic about the company's prospect for continued growth.

Berkshire Hathaway (BRK.B, $150)

The company led by the legendary Warren Buffett had another excellent year in 2014. It's difficult to precisely measure the growth in the company's intrinsic value for the year, but we estimate it close to the 12% mark.

The most important news of the year for us was the acquisition of Duracell. Berkshire exchanged its shares in Procter & Gamble for this solid business. This transaction seems to have been intelligently orchestrated and looks like it will bear fruit in both the short and long term. Another significant transaction was the purchase of Van Tuyl Group which is the largest privately-owned network of car dealerships in the US (and the fifth largest in the industry).

We continue to consider shares in Berkshire as undervalued by the market.

Buffalo Wild Wings (BWLD, $180)

Buffalo Wild Wings (BWW) is a sports-oriented restaurant chain which primarily serves chicken wings, as its name suggests. We have been shareholders in the BWW for five years and have been handsomely rewarded for our ownership. The number of restaurant locations reached 1082 in 2014. The company grew revenue by 20% in 2014, same-store sales rose by 6.5% (5.6% for franchised locations) and its EPS climbed by 31%.

The company anticipates opening 90 new restaurants in 2015 and looks to reach 1700 locations within a few years. We anticipate that earnings will grow at 18% for the coming year.

Cabela's (CAB, $53)

We bought shares in Cabela's in 2013. This company operates a large chain of retail stores serving the hunting, fishing and outdoor apparel market. Cabela's recently adopted a higher-performing business model which drew our attention. By significantly reducing the square footage of its retail locations, the company has been able to significantly improve its return on shareholder equity. This Nebraska-based business only has 4.3% of the market share and could double or maybe triple this number in the next decade.

Still, 2014 was a difficult year for Cabela's. Same-store sales fell by 12%, revenues were flat at $3.6 billion, and EPS decreased by 13% to $2.88. Revenue growth did improve in the fourth quarter, when sales grew by 7%. The company, however, invested heavily in advertising to stimulate growth and its profitability was affected as a result. EPS dropped by 16% for the quarter.

We believe that the company has a solid brand and that its long-term growth prospects should find its prior levels within a few quarters.

Carmax (KMX, $67)

Carmax's fiscal year ends in February. We estimate that sales and EPS will grow by 15%. While the company operates 143 stores in the US, it only has roughly 3% of the used car market. So we see lots of room for growth in this business.

We have been shareholders since 2007, when we purchased the stock for $21. The stock subsequently tumbled by 67% during the crisis (such things happen in the stock market). Yet, Carmax remained profitable during 2008 and 2009. Our patience was rewarded as the company generated earnings in 2014 that were more than three times that of 2007 (or an annualized growth of 18%). And the stock followed suit by rising in a commensurate manner to its EPS growth.

Constellation Software (CSU-T, $345)

We've owned a few software companies over the years. Historically, it was a changing and challenging industry to predict. But in recent years, as this segment of the economy has become more mature, it's become easier to find companies with stable product lines and durable sustainable competitive advantages. We discovered Constellation Software a little while ago. Founded in Toronto in 1995, the company focuses on acquiring software companies with a dominant product in its market.

We consider the CEO of Constellation, Mark Leonard, an exceptional businessman. Its business management philosophy is entirely consistent with our own. The majority of CEOs are in "selling" mode when it comes time to talk about their companies. With Mark, we feel a genuine sense of authenticity when informing us about the company and he seems like he has nothing to sell us (he would rather focus on talking about the kind of companies that he would like to acquire).

The past performance of Constellation is impressive and its long-term prospects seem excellent.

Disney (DIS, $94)

Disney had an excellent 2014, with EPS climbing 25% and the stock appreciating by 23%. "Frozen" was a phenomenal success, with an estimated $1.3 billion in revenues that was contributed to the company over the course of the year.



Source: frozen.disney.com

In 2016, Disney plans to open a theme park based on Frozen in Orlando. No, it is not too early to book your hotel now at one of Disney's!

In 2015, Disney will release a "real" version of the film Cinderella and, at the end of the year, the highly anticipated sequel to Star Wars will be released in theaters. In 2016, Disney expects a "real" version of The Jungle Book and a sequel to Finding Nemo (Finding Dory). So you can spend the money saved at the pump with several family outings at the cinema. I would be remiss not to add that Disney also makes money when you buy figurines and stuffed animals of your favorite Disney characters for your children (or for you).

Bob Iger remains in our judgment one of the best CEOs in the US. We bought shares in Disney the very day Bob Iger was named CEO in September of 2005. Since his arrival at the helm of Disney, the

company's stock has increased by 300%, or 230% more than the performance of the S&P 500 over the course of the same period.

Dollarama (DOL-T, $59)

Five years ago, we were thrilled to see one of the company's we had always admired go public: Dollarama. The reason for this admiration is simple: we think that Larry Rossy, the company's founder and CEO, is one of the best businessmen in Canada. The stock has quntupled since its IPO.

After its first three quarters of 2014 (the company's fiscal year ends on January 31st), revenues have risen by 12% and same-store sales has increased by 4.5%. EPS has climbed 26%. Dollarama now has more than 928 stores in Canada and is preparing for international expansion. December was a bit more difficult for the company due to inclement weather. Also, the depreciation of the Canadian dollar could have a slight impact on gross margins for 2015.

Fastenal (FAST, $48)

Fastenal had a good year in 2014, with revenues rising by 12% and EPS by 11%. The majority of this growth was organic, with the number of stores decreasing by 2% while the number of employees increased by 7%.

We have been shareholders in Fastenal for more than 16 years and have been handsomely rewarded. In 2014, EPS was 9.5 times higher than they were in 1998—equivalent to an annualized growth rate of 15%. We continue to admire the company's culture and management team.

Google (GOOG, $526)

Google grew its revenues by 19%, to $66 billion. The company generates an increasingly significant portion of its revenue from its mobile division which has lower margins, so EPS growth was 10% in 2014. The company also now has 56% of its revenues from outside the United States and is therefore affected by the appreciating US dollar.

We might add that we would appreciate a better capital allocation of the company's excess capital. Aside from this, Google seems to us an exceptional company.

IBM (IBM, $160)

IBM had a difficult year. Revenue decreased 6% (or 1% using a constant currency). Net income dropped by 9% and EPS was down 1%. The company repurchased approximately $14 billion of its own shares but this was not enough to offset the decrease in its operating activities. We are disappointed with these results.

IBM manages its capital brilliantly, which is the primary reason why we became shareholders in the first place. Also, the stock is trading at about 10 times expected earnings for 2015 which seems to be greatly undervalued.

We would clearly like to see some positive growth trends but are keeping our shares for now.

LKQ Corp (LKQ, $28)

We invested in LKQ in 2012. This Chicago-based company refurbishes used automotive parts. The company became the leader in its industry by offering very compelling prices relative to new parts (which pleases the insurance companies) along with an unrivaled distribution network. LKQ has diversified in Europe over the last years by making acquisitions in the United Kingdom, Belgium, France and the Netherlands.

From 2008 to 2014, revenues grew at an annualized rate of 22%, from less than $2 billion to $6.7 billion. In 2014, EPS rose by 21% compared to 2013. In 2015, we expect a lower EPS growth (about 15%) since the profitability will be affected, among other things, by the appreciation of the US dollar.

We believe that the company has excellent long-term growth prospects.

M&T Bank (MTB, $126)

M & T Bank had a difficult year in 2014 and EPS declined by 13%. Low interest rates affected the margins of this Buffalo-based bank and its interest margins decreased from 3.65% in 2013 to 3.31% in 2014. In addition, regulatory costs have risen considerably in recent years. The efficiency ratio increased to over 60%, return on asset was 1.2%, and the return on equity came in at 14%. We believe that these numbers are well below the actual earning power of M&T Bank. The merger with Hudson City Bancorp has also taken significantly more time than expected in receiving approval by regulatory bodies. Once completed, we believe that this acquisition will be beneficial for M&T.

Robert Wilmers has led M&T since 1983 and has done a phenomenal job and, despite turning 80 this year, we hope he'll remain as CEO of this Buffalo-based bank for years to come.

Markel Corporation (MKL, $683)

Markel is an insurance company specializing in various niche markets. The company also manages a private equity division that operates various operating companies and has a significant stock portfolio in public companies (similar to Berkshire Hathaway). We've known the company for several years and we admire its conservative approach to its insurance underwriting. The company's equity portfolio is managed masterfully by Tom Gayner.

We first bought shares in 2013 when Markel announced its large acquisition of Alterra Reinsurance Company. Wall Street was skeptical of the benefits of this acquisition and the stock was trading at a compelling valuation. We seized the opportunity to become shareholders.

2014 was an excellent year for Markel. Two ratios are very important to us: the combined ratio of underwriting profits at the insurance business and the growth in the book value of the company. In 2014, the combined ratio decreased from 97% to 95% (the lower the better). More importantly, the newly-acquired reinsurance division saw its combined ratio improve from 109% to 96%, in line with Markel's other insurance divisions. Book value also increased by 16% in 2014.

Mohawk Industries (MHK, $155)

When we speak of phenomenal CEOs, we would have to include Jeffrey S. Lorberbaum of Mohawk in this league. He has led this company, a leader in floor covering based in Georgia, with great skill and

agility through the residential real estate crisis of 2006-2011. The company improved its balance sheet, made good acquisitions at compelling prices, and substantially improved its cost structure.

2014 was an exceptional year, with revenues rising 6% and adjusted EPS increasing 22% to $8.43 (adjusted for amortization of intangible assets). In January 2015, Mohawk announced another major acquisition: IVC Group. Based in Belgium, IVC manufactures vinyl floors and laminates and the company should add about $700 million of revenue to Mohawk.

We had to remain patient with Mohawk but were finally rewarded. We believe that the company is as solid as ever.

MTY Food Group (MTY-T, $34)

MTY grew its revenues by 14% in 2014, to $115 million. The last quarter of the year was weaker than expected and revenues only increased by 6%. The company's adjusted EPS increased by 7% in 2014.

MTY completed numerous acquisitions in 2014. The company acquired Van Houtte, the chain of coffee shops that was owned by the American company Keurig Green Mountain. MTY now owns more than 30 brands and operates a network of more than 2727 franchised restaurants.

We have been shareholders in MTY for seven years. From 2007 to 2014, adjusted EPS increased from $0.51 to $1.60. We remain great admirers of Stanley Ma, the company's CEO, and we continue to see a bright future for the company.

Precision Castparts (PCP, $241)

Precision Castparts manufactures complex metal composite parts sold primarily to the aerospace industry. The company is a leader in this market and benefits from highly durable competitive advantages which enable it to generate net margins of 18%. This is an exceptional level for an industrial company.

EPS increased by 9% in 2014. The company expects a drop in revenue from its oil and gas customers. So we expect that 2015 will be fairly similar to 2014 as far as EPS growth—below the historical growth rate for Precision Castparts. Despite this, in our view, the company's long term growth prospects are still higher than the average company and the company trades at a discount to the average P/E ratio of the S&P 500. So we believe that the stock is undervalued.

Union Pacific (UNP, $119)

Union Pacific had an exceptional year. EPS rose by 22% versus 2013. The most important factor for shareholders of Union Pacific is the company's capacity to increase its prices. The company increased its prices by 2.5% in 2014 and its operating costs rose by 4% less than its revenues. The company's operating cost ratio decreased from 66.1% in 2013 to 63.5% which is one of the lowest in the North American railroad industry. The company also increased its dividend by 10% and bought back $3.2 billion of its own shares.

Valeant Pharmaceuticals (VRX, $143)

It was another year of solid growth for our Laval-based pharmaceutical. The company continued the acquisition strategy it started a few years ago. Its revenue stream is increasingly diversified, with its

20 most significant sources of revenue only representing 36% of its sales. The company's patent portfolio also remains strong, with only 2% of its 2015 revenue affected by generic versions of patent-protected drugs.

Valeant introduced several new products in 2014, with 20 new products in the United States alone. One example is Jublia, a drug used to combat toenail fungus (why invest in high tech companies when we can find ever-growing businesses such as those providing health care for toenails?)

What really made headlines this year was Valeant's failed attempt to acquire Allergan. The latter is a great company but the price ultimately paid by Actavis seems too high. In our opinion, the management of Valeant was wise not to bid (note: Valeant announced in February 2015 that it had acquired Salix for close to $16 billion).

Adjusted EPS was $8.34 in 2014 compared to $6.24 in 2013, an increase of 34%. 2015 promises to be as healthy, with anticipated growth in excess of 20%. Since we first bought shares in Valeant three years ago, the stock has more than tripled.

The pharmaceutical industry is not easy to predict and analyze. The key reason behind this investment is simple: we greatly admire Valeant's CEO, Michael Pearson.

Visa (V, $262)

Visa had another good year. Revenues increased by 9% and EPS by 17%. Visa has 7% more cards in circulation and the number of transactions increased by 9%. With roughly 48% of the company's revenues generated outside the United States, the appreciation of the US dollar reduced revenue growth in the first quarter 2015 from 11% to 7% (its fiscal year ends on September 30). We nevertheless expect EPS growth of 14% in 2015.

Our purchase of Visa four years ago, after a sharp decline in the stock, has proven to be very rewarding with the stock tripling since.

Wells Fargo (WFC, $55)

Wells Fargo had another good year in 2014. EPS rose 5% to $ 4.10—a record level. We believe that the adjusted EPS of Wells Fargo, taking into account the amortization of certain intangible assets, reached $4.29.

This is not an easy time for banks since the low interest rates reduces the profit margin between the rate charged to customers and the rates paid to lenders (such as what's paid on deposits). Clearly, there is a limit to the low rates that banks can pay to depositors (currently 0.09% at WFC). So the net interest margin has decreased from 3.27% in 2013 to 3.04% in 2014. This ratio, while low, is still higher than many WFC competitors like Bank of America (2.18%) and JP Morgan Chase (2.14%).

The adjusted return on asset was 1.45% and return on equity of 13.4%. We believe that the company has the ability to generate significantly more profit in a more "normal" interest rate environment.

The Podium of Errors

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2014 (or from past years). It is with a constructive attitude, in order to always improve as investors, that we provide this detailed analysis.

As is often the case with stocks, errors from omission (non-purchases) are often more costly than errors from commission (purchases)… even if we don't see those on our statements.

Bronze Medal: Tim Hortons

Last summer, I was interviewed on television (on Canal Argent which is the Quebec's equivalent to CNBC). I discussed the three primary players in the donut industry: Dunkin Brands, Tim Hortons and Krispy Kreme. I explained that it was an industry that I understood very well (being a loyal consumer of all three) and that all three players seemed in excellent financial health. The interviewer then pointed out the large number of calories contained in a donut, to which I replied tit for tat "Yes, but there are no calories in the hole!" I then added that I thought that best stock out of the three was Tim Hortons.

I have always followed the Tim story. In 1995, Tim was acquired by Wendy's and, in 2006, was separated from Wendy's and became a public company. I was finally able to buy a few shares and begin following it more closely. I then repeatedly expressed my opinion that Tim was the strongest business in Canada. However, with the high number of restaurants already present in Canada (in the 3000s), I could not see how the company could continue its high growth rate in the future. Also, true to my bad habits, I hoped that the company's stock traded at a lower P/E ratio. So I never actually invested a significant portion of our portfolio in the business, even after highly recommended it on television this summer.

Then a few weeks after this interview, Burger King announced its intent to acquire Tim Hortons for $11 billion; on top of it, with Berkshire Hathaway's financial assistance! We could have made a gain of 270% over 8 years or 60% in a few weeks this summer if I had been able to convert my own advice (and culinary tastes) into a meaningful investment.

Silver Medal: Signet Group

In 2007, a fellow money manager from Los Angeles named Eric Ende introduced me to a British company that operates a jewelry retail chain in the UK and the US. Before its merger with Zales, Signet operated two retail chains in the United States (Kay and Jared) and two in the UK. Like the entire retail sector, the stock fell sharply in 2007-2008. From a high of $50 in 2007, the stock fell to $20 by the end of the year. Since the company's business model is less focused on the high end jewelry market (such as Tiffany for example), the company seemed fairly resilient to recession. So I studied the company in detail.

Signet generated EPS of $3.08 in 2007 and, by the end of 2008, EPS had slipped to $1.57. I suspected that 2008-09 would be difficult. But I told myself at the end of 2007 that, if the company increased its profits by 50% during the next cycle, that this would result in a potential EPS of over $4.50. So with a P/E ratio of 15x, this would result in a stock price of $67 within 5 or 6 years. So Signet's stock seemed attractive to me when it was trading at $20. I might add that the stock has even fallen below $10 in late 2008 (it's not because a stock is highly undervalued it cannot continue to decline in the short term).

Ultimately, profitability returned to its pre-recession level and then some. The company recently acquired its largest competitor in the United States and greatly increased its competitive advantage in the marketplace. EPS reached $5.60 in 2014 and analysts expect $6.72 for 2015. The stock reached $130 at the end of the year. So we could have made a gain of more than 500% in seven years.

And, believe it or not, this is only the silver medal...

Gold Medal: Hanesbrands

I read Peter Lynch's "One Up On Wall Street" in 1992. In this book, the author talks about L'eggs—the famous pantyhose which was first marketed in 1969 by Hanes, a subsidiary of Sara Lee. Mr. Lynch explained in great detail how the product was a great success. This had not fallen on deaf ears and I have been interested in Sara Lee ever since.

Hanesbrands became a public company in 2006 and I started to follow the company even more closely. Hanes' brands are exceptional: in addition to L'eggs, it owns Champion, Bali, Just My Size and Wonderbra.

On the Financial front, the company had unfortunately inherited a fair amount of debt ($2.5 billion)—a level that seemed high relative to its profit at the time. All companies with high levels of debt fell sharply during the financial crisis of 2008-2009 and Hanes was no exception. Hanes declined from a high of $37 in 2008 to $5 in 2009. The company seemed too risky for us at the time.

It's only in 2011 that I seriously considered becoming a shareholder. Hanes had regained its pre-recession profitability level and the company generated EPS of $ 2.69 (compared to $2.09 in 2008). The balance sheet was also greatly improved, with its level of debt having been greatly reduced to $1.8 billion which was approximately six times the level of net profits. Strangely, the stock was trading for only $22 at the end of 2011—about eight times earnings. In three years, EPS had climbed by nearly 30% and the stock was trading for 40% less than in early 2008.

It is rare to find companies with such strong consumer brands trading at such valuation ratios. It is true that many of our stocks were also undervalued at the end of 2011 and it was hard to choose what to sell to buy Hanes. But we should have been more proactive and done it.

Hanes made a significant acquisition at the end of 2013 when it acquired Maidenform. The company has also greatly increased its revenue and operating margins. Since 2011, EPS has more than doubled at Hanes, to $5.66, and analysts expect $6.44 for 2015.

During these three years, shares in Hanes have increased from $22 to $111. Quintupling your money in three years is not a common thing (in case you're wondering, that's an annualized return of 72%). But I remained on the sidelines and watched the Hanes parade go by, waving a flag instead of filling our pockets!

Conclusion: The Greatest Error of Stock Investors (Part 3)

For the over 21 years I've invested in the stock market, the question that comes up most often is always the same: "Is this the right time to invest in stocks?"

To answer this, let us return to a topic we discussed in previous annual letters. In the 2003 letter, I presented an article by André Gosselin on the results of investors versus the performance of the S&P

500. Mr. Gosselin was inspired by the results of the research firm Dalbar on the behavior of stock market investors. Each year, the firm publishes a fascinating research report on the results of all US investors invested in mutual funds compared to the indices. We have also written on the subject in the 2006 letter (our worst year in terms of relative returns).

In 2014, Dalbar released its 20th report QAIB (Quantitative Analysis of Investor Behavior) and the results for the two decades are very instructive. From 1994 to 2013, the average return of investors in equity funds was 5.02% compared to 9.22% for the S&P 500. Over 20 years, the total return to investors was 166% versus 484% for the S&P 500. This is an astronomical difference. And this shortfall is what might be called a "behavioral penalty."

This loss in annual gains of 4.2% cannot be explained by management fees and transaction costs. The only plausible explanation is that investors, as a whole, buy and sell their fund shares at the wrong time. Like weathervanes, they alternate between two emotions: desire for better returns in bull markets and the fear of losing their savings in bear markets. Their oscillation between these two emotional poles becomes the source of their own underperformance.

This self-destructive behavior is reflected in the average holding period of equity mutual funds in the United States: 3.33 years. This is the equivalent of a third of an economic cycle. We have made many times our money with O'Reilly Automotive over 10 years (see above). But after the initial four years of owning O'Reilly, we had not yet made a profit. Just a few years is not a long time in the world of business and investment.

You might be tempted to believe that investors in bond funds are more rational. Think again! Dalbar shows us otherwise. Over 20 years, the bond fund holder has obtained an average yield of 0.71% compared to 5.74% for the Barclays Index. And the average holding period of such funds was 3.05 years.

The returns of investors in Exchange Traded Funds (ETF) are not studied by Dalbar. Index funds have a very high turnover rate (the SPDR S&P 500 ETF would have an average turnover rate of 8,000%). So it's likely that the same behavioral penalty that diminishes the returns of mutual fund investors also diminishes the returns of index fund investors.

The only solution for the investor who wants to avoid falling into the trap of this behavioral penalty is not to try to predict the stock market. Indeed, the first ingredient for success in the stock market is to be invested in it. So the answer to the original question of whether this is a good time to invest in stocks is simple: it is a long-term winning strategy to always be invested in the stock market. The worst thing to do is to constantly be asking yourself this question since it can lead to behaviors that are destructive to wealth.

Postscript

There is good news even though we've highlighted the self-destructive behaviors of many investors. Just as there is a majority of investors, professional and amateur, who penalize their returns by their behaviors, there is also a minority of investors who have the opposite attitude. Those, like us, who have decided to view stocks as ownership in real businesses within the context of a long-term investment horizon rather than chips in an enormous global casino have a considerably greater chance of success.

Warren Buffett wrote this important phrase a few years ago: "The stock market is a system that transfers money from the active to the patient." You certainly know that we wish to remain in the second category. In fact, we love it when other investors sell us shares in companies we admire at good prices simply because of their lack of patience (or their attempts to take advantage of market highs and lows). The irrationality of the majority of investors turns out to be an ally for us.

They provide us with the right assets at the right prices and we provide the patience.

To Our Partners

Using rationality, along with our unwavering optimism, we trust that the companies we own are exceptional, led by top-notch people, and destined for a great future. They should continue to prudently navigate the often troubled waters of the global economy. Furthermore, the valuation assigned by the market to these outstanding companies is very similar to the valuation of an average company in the S&P 500, despite the fact that our companies have better growth prospects than average. Therefore we consider the appreciation potential for our portfolio, both in absolute and relative terms, to be well above average, especially when compared to other alternative asset classes, such as bonds.

We also want you to know that we are fully aware of and grateful for your votes of confidence. It is imperative for us to not only select outstanding companies for our portfolios, but to also remain outstanding stewards of your capital. We certainly like to achieve good returns (and have developed a taste for it), but it must not come at the cost of taking undue risk. Our philosophy to favor companies with solid balance sheets and dominant business models, along with purchasing these companies at reasonable valuations, is central to the risk management of our portfolios.

Thank you from the entire Giverny Capital team.

We wish a great 2015 to all our partners.



François Rochon and the Giverny Capital team

APPENDIX A

Interview in La Presse from February 14, 2009

SUR LE RADAR

Chaque samedi, un financier différent répond à nos questions. Il donne sa lecture des marchés, offre son point de vue sur la Bourse et lance quelques conseils d'investissement. Cette semaine, François Rochon, de Giverny Capital.

La plus belle occasion de s'enrichir d'une génération

STÉPHANIE GRAMMOND

Q : À votre avis, quel est l'événement le plus significatif de la semaine en Bourse?

Ce qui m'a frappé, ce sont les statistiques sur la balance commerciale (la différence entre les exportations et les importations). D'une part, le Canada a affiché un premier déficit en plus de 30 ans, ce qui est un peu inquiétant pour notre économie dont la croissance dépend beaucoup des exportations. Et d'autre part, le déficit des États-Unis était en forte baisse, ce qui est un bon signe car c'était un de leurs problèmes majeurs. Ce sont de gros changements de tendance par rapport aux cinq dernières années.

Q : Que surveillez-vous le plus attentivement en ce moment?

Notre critère numéro 1, c'est la qualité du bilan. Et c'est encore plus vrai ces temps-ci, car il y a des entreprises dont les profits baissent, d'autres qui deviennent déficitaires. Si elles n'ont pas un beau bilan, elles ne passeront pas à travers la récession.

Q : Que feriez-vous avec 10 000 $ à investir?

Je regarderais les banques aux États-Unis. Leurs titres sont extraordinairement déprimés. Certaines vont disparaître, mais celles qui vont s'en sortir vont ramasser tout le marché.

Par exemple, des actions de Wells Fargo constituent un excellent placement. C'est une banque solide, dont le titre est très bon marché. Dans le prochain cycle, elle dégagera environ 4 $US de bénéfices par action et son titre se situe autour de 17 $. Il peut facilement quadrupler.

Par contre, il est un peu tôt pour regarder du côté des banques canadiennes. Certains de leurs éléments d'actifs, de leurs prêts à risque, n'ont pas encore été dépréciés. Il y a un décalage par rapport aux États-Unis. Et au Canada, la correction du prix des maisons ne fait que commencer.

Par ailleurs, j'achèterais certainement du Walt Disney. C'est une des meilleures entreprises au monde et on peut l'acheter au tiers de sa valeur intrinsèque ces jours-ci.

Q : Quel placement évitez-vous à tout prix?

Si j'avais une chose à éviter, ce serait les titres aurifères et l'or en tant que tel. Il y a un engouement pour ça. Mais la mode risque de passer.

Et j'éviterais aussi comme la peste les obligations: les bons du Trésor de toutes les échéances, surtout celles de plus de cinq ans. Les gens ne le réalisent pas, mais les obligations donnent une garantie d'appauvrissement, en considérant l'inflation et l'impôt. Je trouve ça ridicule.

Moi, j'ai une approche assez différente. Je me dis qu'en ce moment, les investisseurs ont le choix entre les obligations qui rapportent 2 % ou les actions qui vont faire au moins 15 % par année, d'ici cinq ans. C'est le temps d'être à 100 % en actions.

Q : Que lisez-vous en ce moment?

Je suis en train de relire *L'investisseurs intelligent*, de Benjamin Graham.

C'est fascinant de voir à quel point ce qu'il a écrit en 1949 est encore vrai aujourd'hui. Le comportement des investisseurs reste le même. Dans les périodes d'euphorie, les gens achètent des actions à n'importe prix, dont ils sont prêts à se débarrasser à n'importe prix durant les périodes de crise.

On pense que la crise actuelle, c'est du jamais vu. Ben non! La nature humaine ne change pas. En lisant un livre qui a été écrit il y a 60 ans, ça aide à voir plus clair.

Q : Comment entrevoyez-vous l'avenir sur les marchés?

Il ne faut pas avoir peur des mots: c'est l'occasion d'une génération pour investir en Bourse. Il y en a eu une belle en 1974. Une autre dans les années 40. Chaque fois que les investisseurs ont eu le courage d'acheter, alors que l'évaluation des actions étaient tombée aux niveaux actuels, ils ont une eu occasion d'enrichissement extraordinaire.

FRANÇOIS ROCHON

Président de Giverny Capital qu'il a fondé en 1998. La société gère des actifs de 80 millions de dollars, pour le compte de clients fortunés, selon une approche qui repose sur la sélection de titres de qualité pour un horizon de long terme.



PHOTO MARTIN TREMBLAY, ARCHIVE LA PRESSE

APPENDIX B

Investment philosophy

Note: This section is repeated from prior annual letters and is aimed at new partners.

In 2014, we saw a large increase in the number of Giverny Capital partners (the term we use for our clients). With all these newcomers, it is imperative that we write again (and again) about our investment philosophy.

Here are the key points:

- We believe that over the long run, stocks are the best class of investments.
- It is futile to predict when it will be the best time to begin buying (or selling) stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity).
- We choose companies that have high (and sustainable) margins and high returns on equity, good long term prospects and are managed by brilliant, honest, dedicated and altruistic people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be approximately assessed.
- The stock market is dominated by participants that perceive stocks as casino chips. With that knowledge, we can then sometimes buy great businesses well below their intrinsic values.
- There can be quite some time before the market recognizes the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

Experience and common sense teach us that an investment philosophy based on buying shares in companies that are undervalued, and holding these companies for several years, will not generate linear returns. Some years, our portfolio will have a return that is below average. This is a certainty that we must accept.

Another important point: the significant volatility of the market is often perceived negatively by many investors. It's actually the contrary. When we see stock prices as *"what other people believe the company is worth"* rather than the real value (at least in the short term), these fluctuations become our allies in our noble quest for creating wealth. Instead of fearing them, we can profit from them by acquiring superb businesses at attractive prices. The more that markets (the "other" participants) are irrational, the more likely we are to reach our ambitious performance objectives.

Benjamin Graham liked to say that the irrationality of the market provides an extraordinary advantage to the intelligent investor. The person, however, who becomes affected by short-term market fluctuations (less than 5 years) and who makes decisions based on them transforms this advantage into a disadvantage. His or her own perception of stock quotes becomes their own worst enemy. Our approach at Giverny Capital is to judge the quality of an investment over a long period of time.

So patience – ours AND that of our partners – becomes the keystone for success.

APPENDIX C

Notes on the returns of the Rochon portfolios

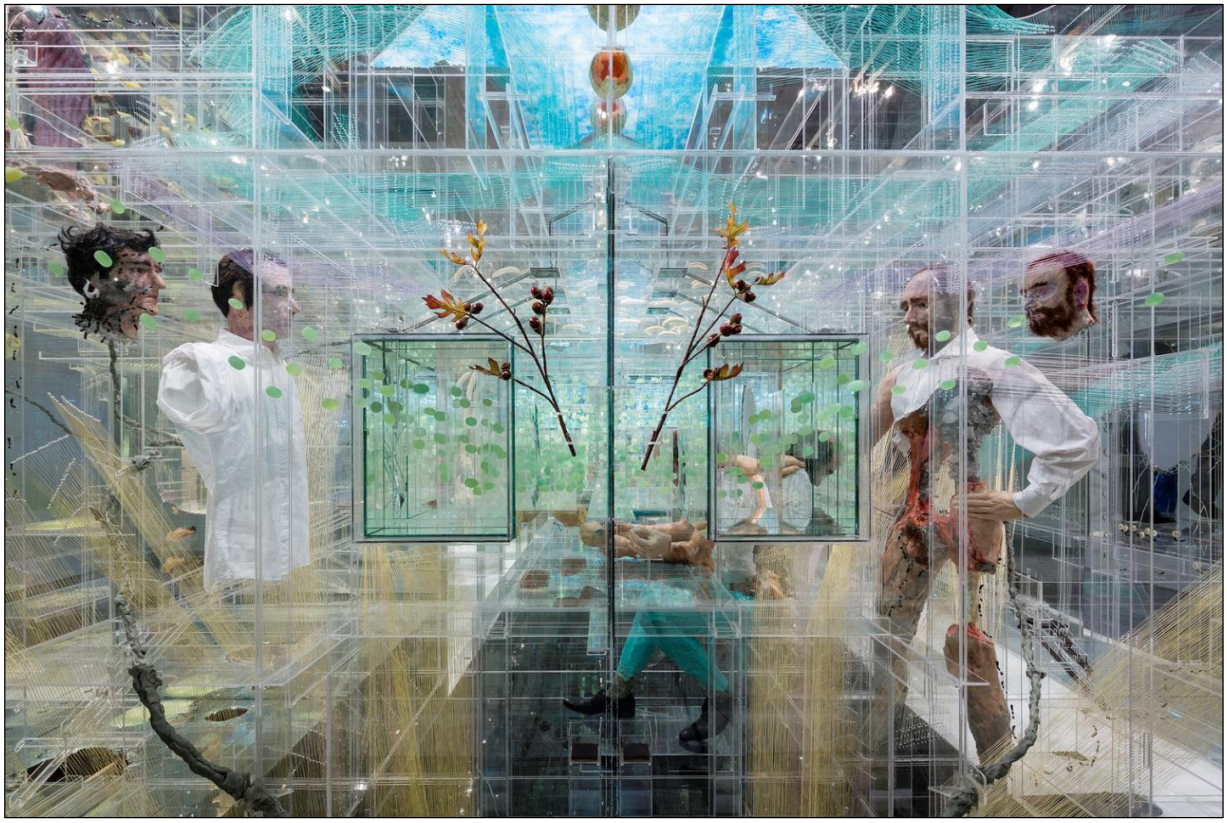
- The Rochon portfolio is a private family group of accounts managed by François Rochon since 1993. The returns of the period from 1993 to 1999 were realized before registration of Giverny Capital Inc. at the AMF in June of 2000.
- The Rochon Global portfolio serves as a model for Giverny Capital's clients, but returns from one client to the other can vary depending on a multitude of factors. The returns indicated include trading commissions, dividends (including foreign withholding income taxes) and other income but do not include management fees. Portfolio returns of the Rochon Global portfolio have been generated in a different environment than Giverny Capital's clients and this environment is considered controlled. For example, cash deposits and withdrawals can increase the returns of the Rochon Global portfolio. Thus, the portfolio returns of the Rochon Global portfolio are often higher than the returns realized by clients of Giverny Capital.
- Past results do not guarantee future results.
- The Rochon Canada and Rochon US portfolios are parts of the Rochon Global portfolio.
- The index benchmark group is selected at the beginning of the year and tends to be a good reflection of the asset composition of the portfolio. Weighted indices presented may not be representative of the Rochon Global portfolio. In 2014 :

    - Giverny Global Portfolio: TSX 16% Russell 2000 42% S&P 500 42%
    - Giverny US Portfolio : S&P 500 100%
    - Giverny Canada Portfolio : S&P/TSX 100%

- The returns for the S&P 500 (in $USD) are provided by Standard & Poors.
- The returns for the various indices used for comparable purposes are deemed reliable by Giverny Capital.
- It should be noted that currency effects on the returns of the Rochon portfolio and indices are estimated to our best effort.
- The custodian of our client portfolios is National Bank Correspondent Network (NBCN) in Canada and TD Ameritrade Institutional in the US.
- The financial statements of the three portfolios are audited at the end of each year. The auditor's data are those provided by our custodian (NBCN). The auditor's annual reports are available upon request.
- For more information, please see the "returns" section of our website.

GIVERNY CAPITAL

Annual Letter to our Partners 2015



David Altmejd
The Flux and the Puddle (detail), 2014
Giverny Capital Collection
On Loan to the Musée National des Beaux-Arts du Québec

Historical Summary

It has been more than two decades since I discovered the writings of Warren Buffett, Benjamin Graham, John Templeton, Philip Fisher and Peter Lynch. I then decided to begin managing a family portfolio based on an investment approach synthesized from these great money managers. By the end of 1998, after five years of satisfactory results, I decided to launch an investment management firm offering asset management services aligned with my own investment philosophy. Giverny Capital Inc. came into existence.

In 2002, Giverny hired its first employee: Jean-Philippe Bouchard (JP for those who know him well). A few years later, JP became a partner and participates actively in the investment selection process for the Giverny portfolio. In 2005, two new persons joined the firm who eventually became partners: Nicolas L'Écuyer and Karine Primeau. Finally, in 2009, we launched a US office in Princeton, New Jersey. The director of our Princeton office, Patrick Léger, shares in the culture and long-term time horizon inherent to Giverny.

We are Partners!

From the very first days of Giverny, the cornerstone of our portfolio management philosophy was to manage client portfolios in the same way that I was managing my own money. Thus, the family portfolio I've managed since 1993 (the "Rochon Global Portfolio") serves as a model for our client accounts. It is crucial to me that clients of Giverny and its portfolio managers are in the same boat! That is why we call our clients "partners".

The Purpose of our Annual Letter

The primary objective of this annual letter is to discuss the results of our portfolio companies over the course of the prior year. But even more importantly, our goal is to explain in detail the long-term investment philosophy behind the selection process for the companies in our portfolio. Our wish is for our partners to fully understand the nature of our investment process since long-term portfolio returns are the fruits of this philosophy. Over the short term, the stock market is irrational and unpredictable (though some may think otherwise). Over the long term, however, the market adequately reflects the intrinsic value of companies. If the stock selection process is sound and rational, investment returns will eventually follow. Through this letter, we give you the information required to understand this process. You will hopefully notice that we are transparent and comprehensive in our discussion. The reason for this is very simple: we treat you the way we would want to be treated if our roles were reversed.

The Artwork on Our 2015 Letter

Since 2004, we have illustrated the cover of our letters with a copy of artwork from our corporate collection. This year we selected a detail of a sculptural installation by the Quebec artist David Altmejd entitled "The Flux and the Puddle". After a summer at the Musée d'art contemporain de Montréal, this work by Mr. Altmejd was exhibited at the Louisiana Museum in Denmark last Fall and will be on exhibit for the next 10 years at the Musée National des Beaux-Arts du Québec beginning on June 24, 2016.

For the year ending December 31st 2015, the return for the Rochon Global Portfolio was 20.2% versus 13.4% for our benchmark, which represents an outperformance of 6.8%. The return of the Rochon Global Portfolio and the one of our benchmark include a gain of approximately 16.3% due to fluctuations in the Canadian currency.

Since its inception on July 1st 1993, the compounded annual return of the Global Rochon Portoflio has been 16.3% versus 9.0% for our weighted benchmark, representing an annualized outperformance of 7.3% over this period. Our ambitious long-term objective is to maintain an annual return that is 5% higher than our benchmark.

The Rochon Global Portfolio: Returns since July 1st 1993

Return *	Rochon	Index **	+ / -	$ US/Can ***
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	3.3%
1994	**16.5%**	3.7%	**12.7%**	6.0%
1995	**41.2%**	24.0%	**17.2%**	-2.7%
1996	**28.0%**	22.8%	**5.2%**	0.3%
1997	**37.8%**	28.6%	**9.2%**	4.3%
1998	**20.6%**	18.8%	**1.8%**	7.1%
1999	**15.1%**	16.3%	**-1.2%**	-5.7%
2000	**13.4%**	3.2%	**10.2%**	3.9%
2001	**15.1%**	-0.4%	**15.5%**	6.2%
2002	**-2.8%**	-18.3%	**15.6%**	-0.8%
2003	**13.6%**	14.0%	**-0.4%**	-17.7%
2004	**1.6%**	6.2%	**-4.5%**	-7.3%
2005	**11.5%**	3.6%	**7.9%**	-3.3%
2006	**3.5%**	17.0%	**-13.5%**	0.2%
2007	**-14.4%**	-11.6%	**-2.8%**	-14.9%
2008	**-5.5%**	-22.0%	**16.5%**	22.9%
2009	**11.8%**	12.2%	**-0.4%**	-13.7%
2010	**16.1%**	13.8%	**2.3%**	-5.3%
2011	**7.6%**	-1.1%	**8.7%**	2.2%
2012	**21.2%**	12.5%	**8.7%**	-2.2%
2013	**50.2%**	38.9%	**11.3%**	6.9%
2014	**28.1%**	17.8%	**10.2%**	9.1%
2015	**20.2%**	13.4%	**6.8%**	19.3%
Total	**2864.3%**	**588.1%**	**2276.2%**	**8.0%**
Annualized	**16.3%**	**9.0%**	**7.3%**	**0.3%**

* All returns are adjusted to Canadian dollars
** Index is a hybrid index (S&P/TSX, S&P 500, MSCI EAFE, Russell 2000) which reflects the weight of the underlying assets
*** Variation of the US dollar compared to the Canadian dollar

Note: Refer to Appendix B for disclosure statements on the Rochon portfolios and their corresponding indices.

The Rochon US Portfolio

We have been publishing the returns of the Rochon US Portfolio, which is entirely denominated in US dollars, since 2003. The Rochon US Portfolio corresponds to the American portion of the Rochon Global Portfolio. In 2015, it realized a return of 1.7% compared to 1.4% for our benchmark, the S&P 500. The Rochon US Portfolio therefore outperformed our benchmark by 0.4%

Since its inception in 1993, the Rochon US Portfolio has returned 2294%, or 15.2% on an annualized basis. During this same period, the S&P 500 has returned 606%, or 9.1% on an annualized basis. Our added value has therefore been 6.1% annually.

Year	Rochon US	S&P 500	+/-
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	37.6%	17.2%
1996	27.0%	23.0%	4.1%
1997	32.9%	33.4%	-0.4%
1998	11.0%	28.6%	-17.6%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-9.1%	20.4%
2001	8.1%	-11.9%	20.0%
2002	-4.4%	-22.1%	17.7%
2003	31.6%	28.7%	2.9%
2004	9.3%	10.9%	-1.6%
2005	12.5%	4.9%	7.5%
2006	3.3%	15.8%	-12.4%
2007	-1.7%	5.5%	-7.2%
2008	-24.3%	-37.0%	12.7%
2009	28.7%	26.5%	2.3%
2010	21.9%	15.1%	6.9%
2011	4.7%	2.1%	2.6%
2012	22.3%	16.0%	6.3%
2013	40.6%	32.4%	8.2%
2014	18.0%	13.7%	4.3%
2015	1.7%	1.4%	0.4%
Total	2293.6%	606.2%	1687.4%
Annualized	15.2%	9.1%	6.1%

Note: Please refer to Appendix B for disclosure statements on the Rochon portfolios and their corresponding indices.

We outperformed the S&P 500 for an eighth consecutive year (just barely). Our objective is to outperform the S&P 500 over the long term.

You will notice that over the 22 years of its track record, our US portfolio has underperformed the S&P 500 on six occasions (or 27% of the time). This is in line with our "Rule of Three" which stipulates that we accept to underperform the index one year out of three on average. This average, if we can maintain it, would be far superior to the overall performance of portfolio managers. It is a difficult task to maintain outperforming the S&P 500 but it is our mission.

We must accept the fact that we will sometimes underperform the index over the short term when our investment style or specific companies are out of favor with mainstream thinking. And we try to welcome rewarding periods of portfolio outperformance with humility.

While it is not always easy, we try to remain impervious to short term results, both good and bad.

Rochon Canada Portfolio

We introduced a portfolio that is 100% focused on Canadian equities in 2007. This corresponds roughly to the Canadian portion of the Rochon Global Portfolio. In 2014, the Rochon Canada Portfolio returned 16.0% versus -8.3% for the S&P/TSX, therefore outperforming the index by 24.3%.

Since 2007, the Rochon Canada Portfolio has returned 331%, or 17.6% on an annualized basis. During this same period, our Canadian benchmark had a gain of 31%, or 3.0% on an annualized basis. Our annual added value is therefore 14.6%.

Year	Rochon Canada	S&P/TSX	+/-
2007	19.7%	9.8%	9.9%
2008	-24.6%	-32.9%	8.3%
2009	28.2%	33.1%	-4.9%
2010	26.7%	17.6%	9.1%
2011	13.5%	-8.7%	22.2%
2012	24.0%	7.2%	16.8%
2013	49.4%	13.0%	36.4%
2014	20.3%	10.6%	9.7%
2015	16.0%	-8.3%	24.3%
Total	330.5%	31.0%	299.4%
Annualized	17.6%	3.0%	14.6%

Note: Please refer to Appendix B for disclosure statements on the Rochon portfolios and their corresponding indices.

Our main Canadian holdings performed very well in 2015 and the all-star in our portfolio was Constellation Software which rose 67%. Dollarama also performed well, rising 35%. Of course, the stock dominating the headlines in Canada in 2015 was Valeant Pharmaceuticals (the stock decreased by 15%). We'll come back to that story later on.

For eight out of the last nine years, the Rochon Canada Portfolio outperformed the TSX. It is also worth repeating that our Canadian portfolio is highly concentrated and has little correlation to the TSX. So the relative performance, whether positive or negative, will therefore often be high.

2015

2015 was a difficult year for investors in the stock market. The dramatic drop in oil prices weakened the economy of many countries from East to West. In fact, nearly all industries linked to natural resources experienced a disastrous year. Consequently, many companies with revenue streams tied to these industries also had a portion of their revenue affected.

Additionally, the strength of the US dollar also had a negative effect on the profitability of many US companies doing business abroad. The combination of these factors created a stagnation in profits for

the companies in the S&P 500—a trend which was ultimately reflected in the market indices (with the Russell 2000 small cap Index suffering a little more, with a decline of 8%).

The situation was worse in Canada. The S&P/TSX declined from a high of 15,625 in 2014 to end 2015 at 13,010. The Canadian market is roughly at the same level it was back in 2007.

2015 was a good year for us. Our companies increased their intrinsic values by approximately 11% (dividend included) which is well above the average rate of earnings growth. And our stocks rose approximately 4% which is also above average. Since this modest absolute performance was still better than our benchmark, we are satisfied with our results.

The recent modest market performance of our companies only means that they have become more undervalued than they were at the same time last year.

Tender Offer for Precision Castparts

It is with mixed emotions that we welcomed the acquisition of Precision Castparts (PCP) by Berkshire Hathaway. As shareholders in Berkshire, we believe that this represents the acquisition of an extraordinary business for a very reasonable price. It's difficult for Berkshire to grow the immense level of capital it manages, and PCP provides both a sizeable capital base as well as a company with significant competitive advantages. The company's growth potential over the long term strikes us as vastly superior to the average and, in our opinion, the company should become a significant division within Berkshire.

As shareholders in PCP, we found ourselves in the difficult position of having to replace a company of rare quality. We resolved the problem pragmatically, by buying more shares in companies already in our portfolio… including Berkshire.

Effect of the Canadian Currency

It should be highlighted that the steep decline in the value of the Canadian dollar contributed significantly to the excellent appreciation of our portfolio in 2015. Our view is that the Canadian dollar has returned to a level that is more in line with its fair value, so we don't anticipate much as far as currency gains in the years to come. This does not mean that a Canadian investor should avoid US companies. It simply means that we don't have the opportunity to buy US companies at an additional discount such as the one that was offered to us in the recent past.

With more than 22 years of historical perspective, we can highlight the fact that the Rochon Global portfolio returned 16.3% on an annualized basis and that the decline in the Canadian currency contributed to only 0.3% of this return. The Loonie has experienced wild fluctuations throughout the years, but ultimately has had a negligible impact on our returns over the long term.

Portfolio Turnover

Our portfolio turnover was less than 10% in 2015 and we estimate that our average turnover during the last several years has been around 15%. In other words, we keep our stocks for 6 to 7 years on average. This compares to an average holding period of 6 months for the average investor (professional or not). So we keep our shares something like 12 times longer than the average investor. Our long holding period is also consistent with our investment philosophy: to generate exceptional returns over the long term, you must own exceptional companies over the long term.

We can ascertain two facts if we look at the 15 most significant holdings in our portfolio. The first is that these holdings represent about 80% of the value of our portfolio. We therefore have a concentrated investment approach. Second, we can see the average holding period for these stocks exceeds 7 years. Here are the details:

Company	Since	Years
Berkshire Hathaway B	2000	15
Bank of the Ozarks	2006	9
Disney (Walt) Co.	2005	10
Carmax Inc.	2007	8
LKQ Corp.	2012	3
Wells-Fargo	2005	10
Visa Inc.	2010	5
M&T Bank	2009	6
O'Reilly Automotive	2004	11
MTY Food Group	2007	8
Markel Corp	2013	2
Dollarama Inc.	2010	5
Ametek Inc.	2015	0
Union-Pacific	2012	3
Constellation Software	2014	1
Top 15 (average)		7

The Keystone of our Philosophy

We believe that exceptional returns can only be obtained by owning assets that intrinsically generate exceptional returns. There are all sorts of assets that an investor can own. In our opinion, the best assets to own are productive assets—ones that are a source of continuous wealth creation. We've learned throughout the years that a company with a durable competitive advantage is an asset that falls in this category.

The basis of our investment approach is that we consider stocks as fractional ownership in real businesses. While this may seem perfectly obvious, the majority of market participants do not approach stocks in this manner (whether consciously or not) and the emphasis is placed almost exclusively on short-term stock quotes. From our perspective, we prefer to remain impervious to stock quotes and favor an analysis based on the intrinsic performance of our companies.

Owner's Earnings

At Giverny Capital, we do not evaluate the quality of an investment by the short-term fluctuations in its stock price. Our wiring is such that we consider ourselves owners of the companies in which we invest. Consequently, we study the growth in earnings of our companies and their long-term outlook.

Since 1996, we have presented a chart depicting the growth in the intrinsic value of our companies using a measurement developed by Warren Buffett: "owner's earnings". We arrive at our estimate of the

increase in intrinsic value of our companies by adding the growth in earnings per share (EPS) of our entire group of companies and the average dividend yield of the portfolio. We believe that this analysis is not exactly precise but approximately correct. In the non-scientific world of the stock market, we believe in the old saying: "It is better to be roughly right than precisely wrong."

This year, the intrinsic value of our companies, as a whole, rose by 11% (10% from the growth in earnings per share and 1% from the average dividend). Despite some of the changes to our portfolio during the year, we consider this estimate to adequately reflect its underlying economic reality.

The market performance of our portfolio was a gain of roughly 4% (including dividends and estimated without currency effects).

	Rochon Global Portfolio			S&P 500		
Year ***	Value *	Market **	Difference	Value *	Market **	Difference
1996	14%	29%	15%	13%	23%	10%
1997	17%	35%	18%	11%	33%	22%
1998	11%	12%	1%	-1%	29%	30%
1999	16%	12%	-4%	17%	21%	4%
2000	19%	10%	-9%	9%	-9%	-18%
2001	-9%	10%	19%	-18%	-12%	6%
2002	19%	-2%	-21%	11%	-22%	-33%
2003	31%	34%	3%	15%	29%	14%
2004	21%	8%	-12%	21%	11%	-10%
2005	14%	15%	0%	13%	5%	-8%
2006	14%	3%	-11%	15%	16%	1%
2007	10%	0%	-10%	-4%	5%	9%
2008	-3%	-22%	-19%	-30%	-37%	-7%
2009	0%	28%	28%	3%	26%	23%
2010	22%	22%	0%	45%	15%	-30%
2011	17%	6%	-11%	17%	2%	-15%
2012	19%	23%	4%	7%	16%	9%
2013	16%	42%	26%	9%	32%	23%
2014	13%	19%	6%	9%	14%	5%
2015	11%	4%	-7%	1%	1%	0%
Total	1102%	1141%	39%	297%	380%	84%
Annualized	13.2%	13.4%	0.2%	7.1%	8.2%	1.0%

* Estimated growth in earnings plus dividend yield
** Market performance, dividend included (please refer to Appendix B for disclosure statements on the Rochon portfolios)
*** All results estimated without currency effects

20 Years of Owner's Earnings

We have presented this chart for 20 years now. As it demonstrates, market performance and company performance are rarely in sync over the course of a single year. In fact, the aggregate stock price for our portfolio has only been within 1% of the change in aggregate (estimated) intrinsic value for any given year for only 3 years out of 20. But as more time passes, the synchronization between the two inevitably begins to reveal itself.

Significant and educational conclusions can be drawn from a 20-year period. Since 1996, our companies have increased their intrinsic value by 1102%, or close to a twelvefold increase. Meanwhile, the value of their stocks has increased 1141% (net of estimated currency effects). On an annualized basis, our

companies increased their intrinsic value by 13.2% and our stock portfolio returned 13.4% per year. The similarity between those two numbers is not a coincidence.

During this same period, the companies comprising the S&P 500 increased their aggregated intrinsic value by 297% and saw their stock prices rise by 380% (dividend included), or 7.1% and 8.2% annually, respectively.

We could split this 20-year period into two distinct decades. The first from 1996 to 2005, and the second from 2006 to 2015. We can see in the chart below that the performance of our stocks during the second period was inferior than that of the first period, in regards to their stock performance as well as the S&P 500. In our opinion, this reflects that corporate profits were slightly higher than their true long-term earning power during 2005-2006 (probably due to higher than normal profits generated from residential real estate). On the other hand, we believe that corporate profits in 2015 were slightly below their long-term earning potential. This combination led to the second decade having slightly lower profits growth than the historical average.

	Rochon Global Portfolio			S&P 500		
Période ***	**Value ***	**Market ****	**+/-**	**Value ***	**Market ****	**+/-**
1996-2005	**14.9%**	**15.7%**	**0.8%**	**8.5%**	**9.1%**	**0.5%**
2006-2015	**11.6%**	**11.2%**	**-0.4%**	**5.8%**	**7.3%**	**1.5%**

* Estimated growth in earnings plus dividend yield
** Market performance, dividend included (please refer to Appendix B for disclosure statements on the Rochon portfolios)
*** All results estimated without currency effects

The Sound Conclusion

Over 20 years, our stocks have outperformed the S&P 500 by 5% annually for the simple reason that the underlying companies in our portfolio have increased their intrinsic value at a rate that is 5% superior than the average. It is in this matter that we intend to continue reaching our goals of outperformance rather than any sort of speculation on the highs and lows of the market, the economy, and/or the political environment. We leave this futile activity to those who don't realize that a stock is simply an ownership stake in a business.

The Flavor of the Day for 2015

Since 2015 was a difficult year for stocks, we were hard pressed to find popular segments of the market. Once again, it's in regards to bonds that we're seeing unbridled optimism. We'll come back to this at the end of our letter.

Housing prices in Canada have also continued to increase in 2015, primarily in British Columbia and Ontario. The average home price in Vancouver now exceeds one million dollars[1]. In Toronto, the average price is $631,000. A significant drop in Canadian real estate prices could have major consequences on various segments of the Canadian economy. We consequently try to stay clear of any businesses that could be affected.

2016 Outlook

As you likely know, we have a minimalistic attitude towards making economic predictions (and a nihilistic attitude regarding short-term stock market predictions). Our opinion is that the outlook for

[1] According to the Canadian Real Estate Association website for January 2016.

economic growth on most parts of the globe will be modest for the year to come. A highly selective investment process for finding truly above-average companies is as critical as ever.

In the US, the strength of the dollar should have less of a dampening effect on the growth of earnings in 2016 versus 2015. We believe that US companies should grow their profits by roughly 6-8% annually. The S&P 500 is now trading at 15-16 times its anticipated profit for the year to come which seems to us a reasonable ratio.

More important to our financial well-being, we believe that our companies should increase their profits by about 12-16% this year, a rate that is roughly twice the one of the average company in the S&P 500. Our stocks are trading at approximately 14-15 times estimated profits. So, not only are our companies offering better-than-average growth prospects in our view, but their shares are actually trading at a slight discount to the P/E of the market.

Closer to home, the economic outlook in Canada seems bleak. Various forces affecting the Canadian economy, such as weak commodity prices, the elevated level of Canadian real estate and a rise in income tax rates do not bode well and are unlikely to improve in the year to come. The significant increase in the federal budget deficit could soften this short-term situation, but it does not seem constructive (to us) over the long term. We are, however, satisfied with the Canadian companies held in our portfolio. Their long-term growth prospects seem very solid.

The year 2016 kicked off with market volatility. We welcome volatility because it allows us to acquire shares of the companies we like at more attractive valuations. We can either invest new capital at good prices or rebalance our portfolio to take advantage of compelling relative opportunities. It's perfectly rational to sell a stock trading at 67% of its fair value to invest the proceed in an existing holding trading at 50% of its fair value. We are all richer today because of past market corrections.

Five-year Post-mortem: 2010

Like we do every year, we go through a five-year post-mortem analysis. We believe that studying our decisions in such a systematic manner, and with the benefit of hindsight, enables us to learn from both our achievements and our errors.

First, in the 2010 Annual Letter, we labeled the price of gold as the "flavor of the day" when it was nearing $1400 per ounce. Five years later, gold is trading at $1065, or 24% lower than the 2010 level. We had no idea how to evaluate the price of gold but we had observed a craze that seemed worthy of highlighting in 2010. We could add that since I started in 1993, the price of gold has risen from $392 to $1065, which is an annual return of 4.6%. This is roughly half the annual return of the S&P 500 over the same period.

In the 2010 letter, we presented two new portfolio purchases: Dollarama and Visa.

Dollarama

Dollarama is the largest dollar store chain in Canada, with over 1000 locations across the country. Founded in 1992, the company's stores offer a vast inventory of consumer products, general merchandise and seasonal items. Products are sold individually or in bulk at fixed prices up to a maximum of $3.

We had gotten to know the company quite well even before it became a public company since Dollarama is a Montreal-based company. We knew that the company's founder and president, Larry Rossy, was

an exceptional businessman and we were saddened when the company was sold to the private equity firm Bain Capital in 2004 instead of going public.

The good news is that there's no sense losing hope in the world of the stock market and Dollarama finally went public in 2009 at $17.50 per share ($8.75 when we adjust for a stock split). A few months later, in 2010, we became shareholders in the company despite the company having a P/E of 18x and having some debt on its balance sheet. This was an act of faith based on Mr. Rossy. EPS rose from $0.82 in 2010 to $2.96 in 2015 (estimated), which represents a 29% annual growth rate. The company's stock rose from $12 to $80 (an annual return of 46%). Dollarama is one of our best investments since the inception of this portfolio 22 ½ years ago. All partners at Giverny Capital owe a debt of gratitude to Larry Rossy.

Visa

We were shareholders of American Express from 1995 to 2013 so we understood quite well the solid competitive advantages of credit card companies. MasterCard went public in 2006 and was an exceptional investment (one which we lamentably missed). We were anxiously waiting for Visa to also go public, which occurred with its 2008 initial public offering. We waited on the sidelines as its shares were trading at $20 when the company was earning $0.62 per share (a P/E of more than 30x).

The stock tumbled to $13 during the crisis of 2008-2009 and then climbed back to $23 in 2010. However, during the summer of 2010, the stock dropped 25% when Senator Dick Durbin introduced a bill which amended the Dodd-Frank bill to limit debit card transaction fees for retailers (interchange fees). The stock fell to $17 and we purchased shares. At that time, the company was earning $1.06 so the P/E had fallen from 23x to 17x within a few weeks. This was a very compelling valuation for this business as we believed that the company's long-term prospects seemed exceptional.



Source du graphique : Bigcharts.com

EPS 2010	EPS 2011	EPS 2012	EPS 2013	EPS 2014	EPS 2015
$1.06	$1.31	$1.62	$1.96	$2.35	$2.68

In the chart above, you can see the incredible performance of Visa over the last five years: EPS has risen from $1.06 to $2.68—or a 20% annual growth rate. You can also see that the company's shares rose from $17 to $78 during this period, or a 350% increase. This has been a very satisfying investment.

I must add a post-script to this port-mortem. We were lucky to have made this investment. Our luck was to have had the 25% drop linked to the Durbin reform as it's highly unlikely that we would have purchased this stock without this unexpected fall. I had followed the company closely and held my nose at the P/E of 23x which was prevalent before the stock's correction in the summer of 2010.

Is the fact that I didn't buy the stock in the beginning of 2010 an error? Absolutely. Imagine if the company's shares hadn't dropped in 2010: by buying at $23, we still would have tripled our money in 5 years. We will still savor the fruits of this investment even if it's a stroke of luck that eventually camouflaged this error.

Our Companies

The Walt Disney Company (DIS, $105): 10 years in our portfolio

We have held shares in Walt Disney for a decade now. Actually, we first bought shares in the company in 1996, following the acquisition of Capital Cities ABC. We sold our shares in early 2000, however. Then, in September 2005, a new CEO was named: Bob Iger. We knew Mr. Iger through his reputation and had great respect for him. He struck us as the perfect leader to bring Disney back to the path of earnings growth. We bought shares in Disney the very day he was named to his new post.

The first challenge he tackled was Pixar. The partnership agreement was about to end and it was it was imperative (this is too weak a word) that it should be renewed. Disney decided to simply acquire Pixar with the approval of its then president, Steve Jobs. This is likely the most important acquisition in the history of Disney. The company's dominance in the production of animated films literally returned to its former glory.

Mr. Iger eventually also acquired Marvel. He understood that with the technical capabilities that now existed, superheroes such as *Iron-Man, Hulk, Thor and Captain America* could take on a totally new dimension at the cinema. This was a homerun for Disney and Marvel's superhero franchises became significant sources of profits for the company.

Lastly, three years ago, Disney acquired Lucasfilm and became the owner of the brand Star Wars. The seventh episode, *The Force Awakens*, premiered on December 18th of last year and within 12 days surpassed the billion dollar mark at the box office on its way to becoming the greatest financial success in the film industry (surpassing *Avatar*).

So within a few years, the entire corporate culture at Disney was transformed and the company found the magic it once had during the decades it was led by its founder. The culmination of this new culture was the creation of *Frozen* which became the greatest success in the history of animated films (I have tears of joy in my eyes when I see all the beautiful Frozen related merchandise sold in stores).

This transformation at Disney is reflected in its financial performance. From 2005 to 2015, EPS surged from $1.33 to $5.51, representing an annualized growth rate of 15%—a phenomenal performance for a company of its size. The company's stock rose from $24 to $105, or a 16% annualized growth rate (not including dividends).



Source: BigCharts.com

Though the incredible performance at Disney is based on the hard work of thousands of people, Bob Iger deserves to be singled out as deserving the credit for leading the company's turnaround. In our opinion, more than $100 billion in shareholder value was created as a result of his leadership.

Walt Disney would likely add: "I only hope that we don't lose sight of one thing - that it was all started by a mouse."

Anecdote on Bob Iger

Before joining Disney, Bob Iger worked with Tom Murphy at Capital Cities ABC. Mr. Murphy is now retired but sits on the board of Berkshire Hathaway. Warren Buffett once said that he was one of the greatest CEO he had ever known in his career (it's tough to get a better compliment). During the 2006 Berkshire shareholder meeting, Jean-Philippe and I crossed paths with Mr. Murphy in the lobby of our hotel. After saluting him with admiration, we dared ask him what he thought of the recent appointment of Bob Iger as CEO of Disney. He spoke about him with great enthusiasm which confirmed our initial judgement. As you can see, our annual visits to Omaha are educational on many fronts.

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Alphabet Inc. (GOOG, $759)

Alphabet (formerly Google) had an excellent year in 2015. Revenues were up 13% despite more than half of its sales originating outside the United States (and therefore strongly affected by the rising US dollar). Adjusted EPS grew by 16% which is a spectacular performance for a large US multinational. The company continued its transition to mobile and profit margins appear to have stabilized. The enormous competitive advantage of Google's web search seems to have transposed itself from desktop (PC) to mobile. This is great news for the intrinsic long-term value of the company.

We maintain a modest weight (about 2-3%) in Alphabet as we find the company to be very generous with its stock option program. We might also add that we would appreciate better allocation of excess capital. Aside from these two factors, Alphabet seems to be an exceptional company.

Ametek (AME, $54)

Ametek is one of two new companies in our portfolio for 2015. This manufacturer of electronic instruments and electromechanical devices was founded in Pennsylvania in 1930 as American Machine and Metals. The company changed its name to Ametek in the early 1960s and is one of the oldest companies listed on the New York Stock Exchange (since its inception in 1930). Yet the company remains largely unknown and isn't closely followed. Its electronic instruments division manufactures products used for monitoring, measuring, testing, and calibrating for markets including aerospace and energy. The electromechanical devices division produces interconnection equipment, engines and systems.

Over the last decade, revenues increased from $1.4 billion to $4 billion and EPS climbed from $0.59 to $2.73, or an annual growth rate of 17%. The company is growing in part by new product introductions and also through acquisitions (23 since 2011).

As is often the case with exceptional companies, it's the corporate culture that really stands out. The first of the four pillars of its business model is "operational excellence" and the company is diligent in reducing its cost structure and improving efficiency while managing its asset base.

The company believes it can double revenues within five years and we share their optimism.

Bank of the Ozarks (OZRK, $49)

2015 was an exceptional year for Bank of the Ozarks, our bank from Little Rock, Arkansas. The company generated a 38% growth in EPS, reaching $2.09. Here are the highlights from 2015:

- The bank's efficiency ratio (a measure of its cost structure), was an impressive 38%.
- Return on Assets reached 2.11%.
- The bank's balance sheet continued to strengthen with returns on equity of 14.8%.
- In February, Ozarks completed its acquisition of Intervest National Bank.
- In August, Ozarks acquired Bank of the Carolinas.
- In October, Ozarks announced its largest acquisition to date: Community & Southern Bank (with 47 branches in Georgia and Florida).
- Deposits increased by 45% to $8.0 billion.
- Total assets grew by 46% to $9.9 billion.

Over the last decade, Ozarks has grown EPS by an annual compounded rate of 16%. Few banks can tout this kind of performance given the difficult economic context of the past years. We anticipate a solid increase in EPS in 2016 and remain optimistic about the company's prospect for continued growth.

Berkshire Hathaway (BRK.B, $132)

The company led by the legendary Warren Buffett had an excellent year in 2015. It's difficult to precisely measure the increase in the company's intrinsic value for the year, but we believe that it was

within the order of 6-8%. The most important news of 2015 was the acquisition of Precision Castparts (see the beginning of the letter).

We believe that Berkshire's shares are undervalued by the market.

Buffalo Wild Wings (BWLD, $160)

Buffalo Wild Wings (BWW) is a sports-oriented restaurant chain which primarily serves chicken wings, as its name suggests. We have been shareholders in the BWW for six years. The number of restaurant locations reached 1175 in 2015, with 93 opening within the last year. The company grew revenue by 21% in 2015, same-store sales rose by 4.2% (2.5% for franchised locations) but its EPS remained flat at $4.97. The company had to deal with pressure on its net margins in 2015 but we believe the situation to be temporary.

The company anticipates opening 87 to 100 new restaurants in 2016 and we forecast that earnings will grow at more than 20% for the coming year.

Carmax (KMX, $54)

Carmax's fiscal year ends in February and we estimate that sales and EPS will grow by about 8% for 2015-16. While the company operates 160 stores in the US, it only has roughly 3% of the used car market. So we see lots of room for growth in this business.

The company's stock fell in 2015 (a fall which continued in the beginning of 2016). The stock seems to be greatly undervalued and we took advantage of the recent decrease to increase our holding.

Constellation Software (CSU-T, $577)

We've been shareholders in Constellation Software for two years. We consider the CEO of Constellation, Mark Leonard, an exceptional businessman. Past performance has been impressive at Constellation and we believe that the long-term prospects are equally excellent. While the company is based in Canada, the majority of its revenue is based in the US and financial results are reported in US dollars.

Revenues grew by 10% in 2015 and losses on currency reduced organic growth by 6%. EPS climbed by 35% and the stock did quite well, surging 67% for the year (in Canadian dollars).

Dollarama (DOL-T, $80)

After its first three quarters of 2015 (the company's fiscal year ends on January 31st), revenues rose by 13% and same-store sales increased by 7.1%. EPS climbed 39% and we anticipate a rise of 34% for the year 2015.

Dollarama now has more than 1005 stores in Canada and we consider the company to be one of the best managed businesses in Canada.

Knight Transportation (KNX, $24)

Older partners might remember being shareholders of Knight Transportation for several years from 2003 to 2011. Knight Transportation is a large trucking company based in Phoenix (AZ). In addition to

offering road transportation services over short and medium distances, it also offers logistic services. We had sold our shares of Knight in 2011 to purchase another security that seemed more undervalued.

The company appointed a new CEO, David A. Jackson in early 2015 and we met him shortly thereafter. As the company's CFO before taking the CEO role, Mr. Jackson reinvigorated the growth strategy for Knight. We were very impressed with this young leader (40) and decided to become shareholders once again.

2015 was difficult for the trucking business (more than we would have thought given an environment of low gas prices). Knight's revenues grew by 7.3% (14.7% excluding the effect of fuel surcharges) and EPS grew by 17%. 2015 ended with a slight decline in profitability that is likely to last a few more quarters. Still, we believe that the company's long-term growth prospects are solid.

LKQ Corp (LKQ, $28)

We invested in LKQ in 2012. This Chicago-based company refurbishes used automotive parts. The company became the leader in its industry by offering very compelling prices relative to new parts (which pleases the insurance companies) along with an unrivaled distribution network. LKQ has diversified in Europe over the last years by making acquisitions in the United Kingdom, Belgium, France, the Netherlands and, more recently, Italy.

From 2008 to 2015, revenues grew at an annualized rate of 20%, from less than $2 billion to $7.2 billion. In 2015, EPS rose by 11% compared to the prior year. The appreciation of the US dollar affected profitability, along with lower prices for scrap metal (what's left of the cars when the company has taken out all the parts to refurbish).

In 2016, we expect EPS growth of 12-15%, We believe that the company has excellent long-term growth prospects and the stock's valuation on the market has rarely been so low!

M&T Bank (MTB, $121)

After three years of regulatory delays, the merger between M&T Bank and Hudson City Bank was finalized in November of 2015. M&T acquired nearly $35 billion in assets.

In 2015, adjusted EPS grew 2%, to $7.74. We believe that M&T Bank should now be able to earn higher returns going forward. We anticipate a significant improvement on the bank's return on assets in 2016, fueled by a lower efficiency ratio and the anticipated synergies from the integration of Hudson City. We believe that the company can generate EPS in excess of $9 in the coming year.

Markel Corporation (MKL, $883)

We first bought shares in Markel in 2013 when the company announced its large acquisition of Alterra Reinsurance Company. Wall Street was skeptical of the benefits of this acquisition and the stock was trading at a compelling valuation. We seized the opportunity to become shareholders.

2015 was an excellent year for Markel. The combined ratio decreased from 95% to 89% (the lower the better). More importantly, the newly-acquired reinsurance division saw its combined ratio improve from 96% to 90%. Book value, however, only increased by 3%. It's worth noting that the market value of the company's stock portfolio has a direct impact on the company's book value. In 2015, Markel took

a $300 million write down on some of its investments, but we believe that these are temporary in nature and will eventually be transformed to gains.

Mohawk Industries (MHK, $189)

We have been shareholders in Mohawk since 2006. 2015 was another good year for Mohawk: revenues grew 3% (10% without a loss related to exchange rates) and EPS rose 25% to $10.51 (adjusted for the amortization of intangible assets).

Mohawk has become a world leader in the floor covering business and we believe that the company is stronger than ever.

MTY Food Group (MTY-T, $32)

Stanley Ma, founder of MTY Group, opened his first restaurant in Montreal in 1979 which was called The Paradise of the Pacific. Then in 1983, MTY developed Tiki-Ming which serves Chinese cuisine. In 1999, the company made its first acquisition when it bought Fontaine Santé which soon assumed the name Veggirama and was gradually converted into restaurants called Cultures. MTY now has 30 brands with nearly 2800 locations in its network of restaurants.

It was another remarkable year for MTY Food. Revenues grew by 26% to $145 million and adjusted EPS rose by 18%. The company's balance sheet remains strong, with nearly no debt and $33 million in cash ready to be used for acquisitions.

One day, I was told that MTY did not spend enough on R&D. I replied that it was the beauty of an egg roll from Tiki-Ming: it hasn't changed in 30 years. There's no need to modernize it. We like companies with simple products that aren't threatened by obsolescence. Notwithstanding, MTY has done a remarkable job with culinary innovation at Thaï Express and Sushi Shop.

We have been shareholders in MTY for eight years. From 2007 to 2015, adjusted EPS increased from $0.51 to $1.87, or an annualized growth rate of 18%. We are huge fans of Stanley Ma, CEO of MTY and believe the company's long term prospects remain excellent.

MTY's stock is currently trading at the same level it did two years ago so we think its valuation has become even more attractive.

O'Reilly Automotive (ORLY, $253)

O'Reilly had another sensational year. Revenue grew by 10% to reach $8 billion, with same store sale growth of 7.5%. Net income rose by 20% and EPS increased 25%, to $9.17 (with 5% of the EPS growth coming from the company's share buyback program).

We anticipate a more moderate EPS growth for 2016, though still within the 12-14% range. We should also add that O'Reilly has made our estimates look too conservative throughout the years!

Stericycle (SRCL, $121)

We decided to become shareholders in Stericycle in 2015 after following the company for many years. The industrial waste division was affected by weakness in the energy sector and the stock fell 20% after

announcing results that disappointed Wall Street. We look further ahead than a quarter or two and believe that the long-term growth prospects of the business are still solid.

Stericycle acquired the Canadian company Shred-it for $2.3 billion in 2015. Shred-it is a leader in the document destruction industry and we know the quality of this company firsthand since we use its services at Giverny Capital. Shred-it was to have an IPO in 2015 and we were looking forward to the roadshow after reading the prospectus, but Stericycle decided to acquire the company just before its IPO.

Stericycle's revenues climbed 17% in 2015 (mainly due to the acquisition of Shred-it). Adjusted EPS, however, rose only 6%. 2016 will probably be similar to 2015 in terms of growth (as the company will continue the integration of Shred-it) but we expect a return to a higher level of growth in 2017.

Union Pacific (UNP, $78)

It was a difficult year for the rail industry and Union Pacific was not spared. UP saw its revenues decline by 9% and its EPS drop by 5%. It should be noted, however, that with dividends and share buybacks, UP returned more than $5.8 billion to shareholders in 2015.

The good news is that the company was able to increase its prices by about 3.5% in 2015 which is a better growth rate than in 2014. UP also achieved an operating ratio of 63.1% in 2015 and the company is more efficient than ever.

UP and BNSF (owned by Berkshire Hathaway) have the equivalent of a duopoly in the western railroad market of the United States. First, a duopoly is the second best thing after a monopoly. But to have a rational competitor is also definitely a good thing over the long run. Still, BNSF had a better year in 2015 than UP after a few years of the reverse situation.

We expect 2016 will still be difficult for UP but we continue to believe that the company has great potential for higher returns on its capital over the long term. The stock has fallen in the stock market over recent quarters and seems to us to be quite undervalued.

Valeant Pharmaceuticals (VRX, $102)

In 22 ½ years of portfolio management, I have never liked to own companies that are in the headlines of newspapers (and/or the Internet). We like "low profile". For most of the first 22 years, we were fortunate to have this wish granted. However, we had a turbulent end of 2015 with our shares in Valeant (and the beginning of 2016 was certainly similar).

We became shareholders in Valeant in 2011. Michael Pearson took over Valeant in 2008 and we followed the phenomenal transformation he led with the company. Instead of spending a large portion of revenues on R&D that often generated low returns on invested capital (something which is almost done out of tradition in this industry), Pearson instead relied on the acquisition of drugs and consumer products that were stable and/or whose likelihood of success was high. The company does spend on R&D (unlike what many say) but only when it believes that the odds are high to achieve success. It is actually one of the most productive companies in the industry in terms of R&D as measured by the number of approvals for new compounds per billion dollars spent.

The optimization of financial resources at the businesses it acquired enabled Valeant to achieve very high operating margins and returns on equity. EPS grew from $2.93 in 2011 to $10.16 in 2015—an

annualized growth rate of 36% over four years. Initially, analysts expected EPS of about $16 for 2016. This explains why the stock went from $40[2] during our initial purchase to a high of $264 last summer.

Valeant also used debt to fuel its growth plan. Following the acquisition of Salix Pharmaceuticals in early 2015 for $11 billion, the level of debt had risen considerably. Due primarily to its debt level, we knew the risk in Valeant was higher than our other investments. So, as the stock rose, we decided to reduce our position on two occasions to limit its weight in the portfolio to about 5%.

At the end of last summer, Valeant had become the target of politicians concerned with the rising price of some of its newly acquired drugs. It should be noted that such increases are often tempered by discounts negotiated by different purchasing groups. Ultimately, despite the income of the three drugs in question corresponded to only 4% of revenues of the company, the public image of Valeant was severely tarnished. In our view, the high price increases of certain drugs, justified or not, fueled the anger of the general public and was unnecessary. Its consequences are far more negative than positive for the company.

Then in October, some short seller suggested that the company had questionable books based on the "complicity" of one of its distributors, Philidor. The company decided to terminate its relationship with this distributor and a few weeks later signed a major distribution agreement with Walgreen's. The company then reduced its estimated profits for 2016 to around $13.50. To make matters worse, Mr. Pearson became seriously ill in late December and was on medical leave for two months.

We waited a few weeks to publish this letter because we wanted to have an update on the financial condition of the company before making a decision about our shares and give you the most accurate information available. At last, the company released its results for 2015 and, more importantly, updated its estimates for 2016. Valeant now expects $9.50 to $10.50 in EPS for the year ahead.

We consider this level of profitability as no longer meeting our criteria in regards to the company's earnings power relative to its debt. So we took the difficult decision to sell our shares in Valeant.

Clearly, we would have liked to have sold earlier but we were bound by the facts rather than the rumors. In light of the updated forecast, we believe that the risk inherent to the company is now too high for us.

Visa (V, $78)

Visa had another good year, with EPS growing by 14% despite a significant decline in revenues due to the strong US dollar. The company announced in November that it was acquiring its European division (Visa Europe) for over $23 billion.

The stock is trading at a P/E that is slightly higher than our other holdings, but its long-term growth prospects are excellent. The company is highly profitable and uses its enormous cash flow to repurchase shares.

Wells Fargo (WFC, $54)

Wells Fargo had a somewhat disappointing year in 2015. EPS was flat in comparison to 2014. This is not an easy time for banks since very low interest rates reduce the profit margin between the rates banks

[2] All figures for Valeant are listed in US dollars

charge customers relative to the rates paid to lenders (such as for deposits). Thus, net interest margin fell from 3.11% in 2014 to 2.95% in 2015.

Adjusted return on assets was 1.3% and the return on equity of 12.7%. We believe the company has the ability to be much more profitable in a more "normal" interest rate environment.

Sales in 2015

Fastenal

We sold our remaining shares of Fastenal in early 2016, after having held the company in our portfolio for over 17 years. Fastenal is a large retailer of fasteners and other equipment mainly used in manufacturing. Fastenal was founded in 1967 by Robert Kierlin in the small town of Winona, Minnesota (population 27,000). The company has over 2600 locations across the United States, Canada and Mexico.

In 1998, we had been following the company for many years and had great admiration for its CEO, Robert Kierlin. Unfortunately, the stock was always trading at very high valuations (with a P/E in the 30s or even more). But we had our chance during the Asian crisis in October 1998 (few people remember this one!) as the stock market declined by almost 20%. Fastenal's stock tumbled from $7 to $3 (price adjusted for subsequent stock splits). We paid 18 times earnings for our first shares in Fastenal—an attractive valuation for a company that was growing at 20% annually.

Having Robert Kierlin as president of one of the companies in our portfolio was a great moment in my investor's life. He was one of the best businessmen of his time and he knew how to establish a phenomenal corporate culture. Fastenal generated strong profit margins and exceptional returns on capital in a very competitive industry. His attention to operating costs became legendary. In 1997, an article was published on Mr. Kierlin in Inc. magazine entitled "The Cheapest CEO in America". The author explained that net margins at Fastenal were 11.3% in 1996 compared to 5.9% for one of its main competitors, W. W. Grainger. This was a very significant difference.

Mr. Kierlin also led by example: he was paid a salary of only $120,000 per year and the company had no stock option program. Most importantly, Mr. Kierlin owned about 12% of the shares of Fastenal. He was very much in the same boat as his fellow shareholders.

The values of Mr. Kierlin went far beyond frugality. Soon after we became shareholders, members of the management team suggested that Fastenal provide a stock option program for employees. Mr. Kierlin agreed but decided to give his own shares in the company to fund the program rather than issuing options that would dilute all shareholders. The number of shares thus remained the same. We had never seen such a thing in a public company and this strengthened our enthusiasm to be partners with Mr. Kierlin.

After Mr. Kierlin stepped down in 2002, it was the turn of Willard Oberton to take over the helm at Fastenal. He also did an outstanding job. Over the 17 years we were shareholders of Fastenal, EPS increased from $0.18 to $1.77—a tenfold increase (equivalent to an annualized growth rate of 15%). We sold our shares for more than 12 times the initial price that was paid in 1998. The company no longer has the same growth rate as in the past and we concluded that, relative to other securities in our portfolio, the company's shares seemed fairly valued. But it is not to say that we will not return again as shareholders one day...

Other Sales

In 2015 and early 2016, we also sold our shares of Cabela's, PRA Group and IBM. Similar to the case of Fastenal, we sold these positions primarily for the simple reason that we were more confident that other securities in our portfolio offered better growth prospects.

The Podium of Errors

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2015 (or from past years). It is with a constructive attitude, in order to always improve as investors, that we provide this detailed analysis.

As is often the case with stocks, errors from omission (non-purchases) are often more costly than errors from commission (purchases)… even if we don't see those on our statements.

Bronze Medal: Amazon

I have been an avid fan of Amazon since the launch of its retail website. However, it was very difficult to see when the company would become profitable when it went public in 1997. Sales increased rapidly but losses followed suit. Slowly, the company has become slightly profitable. The company has a policy of investing heavily in its future and is always willing to sacrifice short-term profits. Amazon spends billions of dollars on a very important activity and a potential source of wealth: to dig a huge economic moat around its business to keep far away competitors. This is the best way that a CEO can spend money (when the moat is real and not imaginary as is so often the case). In our opinion, Jeff Bezos is one of the greatest businessmen in history and we would have liked to become partners with him for many years now.

Historically, Amazon has benefited from Wall Street's support of its bold strategy focused on the long term. In 2014, the stock had corrected from $400 to under $300. With EPS of little over $1, the stock seemed very far from a bargain. I nonetheless took the time to look more closely into their business model and tried to assess the earning power going forward to 2020. My estimates seemed plausible: I arrived at an EPS potential of $28 in 2020. Using a P/E ratio of 25 times, this would justify a stock price of $700 six years later (a potential annualized return of 15%). But hoping for a greater margin of safety, I preferred to wait for a lower price. Today, a little over a year after my analysis, the stock is at $575, or 92% more than the price at which I considered buying shares.

I realize fully that the company is difficult to value with its current level of profitability. The "value investor" in me makes me reluctant to bet too much on the future. But I have often said that "being disciplined is to follow your rules; but being wise is knowing when to break them." Buying shares of Amazon requires an act of faith in Jeff Bezos. With a good enough margin of safety, it might be wise to invest with him.

And we missed that opportunity in 2014.

Silver Medal: O'Reilly Automotive

We have been shareholders in O'Reilly Automotive since 2004 and acquired our first shares for about $20. Shares are trading at $263 as I write this letter. Yet, the stock is only about 4% of the value of our portfolios. If we had kept all our shares, the stock would represent about 11-12% of our portfolios. The

reason is simple: over the years, I have repeatedly reduced our holding in this extraordinary company. My excuse is simple: I found the stock, at times, to be slightly expensive.

My motivation to reduce the number of our shares may seem noble: do not expose too much of our capital to a single stock. First, I could have stuck to our rule of having a maximum weight of 10% for any given holding (with the exception of Berkshire Hathaway). But I thought I should optimize the management of our capital by selling a portion of our position in O'Reilly to buy shares of another company that seemed more undervalued (important nuance: that *seemed* more undervalued).

In 1930, Philip Carrett wrote one of the first books on the stock market entitled "The Art of Speculation." In this book, he lists 12 Commandments of Investing. One in particular has always stuck in my head: "Be quick to take losses and reluctant to take profits." Peter Lynch also mentioned this rule in his own words in 1989 (in the book "One Up on Wall Street") by writing: "Don't pull out the flowers to water the weeds."

I followed this rule only partially with O'Reilly and we paid a high price for this even though it doesn't show up in our account statements.

Gold Medal: Stella Jones

In early 2008, I discovered a Quebec company called Stella Jones. This Montreal-based enterprise is a leader in the production and marketing of pressure treated wood products. Stella Jones provides railway ties and timbers to North American railway operators, as well as posts to electrical utilities and telecommunications companies. Sella Jones also provides lumber for residential use as well as industrial products. Its CEO, Brian McManus, then seemed to be of very high caliber.

As a shareholder at the time in Burlington Northern Santa Fe (subsequently acquired by Berkshire in 2010), I was aware of the strong fundamentals of the railway industry, which is the primary customer base of Stella Jones. The sale of railway ties and poles is my kind of business (glamorous!) The stock was trading around $6-7 in mid-2008 when the company had earned $0.51 for 2007. The P/E of 12-13x was not particularly high, but my fear was that the company was cyclical and would be affected by the recession that had begun. In other words, I wanted a lower P/E. Well, I had my chance: the stock fell to $3.50 in March 2009 but I still ignored the stock despite the P/E having dropped to 6x (because EPS not only did not shrink in 2008, they increased to $0.58 and again in 2009 to $0.62).

Later, in June 2012, Jean-Philippe Décarie of La Presse wrote an excellent article on Mr. McManus. It read: "Brian McManus is a follower of the slimming diet. As proof, the headquarters of the company in the borough of Saint-Laurent has 14 employees to supervise 19 plants, 1 tar distillery, 3 centers for used railways tie collection, 2 distribution centers, 3 plants use for pole production, in 6 provinces and 15 US states." It was music to my ears! The stock was then trading at $14.

Ultimately, Brian McManus continued to manage the business masterfully and took advantage of gloomy times to make many smart acquisitions. In 2015, EPS reached $2, or four times the level of 2007 (a growth rate of 19% on an annualized basis). The stock is now trading at around $45.

Conclusion: The Financial Maginot Line

There is an old military adage that "generals are always ready to fight the previous war". It means that often generals base their strategy on lessons learned during the prior war. Of course, subsequent wars are often different and so such strategies learned from the past can turn out to be ineffective.

After the First World War (called the "Great War" before the second), France decided to set in motion a plan to thwart a future invasion by Germany. The Maginot Line was built. It was a line of fortifications along the border of France and Belgium, Luxembourg, Germany, Switzerland and Italy. In total, the Maginot Line cost over five billion francs when it was built from 1930 to 1936. Unfortunately, during the German invasion of May-June 1940, the Maginot Line brought only little protection to France. Technological advances (primarily the aviation) had rendered this type of fortification almost obsolete.

What is the link with the world of finance? After every financial crisis, our civilization attempts to implement mechanisms to prevent the recurrence of another crisis. This is often set in place through various government regulations. The goal is laudable and the motivations are sincere, but like the Maginot Line, they often prove futile when there are new factors leading to the next financial crisis.

For example, one of the lessons from the 1987 crash was to put mechanisms in place to prevent automated trading programs from potentially crashing the market. So, after falling 500 points on the Dow Jones, the Stock Exchange shuts down (much like a circuit breaker) in the hope of calming the emotions. This did not prevent the tech bubble crash of 2000-2002 or the long bear market of 2008-2009. The manic-depressive behavior of stock market investors is immutable. It is inherent to the nature of human beings and no system is going to change that.

One of the lessons of the latest financial crisis is that US banks should be severely reined in (at least when they exceed $50 billion in assets and become considered "too big to fail"). The goals are quite valid. However, a side effect of these measures is that US big banks are now spending billions of dollars to meet these new regulations—billions that are not devoted to economic growth (through loans and investments). If we look to history for guidance, it is unlikely that the next crisis will have the same origin as the crisis of 2008-2009.

Investors have also created their own form of a Maginot Line. Traumatized by the large market declines of 2008-2009, many investors see a repeat of the previous financial crisis in each market correction. This happened in the fall of 2011 when equities reached very attractive valuations. In our opinion, this is the case again in the beginning of 2016.

The very low interest rates currently available reflect a level of demand for bonds that is absurdly high. Safety at all costs becomes the paramount motivation. Many investors are flocking to GICs (Guaranteed Investment Certificates) and bonds. The emphasis, from both the buyer and the seller, is entirely placed on the "G" in the acronym. Yet, in our opinion, the only thing that is guaranteed with a bond that has a lower interest rate than the rate of inflation is impoverishment. Generating negative real returns goes against the very concept of investment. With each passing year, the holders of this asset class have their capital slowly crumble. From our perspective, the certainty of capital loss in purchasing power is the very definition of risk.

The danger for many bond investors is higher interest rates (more *when* than *if*). A return to a more "normal" economic environment could drive up interest rates on 10-year note from 1.75% to 5% (important note: this is not a prediction). A 10-year note with a coupon of 1.75% in a 5% rate environment would lose a quarter of its market value. Now imagine a 30-year bond with a coupon of 2.5% (the current rate). A rapid rise of rates to 5% would create a decrease in market value of around 38%. Many investors and financial institutions who believe their capital is safe in this type of asset could quickly fall back to Earth.

So, as the Maginot Line in the interwar period, a fortified portfolio of long-term bonds might not keep its promise (or illusion?) of future protection.

P.S.

What would happen to stocks in the event of a significant increase in interest rates? Obviously, we are not soothsayers. Some businesses will be adversely affected by rising interest rates and others will benefit from them. In terms of market valuations in general, with an average P/E of 15-16 times, stocks already reflect long-term interest rates of 6.5% (1 divided by 15.5). So even with a rise of long term interest rates to 5%, stocks would still be attractive relative to bonds. This goes to show the great disparity between these two asset classes at the moment.

To Our Partners

Using rationality, along with our unwavering optimism, we trust that the companies we own are exceptional, led by top-notch people, and destined for a great future. They should continue to prudently navigate the often troubled waters of the global economy. Furthermore, the valuation assigned by the market to these outstanding companies is very similar to the valuation of an average company in the S&P 500, despite the fact that our companies have better growth prospects than average. Therefore we consider the appreciation potential for our portfolio, both in absolute and relative terms, to be well above average, especially when compared to other alternative asset classes, such as bonds.

We also want you to know that we are fully aware of and grateful for your votes of confidence. It is imperative for us to not only select outstanding companies for our portfolios, but to also remain outstanding stewards of your capital. We certainly like to achieve good returns and have developed a taste for it, but it must not come at the cost of taking undue risk. Our philosophy to favor companies with solid balance sheets and dominant business models, along with purchasing these companies at reasonable valuations, is central to the risk management of our portfolios.

Thank you from the entire Giverny Capital team.

We wish a great 2016 to all our partners.



François Rochon and the Giverny Capital team

APPENDIX A

Investment philosophy

Note: This section is repeated from prior annual letters and is aimed at new partners.

In 2015, we saw a large increase in the number of Giverny Capital partners (the term we use for our clients). With all these newcomers, it is imperative that we write again (and again) about our investment philosophy.

Here are the key points:

- We believe that over the long run, stocks are the best class of investments.
- It is futile to predict when it will be the best time to begin buying (or selling) stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity).
- We choose companies that have high (and sustainable) margins and high returns on equity, good long term prospects and are managed by brilliant, honest, dedicated and altruistic people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be approximately assessed.
- The stock market is dominated by participants that perceive stocks as casino chips. With that knowledge, we can then sometimes buy great businesses well below their intrinsic values.
- There can be quite some time before the market recognizes the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

Experience and common sense teach us that an investment philosophy based on buying shares in companies that are undervalued, and holding these companies for several years, will not generate linear returns. Some years, our portfolio will have a return that is below average. This is a certainty that we must accept.

Another important point: the significant volatility of the market is often perceived negatively by many investors. It's actually the contrary. When we see stock prices as *"what other people believe the company is worth"* rather than the real value (at least in the short term), these fluctuations become our allies in our noble quest for creating wealth. Instead of fearing them, we can profit from them by acquiring superb businesses at attractive prices. The more that markets (the "other" participants) are irrational, the more likely we are to reach our ambitious performance objectives.

Benjamin Graham liked to say that the irrationality of the market provides an extraordinary advantage to the intelligent investor. The person, however, who becomes affected by short-term market fluctuations (less than 5 years) and who makes decisions based on them transforms this advantage into a disadvantage. His or her own perception of stock quotes becomes their own worst enemy. Our approach at Giverny Capital is to judge the quality of an investment over a long period of time.

So patience – ours AND that of our partners – becomes the keystone for success.

APPENDIX B

Notes on the returns of the Rochon portfolios

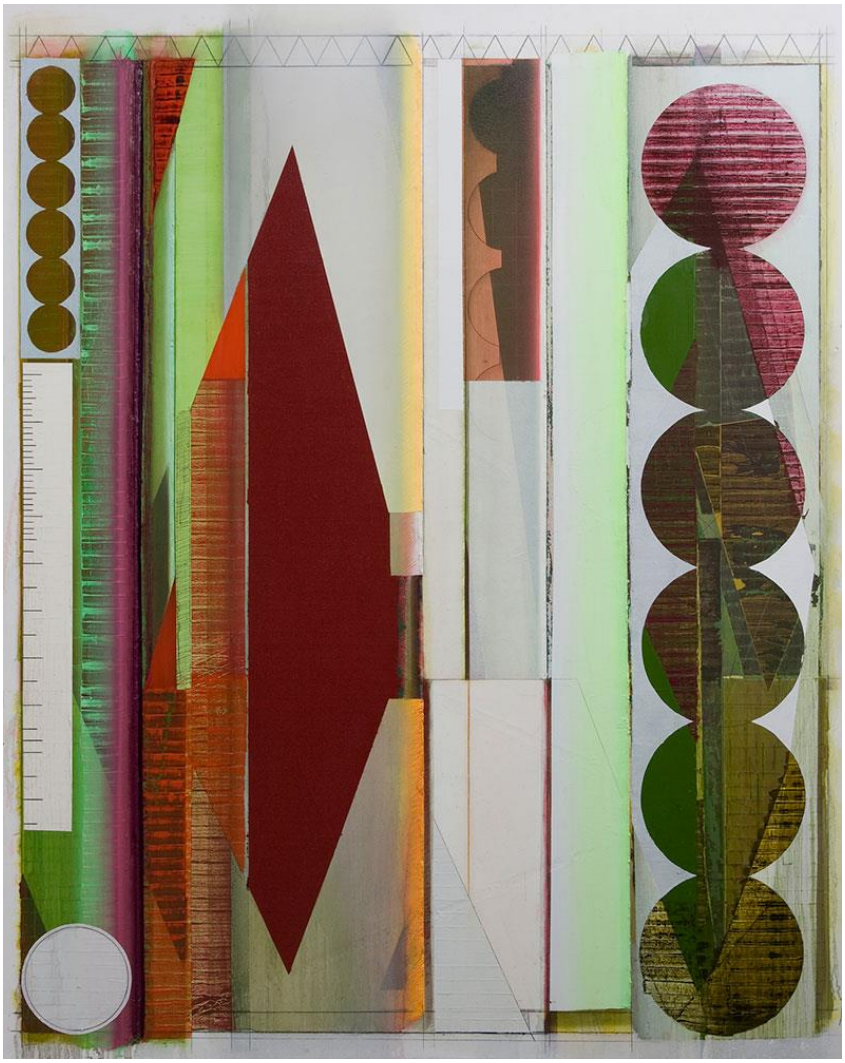
- The Rochon portfolio is a private family group of accounts managed by François Rochon since 1993. The returns of the period from 1993 to 1999 were realized before registration of Giverny Capital Inc. at the AMF in June of 2000.
- The Rochon Global portfolio serves as a model for Giverny Capital's clients, but returns from one client to the other can vary depending on a multitude of factors. The returns indicated include trading commissions, dividends (including foreign withholding income taxes) and other income but do not include management fees. Portfolio returns of the Rochon Global portfolio have been generated in a different environment than Giverny Capital's clients and this environment is considered controlled. For example, cash deposits and withdrawals can increase the returns of the Rochon Global portfolio. Thus, the portfolio returns of the Rochon Global portfolio are often higher than the returns realized by clients of Giverny Capital.
- Past results do not guarantee future results.
- The Rochon Canada and Rochon US portfolios are parts of the Rochon Global portfolio.
- The index benchmark group is selected at the beginning of the year and tends to be a good reflection of the asset composition of the portfolio. Weighted indices presented may not be representative of the Rochon Global portfolio. In 2015 :

    - Rochon Global Portfolio: TSX 16% Russell 2000 42% S&P 500 42%
    - Rochon US Portfolio : S&P 500 100%
    - Rochon Canada Portfolio : S&P/TSX 100%

- The returns for the S&P 500 (in $USD) are provided by Standard & Poors.
- The returns for the various indices used for comparable purposes are deemed reliable by Giverny Capital.
- It should be noted that currency effects on the returns of the Rochon portfolio and indices are estimated to our best effort.
- The custodian of our client portfolios is National Bank Correspondent Network (NBCN) in Canada and TD Ameritrade Institutional in the US.
- The financial statements of the three portfolios are audited at the end of each year. The auditor's data are those provided by our custodian (NBCN). The auditor's annual reports are available upon request.
- For more information, please see the "returns" section of our website.

GIVERNY CAPITAL

Annual Letter to our Partners 2016



Dil Hildebrand
This is not what I want but I want this also, 2015
Giverny Capital Collection

Historical Summary

It has been more than two decades since I discovered the writings of Warren Buffett, Benjamin Graham, John Templeton, Philip Fisher and Peter Lynch. I then decided to begin managing a family portfolio based on an investment approach synthesized from these great money managers. By the end of 1998, after five years of satisfactory results, I decided to launch an investment management firm offering asset management services aligned with my own investment philosophy. Giverny Capital Inc. came into existence.

In 2002, Giverny hired its first employee: Jean-Philippe Bouchard (JP for those who know him well). A few years later, JP became a partner and participates actively in the investment selection process for the Giverny portfolio. In 2005, two new persons joined the firm who eventually became partners: Nicolas L'Écuyer and Karine Primeau. Finally, in 2009, we launched a US office in Princeton, New Jersey. The director of our Princeton office, Patrick Léger, shares in the culture and long-term time horizon inherent to Giverny.

We are Partners!

From the very first days of Giverny, the cornerstone of our portfolio management philosophy was to manage client portfolios in the same way that I was managing my own money. Thus, the family portfolio I've managed since 1993 (the "Rochon Global Portfolio") serves as a model for our client accounts. It is crucial to me that clients of Giverny and its portfolio managers are in the same boat! That is why we call our clients "partners".

The Purpose of our Annual Letter

The primary objective of this annual letter is to discuss the results of our portfolio companies over the course of the prior year. But even more importantly, our goal is to explain in detail the long-term investment philosophy behind the selection process for the companies in our portfolio. Our wish is for our partners to fully understand the nature of our investment process since long-term portfolio returns are the fruits of this philosophy. Over the short term, the stock market is irrational and unpredictable (though some may think otherwise). Over the long term, however, the market adequately reflects the intrinsic value of companies. If the stock selection process is sound and rational, investment returns will eventually follow. Through this letter, we provide you with the information required to understand this process. You will hopefully notice that we are transparent and comprehensive in our discussion. The reason for this is very simple: we treat you the way we would want to be treated if our roles were reversed.

The Artwork on Our 2016 Letter

Since 2004, we have illustrated the cover of our letters with a copy of artwork from our corporate collection. This year we selected a painting by the Quebec artist Dil Hildebrand entitled "*This is not what I want but I want this also*".

For the year ending December 31st 2016, the return for the Rochon Global Portfolio was 7.3% versus 14.3% for our benchmark, which represents a relative performance of -7.0%. The return of the Rochon Global Portfolio and the one of our benchmark include a loss of approximately 2.8% due to fluctuations in the Canadian currency.

Since its inception on July 1st 1993, our compounded annual growth rate has been 15.9% versus 9.2% for our weighted benchmark, representing an annualized outperformance of 6.7% over this period. Our long-term (and quite ambitious) objective is to maintain an annual return that is 5% higher than our benchmark.

The Rochon Global Portfolio: Returns since July 1st 1993

Year *	Rochon	Index **	+ / -	$ US/Can ***
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	3.3%
1994	**16.5%**	3.7%	**12.7%**	6.0%
1995	**41.2%**	24.0%	**17.2%**	-2.7%
1996	**28.0%**	22.8%	**5.2%**	0.3%
1997	**37.8%**	28.6%	**9.2%**	4.3%
1998	**20.6%**	18.8%	**1.8%**	7.1%
1999	**15.1%**	16.3%	**-1.2%**	-5.7%
2000	**13.4%**	3.2%	**10.2%**	3.9%
2001	**15.1%**	-0.4%	**15.5%**	6.2%
2002	**-2.8%**	-18.3%	**15.6%**	-0.8%
2003	**13.6%**	14.0%	**-0.4%**	-17.7%
2004	**1.6%**	6.2%	**-4.5%**	-7.3%
2005	**11.5%**	3.6%	**7.9%**	-3.3%
2006	**3.5%**	17.0%	**-13.5%**	0.2%
2007	**-14.4%**	-11.6%	**-2.8%**	-14.9%
2008	**-5.5%**	-22.0%	**16.5%**	22.9%
2009	**11.8%**	12.2%	**-0.4%**	-13.7%
2010	**16.1%**	13.8%	**2.3%**	-5.3%
2011	**7.6%**	-1.1%	**8.7%**	2.2%
2012	**21.2%**	12.5%	**8.7%**	-2.2%
2013	**50.2%**	38.9%	**11.3%**	6.9%
2014	**28.1%**	17.8%	**10.2%**	9.1%
2015	**20.2%**	13.4%	**6.8%**	19.3%
2016	**7.3%**	14.3%	**-7.0%**	-3.0%
Total	**3080.3%**	**686.2%**	**2394.1%**	**4.8%**
Annualized	**15.9%**	**9.2%**	**6.7%**	**0.2%**

* All returns are adjusted to Canadian dollars
** Index is a hybrid index (S&P/TSX, S&P 500, MSCI EAFE, Russell 2000) which reflects the weight of the underlying assets
*** Variation of the US dollar compared to the Canadian dollar

Refer to Appendix B for disclosure statements on the Rochon portfolios.

The Rochon US Portfolio

The Rochon US Portfolio corresponds to the American portion of the Rochon Global Portfolio. In 2016, it realized a return of 7.5% compared to 12.0% for our benchmark, the S&P 500. The Rochon US Portfolio therefore underperformed the benchmark by 4.5%.

Since its inception in 1993, the Rochon US Portfolio has returned 2473%, or 14.8% on an annualized basis. During this same period, the S&P 500 has returned 691%, or 9.2% on an annualized basis. Our added value has therefore been 5.6% annually.

Year	Rochon US	S&P 500	+/-
1993 (Q3-Q4)	**32.7%**	5.0%	**27.7%**
1994	**9.9%**	1.3%	**8.6%**
1995	**54.8%**	37.6%	**17.2%**
1996	**27.0%**	23.0%	**4.1%**
1997	**32.9%**	33.4%	**-0.4%**
1998	**11.0%**	28.6%	**-17.6%**
1999	**15.9%**	21.0%	**-5.1%**
2000	**11.3%**	-9.1%	**20.4%**
2001	**8.1%**	-11.9%	**20.0%**
2002	**-4.4%**	-22.1%	**17.7%**
2003	**31.6%**	28.7%	**2.9%**
2004	**9.3%**	10.9%	**-1.6%**
2005	**12.5%**	4.9%	**7.5%**
2006	**3.3%**	15.8%	**-12.4%**
2007	**-1.7%**	5.5%	**-7.2%**
2008	**-24.3%**	-37.0%	**12.7%**
2009	**28.7%**	26.5%	**2.3%**
2010	**21.9%**	15.1%	**6.9%**
2011	**4.7%**	2.1%	**2.6%**
2012	**22.3%**	16.0%	**6.3%**
2013	**40.6%**	32.4%	**8.2%**
2014	**18.0%**	13.7%	**4.3%**
2015	**1.7%**	1.4%	**0.4%**
2016	**7.5%**	12.0%	**-4.5%**
Total	**2472.8%**	**690.6%**	**1782.2%**
Annualized	**14.8%**	**9.2%**	**5.6%**

Refer to Appendix B for disclosure statements on the Rochon portfolios.

For the first time since 2007, the Rochon US Portfolio underperformed its benchmark, the S&P 500. No individual holding contributed significantly to this underperformance. In fact, out of the 20 stocks in the portfolio, 14 underperformed the S&P 500. We have held the stocks in our portfolio for an average of almost seven years and the majority of them have accumulated high returns over the years (justified by their exceptional intrinsic performance). This year, the stocks of our companies as a whole, increased roughly in line with their earnings growth. It is the market indices that grew faster than the profits of their underlying companies (we will return to this in the "Owner's Earnings" section).

You will note that over 23 years, the Rochon US Portfolio underperformed the S&P 500 on seven occasions (or roughly 30% of the time). This is very much in line with our "rule of three" where we

anticipate underperforming the indices at least one year out of three on average. And such an average, if we can maintain it, is much better than that of the average fund manager.

We accept in advance that we will sometimes underperform the S&P 500 in the short term when our style and/or our companies are out of favor (and sometimes for no reason). While it is not always easy, we try to remain impervious to short-term results, both in good times and in bad.

Rochon Canada Portfolio

We introduced a portfolio that is 100% focused on Canadian equities in 2007. This corresponds to the Canadian portion of the Rochon Global Portfolio. In 2016, the Rochon Canada Portfolio returned 11.0% versus 21.1% for the S&P/TSX, therefore underperforming its index by 10.1%.

Since 2007, the Rochon Canada Portfolio has returned 378%, or 16.9% on an annualized basis. During this same period, our benchmark had a gain of 59%, or 4.7% on an annualized basis. Our annual added value is therefore 12.2%.

Year	Rochon Canada	S&P/TSX	+/-
2007	**19.7%**	9.8%	**9.9%**
2008	**-24,6%**	-33,0%	**8,4%**
2009	**28,2%**	35,1%	**-6,9%**
2010	**26.7%**	17.6%	**9.1%**
2011	**13.5%**	-8.7%	**22.2%**
2012	**24.0%**	7.2%	**16.8%**
2013	**49.4%**	13.0%	**36.4%**
2014	**20.3%**	10.6%	**9.7%**
2015	**16.0%**	-8.3%	**24.3%**
2016	**11.0%**	21.1%	**-10.1%**
Total	**377.8%**	**58.7%**	**319.1%**
Annualized	**16.9%**	**4.7%**	**12.2%**

Refer to Appendix B for disclosure statements on the Rochon portfolios.

10 Years of Returns for the Rochon Canada Portfolio

The Rochon Canada portfolio was created in early 2007. It is not a separate portfolio from the Rochon Global portfolio, but rather represents its Canadian component.

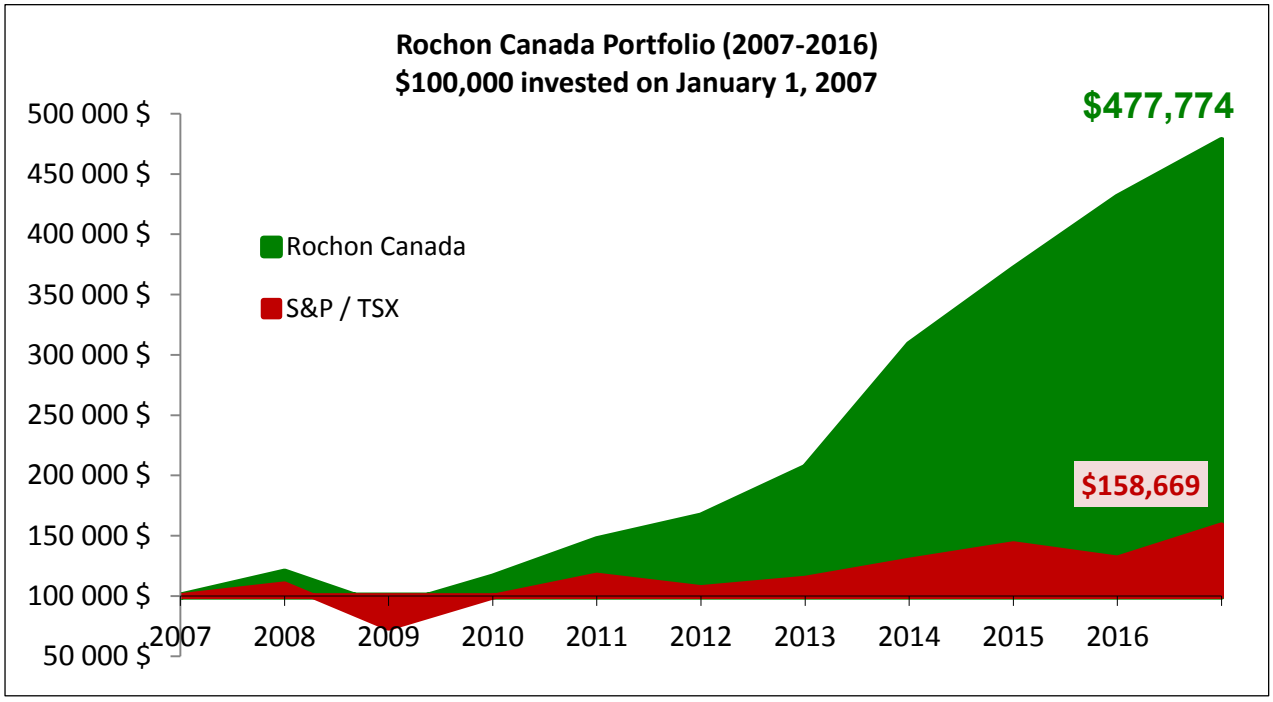
In 2006, some partners wrongly perceived us as managers specialized only in the American market and they concluded, simplistically, that we didn't know the Canadian market well. We have, however, always held Canadian equities in our portfolio. Our overarching goal is to find the best companies for our portfolio, regardless of their location. Consequently, about 80% of our companies have historically been in the US. If you objectively selected 100 North American companies at random, you would likely have about 93 American companies and seven Canadian ones. So a portfolio comprised of 80% American companies is therefore not abnormal on a statistical level. Moreover, our investment philosophy which excludes companies focused on natural resources further reduces investments candidates located in Canada.

In response to the inaccurate perception of certain partners, we therefore launched a separate measure of Canadian securities held in the Global portfolio in January of 2007. The Rochon Canada Portfolio is

therefore highly concentrated, with the vast majority of the portfolio invested in three stocks: MTY Food Group, Constellation Software and Dollarama.

Such a concentrated portfolio results in two consequences. First, it is an insufficient number of holdings to be considered a sufficiently diversified portfolio. Second, the correlation with the Canadian benchmark (the S&P/TSX) is essentially nonexistent, so the stock market performance of this portfolio will always be very different from that of its benchmark.

It's time for a post-mortem after a decade of returns. Here is a chart illustrating the performance of the Rochon Canada Portfolio versus its benchmark, the S&P/TSX:



Refer to Appendix B for disclosure statements on the Rochon portfolios.

Over 10 years, the performance of our Canadian securities has been significantly higher than that of the S&P/TSX and even higher than that of our US stocks. A concentrated portfolio can drastically exceed the performance of the indices but the risks inherent to high concentration is not appropriate for a portfolio that is to be managed prudently. In fact, we consider that a portfolio of about 20 securities is the right balance between having a minimum diversification level to reduce company-specific risk while also having few enough companies to improve the odds of beating the market indices. Since this portfolio represents only a portion (approximately 15%) of the Rochon Global Portfolio, our diversification requirements are met.

The Canadian portfolio has, however, achieved the original objective of invalidating the idea that we were exclusively "American managers".

I would like to add that the three most significant Canadian companies we own in this portfolio are of the utmost quality and all have one thing in common: they are led by exceptional CEOs.

2016

There are three periods that can sum up the year 2016. The beginning of the year was marked by a stock market correction of 13%. After the recovery that followed, the stock market was confronted by the Brexit vote in June (the vote by the United Kingdom to leave the Eurozone) and another stock market correction occurred followed quickly by another rebound in stock prices.

The last stage of the year started on November 8, when the United States elected a new president. Taking all the "experts" by surprise, the stock market rose dramatically in the days following the election. By the end of the year, the S&P 500 generated a return of 12% (including dividends). We have repeatedly stated that the stock market is unpredictable over the short term and the market did everything in 2016 to prove us right.

The Canadian market did even better than its US counterpart in 2016, with the TSX increasing by 21% (including dividends). But it should be pointed out that the TSX made up what it had lost during the previous year. Over the past two years, the TSX has achieved a total return of 11% versus 14% for the S&P 500 (without currency effect).

Looking at economic fundamentals, the profits of American companies stagnated in 2016 for the second year in a row. Several causes explain this stagnation of profits on a global scale and we see this economic sluggishness as temporary. As we wrote in our first quarterly letter, we believe that corporate earnings power in the US is higher than what 2016 suggests.

A longer-term horizon provides more perspective on the profit growth of the companies in the S&P 500. Since I started in 1993, the companies comprising the S&P 500 have increased their profits by 450%, which is equivalent to an annual growth rate of 7.3%. The stock market rose from 423 at the end of 1992 to 2239 at the end of 2016, which is an increase of 429% or 7.2% annually. In the long run, there is a direct correlation between the performance of the stock market and the performance of the underlying companies. If dividends are included, the annual return of the S&P 500 has been over 9% per year since 1993.

Imagine everything that has happened since 1993 (when the Internet was still in its infancy). There were two recessions, six US elections (with three Democratic terms and three Republican terms). There have been wars, economic and political crises, horrendous terrorist attacks and worries of all sorts (remember the "Y2K bug" or concerns about the "US debt ceiling" and the "fiscal cliff" of 2012?) Yet, markets did well for the simple reason that all of the companies that make up the index did well. This was achieved despite all the crises and calamities that plagued our civilization. DESPITE is the key word in this sentence.

It was ten years ago…

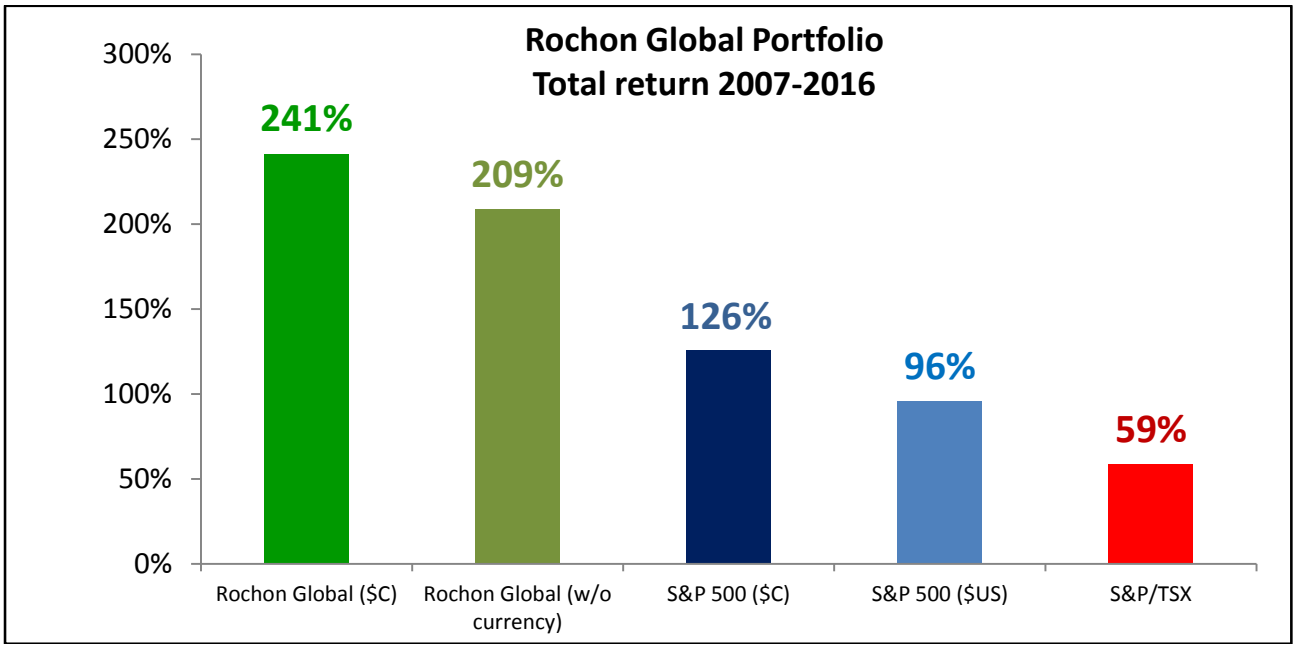
Giverny Capital went through a difficult time in 2006-2007, when we underperformed the indices for two years in a row. In fact, the only sectors that "worked" at the time were those related to natural resources (with oil leading the way). As you know, we have always avoided these types of companies because we believe that it is extremely difficult to have a competitive advantage in these types of industries.

In addition, the dizzying rise of the Canadian dollar at that time also contributed to our weak short-term results. Many investors and "experts" predicted a bleak future for the United States and its currency at

the time. China, Europe (and the Euro) and Canada (and its dollar) were popular with investors around the world.

We stayed the course of our investment philosophy even though we were under a certain (very certain) pressure from several partners to "invest in what worked". We had a similar situation in 1999 when the only sector that buoyed the stock market was technology. With the stock market, you have to be able to do nothing when almost everyone else wants to do something at the same time! We knew then that our philosophy of selecting high quality companies was sound and we also believed that the Canadian dollar trading at par with its US counterpart made no sense. Patience was therefore the key, as we wrote at the time.

This patience proved rewarding for us and our partners. Here is a chart that shows the performance of the Rochon Global portfolio (with and without currency effect) compared to the S&P 500 (with and without currency effect) and the S&P/TSX for the 10-year period beginning January 1, 2007:



Refer to Appendix B for disclosure statements on the Rochon portfolios.

The S&P/TSX achieved a return of only 59% over 10 years, or 4.7% on an annualized basis compared to 126% for the S&P 500 (8.5% annualized) and 241% for the Rochon Global Portfolio, or 13.1% on an annualized basis.

How did the European market fare over this same period? The MSCI Europe Index returned approximately 27%, or 2.4% annualized (in Canadian dollars). Finally, the SSE Index of the Shanghai Stock Exchange achieved only 13% in total over ten years (excluding dividends). And what about the price of oil? It is lower today than it was in early 2007. As is so often the case, following the herd in the financial markets is rarely a winning strategy.

Owner's Earnings

At Giverny Capital, we do not evaluate the quality of an investment by the short-term fluctuations in its stock price. Our wiring is such that we consider ourselves owners of the companies in which we invest. Consequently, we study the growth in earnings of our companies and their long-term outlook.

Since 1996, we have presented a chart depicting the growth in the intrinsic value of our companies using a measurement developed by Warren Buffett: "owner's earnings". We arrive at our estimate of the increase in intrinsic value of our companies by adding the growth in earnings per share (EPS) and the average dividend yield of the portfolio. We believe that analysis is not exactly precise but approximately correct. In the non-scientific world of the stock market, we believe in the old saying: "It is better to be roughly right than precisely wrong."

This year, the intrinsic value of our companies, as a whole, rose by about 9% (8% from the growth in earnings and 1% from the average dividend). Despite some of the changes to our portfolio during the year, we consider the estimate of the EPS growth at our companies during 2016 to adequately reflect their economic reality. The market value of our portfolio increased by roughly 10% (without any currency effect). It was therefore the fourth year (out of 21) where the market performance of our holdings followed closely their intrinsic performance.

The companies in the S&P 500, however, experienced a second consecutive year of weak earnings growth. Still, the index performed better than what can be justified by its fundamentals. So the S&P 500 seems to already reflect a significant improvement in earnings growth for 2017.

	Rochon Global Portfolio			S&P 500		
Year ***	Value *	Market **	Difference	Value *	Market **	Difference
1996	14%	29%	15%	13%	23%	10%
1997	17%	35%	18%	11%	33%	22%
1998	11%	12%	1%	-1%	29%	30%
1999	16%	12%	-4%	17%	21%	4%
2000	19%	10%	-9%	9%	-9%	-18%
2001	-9%	10%	19%	-18%	-12%	6%
2002	19%	-2%	-21%	11%	-22%	-33%
2003	31%	34%	3%	15%	29%	14%
2004	21%	8%	-12%	21%	11%	-10%
2005	14%	15%	0%	13%	5%	-8%
2006	14%	3%	-11%	15%	16%	1%
2007	10%	0%	-10%	-4%	5%	9%
2008	-3%	-22%	-19%	-30%	-37%	-7%
2009	0%	28%	28%	3%	26%	23%
2010	22%	22%	0%	45%	15%	-30%
2011	17%	6%	-11%	17%	2%	-15%
2012	19%	23%	4%	7%	16%	9%
2013	16%	42%	26%	9%	32%	23%
2014	13%	19%	6%	9%	14%	5%
2015	11%	4%	-7%	1%	1%	0%
2016	9%	10%	1%	3%	12%	9%
Total	1210%	1266%	55%	309%	436%	127%
Annualized	13.0%	13.3%	0.2%	6.9%	8.3%	1.4%

* Estimated growth in earnings plus dividend yield
** Market performance, inclusive of dividends (refer to Appendix B for disclosure statements on our returns)
*** Results estimated without currency effects

For the last 21 years, our companies have grown their value by about 1210% and their stocks have achieved a total return of approximately 1266%. On an annualized basis, our companies achieved an

intrinsic return of 13.0% versus 13.3% for their stock market performance (dividend included in both cases). The correlation between the two figures over a long period is not accidental since the stock market always reflects the fair value of companies in the long run.

Our stocks have outperformed the S&P 500 by 5% annually over the last 21 years for the simple reason that our companies grew their intrinsic values at a rate that was 5% greater than that of the group of companies that make up the S&P 500.

The Flavor of the Day for 2016

Every year, we present to you what we consider the "flavor of the day" in the financial world. In our opinion, the top prize for 2016 goes to index funds.

It's not a coincidence if you have a feeling of *déjà vu*, since we proclaimed index funds as our "flavor of the day" in our 1998 annual letter. At the time, several investors, both institutional and private, had abdicated from active management and moved towards passive investing. The S&P 500 was then perceived by many investors as "unbeatable" and, as always, the trend of the day eventually subsided. The period from 1999 to 2002 was our best relative period to date, with the Rochon Global portfolio achieving a total return of +46% versus -22% for the S&P 500 over those four years.

At the risk of repeating what I wrote 18 years ago, the basic principle behind the purchase of index funds is perfectly legitimate. Indeed, the vast majority of portfolio managers do not beat their benchmarks so therefore an investment approach that favors investing in all the holdings making up market indices makes a lot of sense for those who do not know how to choose superior companies or managers capable of creating value. Obviously, I would be remiss if I did not point out that because our primary mission is to do better than the indices, which we have done since 1993, we are therefore in favor of an active (and assiduous) stock selection process.

The problem with passive management is that it is not really "passive" for the vast majority of its followers. First, several investors act like weathervanes with the market by buying after good years and selling after bad ones. Indexing will not solve anything for these part-time market players. Second, even those who are always present with the stock market tend to change styles, index fund types, or managers according to what's most in favor. Basically, they tend to sell funds that have underperformed in the short term to buy those that have done well more recently.

It is therefore not surprising that when passive management has done well relative to active management for a few years, investors tend to favor the former. Further, moving out of active management towards passive management, when carried out on a large scale, continues to fuel the divergence between the two approaches. The larger stocks within the indices, now more in demand, continue to increase making active management seems even less effective.

The best parameter to illustrate how passive management can be unsuccessful is the average turnover rate of exchange traded funds (ETFs), which is 880% per year[1]. In other words, average "passive" investors hold their ETFs only about 47 days! It's even worse with the SPY index fund (linked to the S&P 500), with an average holding period of around 12 days, or an annual turnover rate of around 3,000%. This compares with an average turnover rate of 120% for stocks in general. Just to give you an order of magnitude for the purpose of comparison, the turnover rate of our model portfolio is around 14%, which means that we keep our stocks on average for about 2,500 days at Giverny Capital!

[1] Source: Financial Times: *Jack Bogle: the lessons we must take from ETFs* (December 11, 2016)

High turnover leads to lower returns (the second principle of thermodynamics applied to the stock market). For example, the SPY index fund has achieved an annual return of 6.9% over the last decade. Yet, the holders of this fund, as a whole, only achieved an annual return of 3.5%[2]. Half of the return has literally "evaporated" into transactional activities.

Of course, Wall Street is always on the lookout for what is popular (and sources of income from issuing shares and trading), and has benefited from the passive investing windfall: there are now more than 6000 different ETFs (Exchange Traded Funds) compared to 1000 a decade ago. The large amount of choice and ease of transaction inherent to ETFs make their owners even more irrational.

In short, whether it is "robots" or passive funds, the problem is not the financial product but rather the self-destructive behavior of investors. By their impatience and willy-nilly behavior, investors are often paradoxically the cause of their own underperformance.

At Giverny Capital, we believe that a cautious selection of securities with a clear long-term horizon will eventually generate higher than average returns. We've met this goal so far.

Five-year Post-mortem: 2011

Like we do every year, we go through a five-year post-mortem analysis. We believe that studying our decisions in a systematic manner, and with the benefit of hindsight, enables us to learn from both our achievements and our errors.

We acquired shares in Google (now Alphabet) in May 2011 when the stock was particularly attractive to us. Since then, the stock has risen by almost 195% versus 65% for the S&P 500. We also made other transactions in the fall of 2011 during the stock market correction of that time. We first sold securities with a more limited appreciation potential to increase our stake in Berkshire Hathaway and Wells Fargo, which we considered quite undervalued. These two stocks rose by approximately 130% versus 100% for the S&P 500 (without dividend) from the end of September 2011 to the end of 2016.

Unfortunately, we didn't have clairvoyance for all of our portfolio holdings in the fall of 2011. If we had instead increased our holdings in Bank of the Ozarks and/or O'Reilly Automotive instead of increasing our ownership in Wells Fargo, the result would have been considerably better. Shares of Bank of the Ozarks increased by 420% from the end of September 2011 to the end of 2016, while O'Reilly more than quadrupled over the same period.

Revisiting a prediction from 2011

Wall Street strategists have understood something for a long time: the key to predictions is to make them often. As you might have guessed, a strong marketing team is then in charge of flying balloons for those predictions that have proven to come true. We take the opposite approach at Giverny Capital by rarely making predictions and evaluating our prediction regardless of their outcome.

I wrote a column in the Montreal Gazette with a rare prediction on August 30, 2011[3]. The market experienced a crisis between August and October of that year and the equities tumbled 19% from their high of March 2011 (quick quiz: what was one of the main causes of this panic?). I then publicly

[2] Source: Morningstar; www.seeitmarket.com; Credit Suisse

[3] You can find this article on our website, under the "In the News" section.

predicted that within five years (in 2016), the Dow Jones would climb to 17,000 points compared to 11,280 when I wrote the column.

I repeated this prediction in our 2011 annual letter and I promised to come back to you regarding this prediction in 2016. Keeping to my word, five years to the day, on August 30, 2016, the Dow Jones was at 18,454. And that was before the "post-election" stock market rally of November.

We remain highly skeptical about stock market predictions. Yet, when we make them, it is within the scope of a very long time horizon and when the margin of error seems very wide.

Quiz Answer: On August 8, 2011, the Dow Jones declined 635 points to 10,809 as a result of the decision by Standard & Poors to lower the credit rating of US debt from AAA to AA+. This news was in conjunction with the significant problems with government debt in Europe, with Greece at the top of the list.

Our Companies

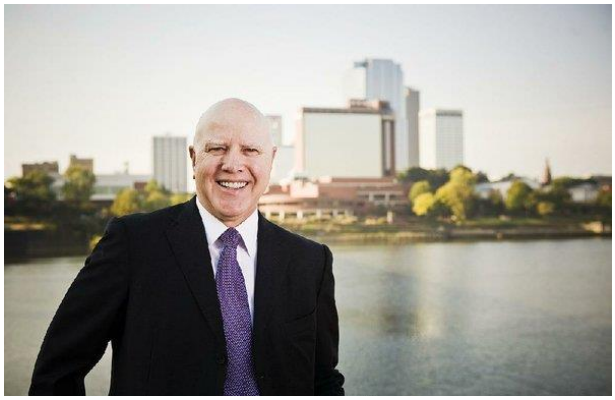
"Money is made by sitting, not trading."

Jesse Livermore

Bank of the Ozarks (OZRK, $53): 10 years in our portfolio

We've now owned shares in Bank of the Ozarks for more than 10 years. The bank, located in Little Rock, Arkansas, was often listed as the top bank in American Banker magazine for its return on assets (among all small banks in the US). Since I had never heard of this company before (and had no idea that the Ozarks is a region of northern Arkansas), I decided to go and meet with the bank's management in November 2006.

President George Gleason greeted me with twenty or so vice presidents in the boardroom of the bank's headquarters in Little Rock (his daughter even picked me up at the airport). Mr. Gleason explained the culture of Bank of the Ozarks to me and its history. What struck me most was that he seemed to know almost every loan on the bank's books.



George Gleason *Source: Democrat Gazette*

We then went to visit several local branches and he showed me some of the buildings that the bank had financed. While the major US banks were adopting complex lending strategies and muddling their balance sheets with esoteric derivatives at the time, Bank of the Ozarks kept its traditional approach to banking. There also was no real estate speculation in Little Rock, with the average price of a house in 2006 coming in at a whopping $130,000.

We decided to buy shares in the bank upon my return to Montreal, when the stock traded at $8 (adjusted for splits). The company earned $0.48 per share in 2006 so its P/E multiple was 17 times. Never would I have thought of paying such a rich ratio for a bank but Bank of the Ozarks was no ordinary bank!



Source: BigCharts.com

As you can see from the chart above, we were not immediately rewarded with this investment. During the 2008 crisis, the stock fell by 50% when all bank stocks were tarred with the same brush. We knew that the bank was very prudently managed and we kept the course.

After four years of stagnation, the stock began to climb and we made about seven times our money in 10 years. The reason for this performance is simple: EPS increased from $0.48 in 2006 to $ 2.62 in 2016, or an annualized growth rate of 18%. To my knowledge, no bank in the United States has achieved such a growth rate during this extremely difficult period for the banking sector. The bank's efficiency ratio (under 36%) is nearly unparalleled and its return on assets (around 1.9%) still ranks among the best. Its bad debt ratio is one of the lowest in the industry.

We have George Gleason to thank for this phenomenal performance. He's visited us twice in Montreal over the years and we were able to properly welcome him to Quebec, with smoked meat, poutine and *pouding chômeur*.

The growth prospects for Bank of the Ozarks' look solid and the valuation of its stock seems reasonable.

Alphabet Inc. (GOOG, $772)

Alphabet (formerly Google) had an excellent year in 2016. Revenues grew by 21% and adjusted EPS rose by 18%. We include stock options expenses to arrive at our profit estimates for Alphabet, unlike many Wall Street analysts who often like to present figures excluding them.

We have been Google shareholders since 2011 and, in our opinion, the company has an extremely strong competitive advantage. The verb "google" has even entered our vocabulary for searching the Internet and visiting google.com has become a reflex of our thought process.

The idea came to us thanks to Charlie Munger, the longtime partner of Warren Buffett. Mr. Munger explained at a conference that many companies that historically had wide competitive moats had seen their moats "filled up with sand" (an analogy meaning that their competitive advantage was deteriorating). I then asked him if he saw new companies with a wide moat and, after reflection, he replied Google. His comments did not fall on deaf ears and Jean-Philippe and I started looking at the company from a whole new perspective.

We were able to buy the stock at very good prices in 2011 when Wall Street was fearful of the company's transition of its users from PCs to mobile devices. There was a readjustment of profit margins when Google migrated to mobile applications but this transition was a success. Earnings have grown by 12% on an annualized basis since 2011 and the stock has more than tripled since our purchase.

The stock is currently trading at about 24 times its expected profits for 2017. This is a justified valuation, in our opinion, given the high quality of the competitive advantages of Google's wide range of producing assets.

AMETEK (AME, $49)

AMETEK has two divisions. The electronic instruments segment produces instruments for monitoring, measuring, testing, calibrating, displaying, etc. for the aeronautics, energy and various industrial markets. The electromechanical division produces interconnection equipment, motors, motion control systems and thermal management systems.

It was a tough year for Ametek, with revenues decreasing by 3% and EPS falling by 9%. Sales from the energy sector had another difficult year. The company continued to make acquisitions (five in 2016) and developed a number of new products.

The company expects a return to growth in 2017.

Berkshire Hathaway (BRK.B, $163)

We estimate that Berkshire achieved an 11% increase in its intrinsic value, so it was another great year for the conglomerate led by Warren Buffett. Although some divisions experienced a decline in profitability (such as BNSF), Berkshire nevertheless slightly increased its operating profits.

Mr. Buffett and his two assistant investment managers (Ted and Todd) deployed several billion dollars in the purchase of stocks, with approximately $20 billion invested after the US election.

We believe that Berkshire's growth outlook remains above average.

Carmax (KMX, $64)

We have been shareholders in Carmax since 2007. Carmax has revolutionized the used car retail industry and its *raison d'être* is simple: to bring integrity to the world of second-hand cars by being honest and transparent in every transaction. Its brand has become synonymous with a good warranty

and reliability in an industry where consumers previously had very little recourse. The company now operates 169 megastores and has a market share of over 3%.

A friend of ours who's a portfolio manager told us that he went to Carmax to sell his car stipulating that he wanted to be out of there in 10 minutes. He had his check in hand within that time! Carmax had a good year, albeit slightly below our expectations. After the first three quarters, revenues were up 3% and EPS rose 6%. The company opened 15 new stores in 2016 and is planning a similar opening in 2017.

The stock has been volatile in recent months, dropping from a high of $74 in 2015 to less than $45 in early 2016. We took the opportunity to increase our investment and the stock subsequently bounced back to finish the year at $64. We believe that the market valuation of Carmax's shares does not adequately reflect the company's excellent long-term growth prospects.

Constellation Software (CSU-T, $610)

Our Toronto-based software company had another good year, with revenues growing by over 15%. The majority of this growth was attributable to acquisitions and organic revenues, on the other hand, grew by 2%. The company has a significant share of its revenues from maintenance activities, which had organic growth of 4% in 2016. Constellation spent approximately $175 million on acquisitions, compared to $235 million in 2015. EPS in US dollars grew by 6% and we expect growth of around 15% for 2017.

Mark Leonard continues to be an exceptional CEO, though he is extremely low-key and discreet in today's world of flashy corporate CEOs. We are very pleased to be associated with him.

Walt Disney (DIS, $104)

It was a tough year for Disney. For its fiscal year ended September 30, revenues increased by 6% and EPS by 11%. But if we look at the same figures for a calendar year (January to December), EPS increased only by about 2%.

The television revenue division experienced a 1% decline in profitability (with -13% in the September quarter and -11% in the first quarter of 2017). The primary cause was the decline in profitability of the sports channel ESPN, with the increase in licensing costs (including the NFL) and a decline in subscribers and advertising revenue the primary culprits. Worried about this trend, we met last summer with the person who (in our opinion) knows the most about the history of the media industry in the United States. According to him, the situation at ESPN, although far from catastrophic, could be improved but with difficulty. So it is quite possible that Disney and its shareholders will have to accept that this great division could become less and less an important source of profits.

Now let's talk about the good news. The film division experienced a spectacular year with operating profits rising 37%. The movie *Star Wars: The Force Awakens* was a huge success. Three other Disney movies reached the billion dollar mark: *Finding Dory, Captain America: Civil War and Zootopia.*

Finally, the company opened its new theme park in Shanghai and the resort division increased its profits by 9%.

Bob Iger, the fabulous CEO of Disney, is confident that the next few years will be better. We share in his optimism and we expect EPS growth of 9% in 2017. We believe that the core of Disney remains the

production of family-friendly films and this source of revenue, along with amusement parks, will become the primary source of profitability for Disney and offset the gradual decline in television profits.

Dollarama (DOL-T, $98)

We have been shareholders of Dollarama for almost seven years now. We temper our expectations every year and see the company exceed our expectations every year. After three quarters, sales increased by 12% and same-store sales grew by nearly 6%. EPS rose by 22%, helped by a repurchase of approximately 7% of the company's shares outstanding.

On the first of May of last year, Larry Rossy transferred his position as President and Chief Executive Officer to his son Neil, while continuing to serve as Chairman of the Board. Neil (46 years old) has worked at the company since 1992 when the company opened its first stores, and served as Chief Marketing Officer and Member of the Board of Directors since 2004. We believe that the company's culture is part of its DNA (literally and figuratively) and we thank Larry Rossy for his extraordinary work over the last few decades. The partners of Giverny Capital are wealthier thanks to him. We would retire the number on his jersey if he had one.

Fortune Brands Home & Services (FBHS, $54)

Fortune Brands Home & Services operates four manufacturing divisions for the home: cabinets (kitchen and bathroom), plumbing (mainly the Moen brand), doors and security products (padlocks).

FBHS had another excellent year, with sales growing by 9% and EPS increasing by 33%. The company realized a significant improvement in its operating margins and also repurchased approximately 4% of its shares outstanding. We believe that the prospect for earnings growth remains solid and that the stock's valuation is reasonable.

Heico (HEI.A, $68)

We acquired a stake in this Florida-based company over the course of the year. Heico has two manufacturing divisions: equipment for the aviation industry and an electronics group.

The first division is the one that caught our attention. Heico sells alternative aircraft equipment (non-OEM) to aviation companies. The difficulty in obtaining approval from the Federal Aviation Administration (FAA) for these aircraft parts, along with extensive catalog of parts available from the company that was built over several years, provide a very significant competitive advantage for Heico.

Revenues rose 16% and EPS climbed 17% in 2016. EPS has grown by about 19% annually over the last decade—an exceptional performance.

LKQ Corp (LKQ, $31)

LKQ specializes in the distribution of "alternative" car parts, meaning either original or refurbished auto parts, as well specialized accessories primarily for the auto repair market. Basically, the company offer products equivalent to original auto parts at lower costs.

This Chicago-based business had another good year and continued its expansion plan in Europe with a major acquisition in Italy. The company now generates about a third of its revenues from overseas. It also made a sizable acquisition in the United States when it bought Pittsburgh Glass Works (PGW). The

latter specializes, among other things, in the windshield market. LKQ subsequently resold the OEM (Original Equipment Manufacturer) portion of PGW's operations.

Sales increased 19% in 2016 (nearly 5% organically). EPS grew by 21% to $1.80 (13% to $1.69 excluding PGW's discontinued operations). It's worth noting that the company was slightly affected by the decline of the British Pound in its British division (decreasing EPS by approximately of $0.05).

The potential for LKQ increasing its profitability in future years is high, especially if the company fully succeeds in its plan to become as dominant in Europe as in the United States. The company has done an excellent job of consolidating this fragmented industry.

M&T Bank (MTB, $156)

Buffalo-based M&T Bank didn't meet our expectations in 2016. Adjusted EPS increased by 4% and return on assets declined slightly from 1.18% to 1.14%. Still, we believe that several projects bode well for the bank over the next few years. First, the integration of Hudson City Bancorp should help improve operating margins. Also, the new US banking regulatory policy is expected to be very positive for M&T (which has invested enormous resources in recent years in this activity). Finally, a rise in interest rates should help improve its interest income margins.

We therefore expect a 14% increase in EPS in 2017.

Markel Corporation (MKL, $905)

Markel had a good year 2016, but not as good as 2015. While the underwriting ratio of its insurance divisions increased from 89% to 92% (a lower rate is better), this Richmond (Virginia) company remains very profitable.

Book value climbed from $561 to $606 in 2016, or an increase of only 8%. We believe that the company can maintain an increase of about 12% annually over the long term. We have great admiration for Markel's co-CEO, Tom Gayner, and are very pleased to be long-term partners with him.

Mohawk Industries (MHK, $200)

We have owned shares of Mohawk, a floor covering company, since 2007. The Calhoun (Georgia) company had an exceptional year in 2016, with revenues increasing 11% (reaching $ 9 billion) and adjusted EPS rising 24%. Jeff Lorberbaum is a high-caliber CEO and we trust his management style which masterfully combines dynamism and prudence.

MTY Food Group (MTY-T, $51)

MTY Food franchises chain restaurants of all kinds, primarily located in shopping centers. We have been shareholders of MTY Food since 2007 and have great confidence in the qualities of its CEO, Stanley Ma. We believe him to be one of Canada's top executives.

2016 was a very busy year for MTY Food. At the end of May, MTY announced the acquisition of Kahala Brands for approximately US$ 300 million. Kahala is located in Scottsdale, Arizona, and franchises and operates approximately 2,800 locations under 18 brands in 25 countries. This acquisition represented an important milestone for MTY as it solidified its presence in the United States which will become one of the primary avenues for growth for the company, both for the brands already operating

in the United States as well as for other MTY brands. This Montreal company now has a portfolio of approximately 5500 locations under 57 brands.

The company thus increased its revenues from $145 million to $ 196 million in 2016. We estimate its adjusted EPS to be approximately $2.36, or an increase of 27% from 2015.

Since becoming shareholders, EPS has more than quadrupled (an annualized growth rate of 18%) and we believe the company continues to have exceptional future prospects and we are happy to keep our shares.

O'Reilly Automotive (ORLY, $278)

We have been O'Reilly's shareholders since 2004. The Springfield (Missouri) company consistently defies our most optimistic expectations and this was again the case in 2016. Revenues rose 8%, driven by excellent organic growth of 4.8%. EPS grew by 17% to $10.73—representing the eighth consecutive year that O'Reilly increases its EPS by more than 15%.

Our only regret is that we reduced our portfolio allocation to this stock over the years when its valuation seemed too high. But such a valuation is greatly deserved.

Union Pacific (UNP, $104)

Union Pacific had a tough year in 2016. Revenues dropped by 9% and EPS declined by 8%. The good news is that the fourth quarter showed a return to growth (EPS grew by 6%). We believe that the downturn in its business in 2016 is cyclical in nature and that its strong competitive advantages remain intact. Along with BNSF (owned by Berkshire Hathaway), Union Pacific continues to dominate the rail transportation market in the western United States.

Union Pacific's growth prospects for 2017 are better and we expect a return to increased profitability. The stock market has already anticipated this turnaround (the stock rose 33% in 2016) but we believe that the company's solid long-term outlook justifies its current price.

Visa (V, $78)

We bought shares in Visa back in 2010 when Senator Richard Dubin led a legislative overhaul of the fees charged by credit card companies. We believed then that the effects on Visa would be benign and temporary. The fears on Wall Street allowed us to buy shares of this dominant company at an excellent price.

2016 was a transitional year for Visa, following the major acquisition of its European activities. EPS growth was still 12% in 2016. We expect even better growth in 2017. Visa's stock price has increased fivefold since our purchase in the summer of 2010.

Wells Fargo (WFC, $55)

It was a tough year for Wells Fargo. Last September, the company revealed an unacceptable practice in its ranks: bank advisors were opening accounts for customers for the sole purpose of meeting their sales objectives (and getting bonuses that went along with it). Management fired the guilty parties, paid a fine and resolved to put in place a new formula for compensation. Approximately 5% of the accounts in question had fees and were reimbursed to customers (for a total of $2.6 million).

CEO John Stumpf faced the music and has done everything to restore WFC's prestigious reputation in the banking world. Ultimately, Mr. Stumpf decided to take a big part of the blame by announcing his retirement on October 12th.

For the year, revenues grew by 3%, with loans rising by 7% and deposits by 5%. The company succeeded in maintaining its customer base despite its challenges. Adjusted EPS decreased slightly by around 2%.

The new US administration plans to significantly reduce bank regulation. This, along with a reduction in the corporate tax rate and a possible rise in interest rates, greatly improves the profitability prospects for US banks, including Wells Fargo. We believe that the worst is behind for Wells Fargo and that the next few years bode well.

The Podium of Errors

"I like people admitting they were complete stupid horses' asses. I know I'll perform better if I rub my nose in my mistakes. This is a wonderful trick to learn."

Charlie Munger

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2016 (or from past years). It is with a constructive attitude, in order to always improve as investors, that we provide this detailed analysis.

As is often the case with stocks, errors from omission (non-purchases) are often more costly than errors from commission (purchases)… even if we don't see those on our statements.

However, the first error for this year fell into the second category.

Bronze Medal: Valeant Pharmaceuticals

We discussed the sale of our shares in Valeant at the beginning of 2016 in great detail in our 2015 annual letter. We also answered a large number of questions about this investment during the annual evenings with our partners. I have nevertheless decided to return to this error and close this chapter by awarding it a medal.

We acquired our first shares in Valeant in 2011 at approximately US$45. At the time, the pharmaceutical company had a fairly simple business model and few of its products had patent protection (and therefore wasn't subject to generic competition). The acquisition of Bausch & Lomb in early 2013 further strengthened our enthusiasm and this company, which we have known for a long time, seemed of the highest quality and with stable and recurring revenues.

We knew that Valeant had aggressive accounting and a higher level of debt than the typical companies in which we invest. So it was not consistent with our usual type of investment. We still decided to invest in the company because of our confidence in its CEO Michael Pearson. We believed that he had a solid plan to improve the profitability of the numerous pharmaceutical companies that Valeant was acquiring. The industry needed (and still needs, in our opinion) to refocus on better returns on capital and Mr. Pearson had a credible plan to make this shift at Valeant.

Realizing that Valeant was more risky than our usual investments, we decided to manage this investment risk by initially allocating a 3% weight to this position and more importantly, limiting the maximum weight in the portfolio to 5% regardless of appreciation in the company's shares or how good its financial results were.

In early 2015, a few months after a failed takeover bid for Allergan, Valeant completed the major $15 billion acquisition of Salix Pharmaceuticals. This acquisition doubled the level of debt for Valeant. Salix had obtained approval from the FDA for a drug that had the potential to become a blockbuster. Valeant also made a smaller acquisition that proved to be a mistake: Marathon Pharmaceuticals. The company then acquired drugs that, according to management, had prices that could be increased drastically. The contribution of these drugs was minor to Valeant's overall operations (about 3-4% of revenues) but the consequence of the sharp rise in prices on the company's image was catastrophic. For a slim financial benefit, the company significantly tarnished its reputation. There is a social dimension to the price of drugs that needs to be considered. The company, and us in parallel, very poorly assessed the impact of rising drug prices on Valeant's image and reputation.

On two occasions, in 2013 and in 2015, we sold Valeant shares as the stock exceeded the 5% limit we had set. In March 2016, the company greatly reduced its profitability estimates for the current year (and therefore the debt-to-profit ratio increased to a worrying level), and we decided that the stock had become too risky for us and sold everything at about US$52. If we include the two sales of the stock over the years and the gains in the US currency, the overall result is that we achieved a return of approximately 190% in five years in Canadian currency. Even without the currency gain, we more than doubled our investment in less than 5 years.

Regardless, this was an important mistake on our part. Our confidence in the CEO was, in retrospect, a serious misjudgment of the person and his leadership qualities. Clearly, under pressure to maintain a high rate of growth, deleterious decisions were made. This was coupled with a significant increase in indebtedness.

It may seem surprising to list as a mistake an investment decision that resulted in doubling our money in five years. We have often stated that the stock selection process is more important than the result. A very important part of our process, the judgment of the qualities of management, proved to be wrong in this case.

Silver Medal: Alimentation Couche-Tard

*** *Warning: some of the following statements may be offensive to readers* ***

I have followed Alimentation Couche-Tard since my very beginnings in 1993. The history of the convenience store industry in Quebec is complex and I will try to sum it up. For years, laws in Quebec prevented major food chains (such as Steinberg and Provigo) from opening in the evenings and Sundays. The convenience stores stepped in to provide a retail option during hours not covered by the grocery stores. This legislation was repealed in the early 1990s and many predicted the almost end of convenience stores. As the big players left the industry, Alimentation Couche-Tard took advantage of this to slowly consolidate the Canadian market.

I've never been a big fan of part of Couche-Tard's operations: gas retail. This activity is hyper competitive and, in my opinion, lacks any competitive advantage. Despite my skepticism, Couche-Tard

did a remarkable job and achieved solid profitability and the stock rose by about 2000% from 1993 to 2003.

In 2003, the company made a major acquisition in the United States when it bought Circle K. Fascinated by this incursion south of our border, I went to listen to the CEO, Alain Bouchard, at the annual meeting in early 2004. I was very impressed by Mr. Bouchard and decided to buy a small stake in Couche-Tard to better follow the company.

About a year later, I decided to sell our shares for a very simplistic reason: I did not like the way financial results were presented (it is a bit complex to go into details in this letter). Needless to say, it was a stupendous mistake.

I continued to monitor Couche-Tard's progress in the United States and subsequently in Norway. Since 2005, the stock has climbed by nearly 1000%. In 23 years, the stock has multiplied by more than 200 times. You read that correctly… there is not one zero too many.

Mr. Bouchard has certainly been the maestro of this phenomenal performance for over two decades. An autobiography was published this year and I strongly recommend reading it.

This omission mistake has been haunting me for more than 20 years. Although, our return has been satisfactory since 1993, they could have been even better if I had translated my admiration for M. Bouchard into a sizable investment.

Gold Medal: Mohawk Industries (in 2008)

After the majestic silver medal, you may be wondering how I could have possibly done worse for the gold medal. In my defense, Couche-Tard did not perfectly fit our investment philosophy. But this is sadly not the case for this next company.

Our current investment in Mohawk Industries had exceptional results in 2016 which highlighted an error that occurred approximately eight years ago.

I discovered Mohawk when I read an article by Peter Lynch in the magazine *Worth*. He talked about the company in very good terms, comparing it with Shaw Industries. Shaw is a leading company in the carpet manufacturing industry and is the main competitor to Mohawk. I already knew Shaw well enough, as Mr. Lynch had discussed it in the book *Beating the Street* published in 1992 (which I must have read ten times in my youth).

In 1998, I wrote a complimentary article on Shaw Industries in *Le Journal Les Affaires*. A few months later, the company was acquired by Berkshire Hathaway. I then focused on its main competitor, Mohawk. The company, initially focused on carpet manufacturing, has diversified into various forms of floor covering (ceramic tiles, vinyl, laminate flooring, etc.). By studying Mohawk in more detail, I realized the exceptional qualities of its CEO, Jeff Lorberbaum. Along with Shaw, Mohawk has come to dominate the flooring industry (each with about a 22% market share).

In 2007, when the housing market was already in a deep recession, Mohawk's share declined from $102 to $75 and we took the opportunity to buy shares in the company. Today, the stock is trading at $226. We therefore realized a gain of approximately 200% or 12% annualized (before currency gains), representing a 5% annual increase over the S&P 500 over the same period.

But we could have made a much higher return. First my conviction in Mohawk and its president was not reflected in the small allocation of this stock in our portfolio (about 2%). But worse still, the stock fell sharply in the fall of 2008 during the financial crisis to hit a low of $24 (even at $17 for a brief moment). At our annual meeting that year, in November 2008, a partner from Giverny asked whether Mohawk was a bargain at this price. I replied: "as the company earned more than $7 per share before the crisis, and I believe that in the next cycle it will earn at least that much, so yes the stock looks extremely attractive." Unfortunately, I did not convert these beautiful words into dollars. We kept our shares without adding more to our position. If we had only doubled our investment and thus lowered our average cost from $75 to $50, our return on that investment would have been 17% annualized over 9 years. If we had increased the weight of the portfolio to 4% at that time, our annual return on the stock would have been more than 20%.

It is an error of "golden" caliber because I understood Mohawk very well and knew that it fit perfectly within our investment philosophy. I knew that Mr. Lorberbaum was a brilliant manager and that he would lead the company through the recession with brilliance and utmost leadership. I also knew that the stock market valuation in November 2008 was extraordinarily low. We could have taken advantage of the irrational behavior of the stock market at that time to drastically lower our acquisition cost and thus greatly amplify the return on our capital.

Conclusion: What About Politics?

We have received several questions about the newly elected US president, Donald Trump. Our role is to manage and be good stewards of your capital. It would be a mistake to let our political ideas, as valid as they may seem in our point of view, to blurry our investment decisions.

For example, I remember the 2004 US election very well, when the reelection of George W Bush in early November of that year scared many Canadian investors (for whatever reasons). From November 2004 to today, the total return of the Rochon Global portfolio has been over 400% (12% on an annualized basis). Without taking anything away from Mr. Bush, I sincerely believe that this performance has been achieved because of the exceptional companies we have owned over the past twelve years, with the vast majority of them based in the United States.

Investing in the stock market is not about betting on the vicissitudes of the political world (and voters). Rather, investing is about owning businesses and nothing else. Strong companies do well because they create unique products and services that serve their customers and potentially enrich their shareholders. Political trends pass but good companies endure. I believe that the vast majority of companies that are doing well do so not because of politicians but in spite of them.

We will surely face another set of political uncertainties and economic worries over the next decade. They will have one thing in common: they will all be unpredictable. Despite this, what is predictable for a seasoned investor is that owning shares of quality companies will give rise to positive financial rewards over the long run.

To Our Partners

Using rationality, along with our unwavering optimism, we trust that the companies we own are exceptional, led by top-notch people, and destined for a great future. They should continue to prudently

navigate the often troubled waters of the global economy. Furthermore, the valuation assigned by the market to these outstanding companies is very similar to the valuation of an average company in the S&P 500, despite the fact that our companies have better growth prospects than average. Therefore we consider the appreciation potential for our portfolio, both in absolute and relative terms, to be well above average, especially when compared to other alternative asset classes, such as bonds.

We also want you to know that we are fully aware of and grateful for your votes of confidence. It is imperative for us to not only select outstanding companies for our portfolios, but to also remain outstanding stewards of your capital. We certainly like to achieve good returns and have developed a taste for it, but it must not come at the cost of taking undue risk. Our philosophy to favor companies with solid balance sheets and dominant business models, along with purchasing these companies at reasonable valuations, is central to the risk management of our portfolios.

Thank you from the entire Giverny Capital team and we wish a great 2017 to all our partners.



François Rochon and the Giverny Capital team

APPENDIX A

Investment philosophy

Note: This section is repeated from prior annual letters and is aimed at new partners.

In 2016, we saw a large increase in the number of Giverny Capital partners (the term we use for our clients). With all these newcomers, it is imperative that we write again (and again) about our investment philosophy.

Here are the key points:

- We believe that over the long run, stocks are the best class of investments.
- It is futile to predict when it will be the best time to begin buying (or selling) stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity).
- We choose companies that have high (and sustainable) margins and high returns on equity, good long term prospects and are managed by brilliant, honest, dedicated and altruistic people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be approximately assessed.
- The stock market is dominated by participants that perceive stocks as casino chips. With that knowledge, we can then sometimes buy great businesses well below their intrinsic values.
- There can be quite some time before the market recognizes the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

Experience and common sense teach us that an investment philosophy based on buying shares in companies that are undervalued, and holding these companies for several years, will not generate linear returns. Some years, our portfolio will have a return that is below average. This is a certainty that we must accept.

Another important point: the significant volatility of the market is often perceived negatively by many investors. It's actually the contrary. When we see stock prices as *"what other people believe the company is worth"* rather than the real value (at least in the short term), these fluctuations become our allies in our noble quest for creating wealth. Instead of fearing them, we can profit from them by acquiring superb businesses at attractive prices. The more that markets (the "other" participants) are irrational, the more likely we are to reach our ambitious performance objectives.

Benjamin Graham liked to say that the irrationality of the market provides an extraordinary advantage to the intelligent investor. The person, however, who becomes affected by short-term market fluctuations (less than 5 years) and who makes decisions based on them transforms this advantage into a disadvantage. His or her own perception of stock quotes becomes their own worst enemy. Our approach at Giverny Capital is to judge the quality of an investment over a long period of time.

So patience – ours AND that of our partners – becomes the keystone for success.

APPENDIX B

Notes on the returns of the Rochon portfolios

- The Rochon portfolio is a private family group of accounts managed by François Rochon since 1993. The returns of the period from 1993 to 1999 were realized before registration of Giverny Capital Inc. at the AMF in June of 2000.
- The Rochon Global portfolio serves as a model for Giverny Capital's clients, but returns from one client to the other can vary depending on a multitude of factors. The returns indicated include trading commissions, dividends (including foreign withholding income taxes) and other income but do not include management fees. Portfolio returns of the Rochon Global portfolio have been generated in a different environment than Giverny Capital's clients and this environment is considered controlled. For example, cash deposits and withdrawals can increase the returns of the Rochon Global portfolio. Thus, the portfolio returns of the Rochon Global portfolio are often higher than the returns realized by clients of Giverny Capital.
- Past results do not guarantee future results.
- The Rochon Canada and Rochon US portfolios are parts of the Rochon Global portfolio.
- The index benchmark group is selected at the beginning of the year and tends to be a good reflection of the asset composition of the portfolio. Weighted indices presented may not be representative of the Rochon Global portfolio. In 2016 :

    - Giverny Global Portfolio: TSX 14% Russell 2000 43% S&P 500 43%
    - Giverny US Portfolio : S&P 500 100%
    - Giverny Canada Portfolio : S&P/TSX 100%

- The returns for the S&P 500 (in $USD) are provided by Standard & Poors.
- The returns for the various indices used for comparable purposes are deemed reliable by Giverny Capital.
- It should be noted that currency effects on the returns of the Rochon portfolio and indices are estimated to our best effort.
- The custodian of our client portfolios is National Bank Correspondent Network (NBCN) in Canada and TD Ameritrade Institutional in the US.
- The financial statements of the three portfolios are audited at the end of each year. The auditor's data are those provided by our custodian (NBCN). The auditor's annual reports are available upon request.
- For more information, please see the "returns" section of our website.

GIVERNY CAPITAL

Annual Letter to our Partners 2017



Anthony Burnham
Beside itself, 2017
Giverny Capital Collection

Historical Summary

It has been more than two decades since I discovered the writings of Warren Buffett, Benjamin Graham, John Templeton, Philip Fisher and Peter Lynch. I then decided to begin managing a family portfolio based on an investment approach synthesized from these great money managers. By the end of 1998, after five years of satisfactory results, I decided to launch an investment management firm offering asset management services aligned with my own investment philosophy. Giverny Capital Inc. came into existence.

In 2002, Giverny hired its first employee: Jean-Philippe Bouchard (JP for those who know him well). A few years later, JP became a partner and participates actively in the investment selection process for the Giverny portfolio. In 2005, two new persons joined the firm who eventually became partners: Nicolas L'Écuyer and Karine Primeau. Finally, in 2009, we launched a US office in Princeton, New Jersey. The director of our Princeton office, Patrick Léger, shares in the culture and long-term time horizon inherent to Giverny.

We are Partners!

From the very first days of Giverny, the cornerstone of our portfolio management philosophy was to manage client portfolios in the same way that I was managing my own money. Thus, the family portfolio I've managed since 1993 (the "Rochon Global Portfolio") serves as a model for our client accounts. It is crucial to me that clients of Giverny and its portfolio managers are in the same boat! That is why we call our clients "partners".

The Purpose of our Annual Letter

The primary objective of this annual letter is to discuss the results of our portfolio companies over the course of the prior year. But even more importantly, our goal is to explain in detail the long-term investment philosophy behind the selection process for the companies in our portfolio. Our wish is for our partners to fully understand the nature of our investment process since long-term portfolio returns are the fruits of this philosophy. Over the short term, the stock market is irrational and unpredictable (though some may think otherwise). Over the long term, however, the market adequately reflects the intrinsic value of companies. If the stock selection process is sound and rational, investment returns will eventually follow. Through this letter, we provide you with the information required to understand this process. You will hopefully notice that we are transparent and comprehensive in our discussion. The reason for this is very simple: we treat you the way we would want to be treated if our roles were reversed.

The Artwork on Our 2017 Letter

Since 2004, we have illustrated the cover of our letters with a copy of artwork from our corporate collection. This year we selected a recent painting by the Quebec artist Anthony Burnham entitled "*Beside itself*".

For the year ending December 31st 2017, the return for the Rochon Global Portfolio was 13.1% versus 10.2% for our benchmark, which represents a relative outperformance of 2.9%. The return of the Rochon Global Portfolio and the one of our benchmark include a loss of approximately 7% due to fluctuations in the Canadian currency.

Since its inception on July 1st 1993, our compounded annual growth rate has been 15.7% versus 9.2% for our weighted benchmark, representing an annualized outperformance of 6.5% over this period. It's worth noting that the effect of the fluctuations in the value of the US Dollar has been nearly nonexistent on our returns. Over 24 years, the US currency has depreciated by 2.1% relative to the Canadian Dollar, which corresponds to an effect of -0.1% on our annualized returns. Our long-term – and quite ambitious – objective is to maintain an annual return 5% higher than our benchmark.

The Rochon Global Portfolio: Returns since July 1st 1993

Year *	Rochon	Index **	+ / -	$ US/Can ***
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	3.3%
1994	**16.5%**	3.7%	**12.7%**	6.0%
1995	**41.2%**	24.0%	**17.2%**	-2.7%
1996	**28.0%**	22.8%	**5.2%**	0.3%
1997	**37.8%**	28.6%	**9.2%**	4.3%
1998	**20.6%**	18.8%	**1.8%**	7.1%
1999	**15.1%**	16.3%	**-1.2%**	-5.7%
2000	**13.4%**	3.2%	**10.2%**	3.9%
2001	**15.1%**	-0.4%	**15.5%**	6.2%
2002	**-2.8%**	-18.3%	**15.6%**	-0.8%
2003	**13.6%**	14.0%	**-0.4%**	-17.7%
2004	**1.6%**	6.2%	**-4.5%**	-7.3%
2005	**11.5%**	3.6%	**7.9%**	-3.3%
2006	**3.5%**	17.0%	**-13.5%**	0.2%
2007	**-14.4%**	-11.6%	**-2.8%**	-14.9%
2008	**-5.5%**	-22.0%	**16.5%**	22.9%
2009	**11.8%**	12.2%	**-0.4%**	-13.7%
2010	**16.1%**	13.8%	**2.3%**	-5.3%
2011	**7.6%**	-1.1%	**8.7%**	2.2%
2012	**21.2%**	12.5%	**8.7%**	-2.2%
2013	**50.2%**	38.9%	**11.3%**	6.9%
2014	**28.1%**	17.8%	**10.2%**	9.1%
2015	**20.2%**	13.4%	**6.8%**	19.3%
2016	**7.3%**	14.3%	**-7.0%**	-3.0%
2017	**13.1%**	10.3%	**2.9%**	-6.6%
Total	**3498.5%**	**767.0%**	**2731.0%**	**-2.1%**
Annualized	**15.7%**	**9.2%**	**6.5%**	**-0.1%**

* All returns are adjusted to Canadian dollars
** Index is a hybrid index (S&P/TSX, S&P 500, Russell 2000) which reflects the weight of the underlying assets at the beginning of the year.
*** Variation of the US dollar compared to the Canadian dollar

Refer to Appendix B for disclosure statements on the Rochon portfolios.

The Rochon US Portfolio

We have been publishing the returns of the Rochon US Portfolio, which is denominated in US dollars, since 2003. The Rochon US Portfolio corresponds to the American portion of the Rochon Global Portfolio. In 2017, it realized a return of 19.7% compared to 21.8% for our benchmark, the S&P 500. The Rochon US Portfolio therefore underperformed our benchmark by 2.1%.

Since its inception in 1993, the Rochon US Portfolio has returned 2980%, or 15.0% on an annualized basis. During this same period, the S&P 500 has returned 863%, or 9.7% on an annualized basis. Our added value has therefore been 5.3% annually.

Year	Rochon US	S&P 500	+/-
1993 (Q3-Q4)	**32.7%**	5.0%	**27.7%**
1994	**9.9%**	1.3%	**8.6%**
1995	**54.8%**	37.6%	**17.2%**
1996	**27.0%**	23.0%	**4.1%**
1997	**32.9%**	33.4%	**-0.4%**
1998	**11.0%**	28.6%	**-17.6%**
1999	**15.9%**	21.0%	**-5.1%**
2000	**11.3%**	-9.1%	**20.4%**
2001	**8.1%**	-11.9%	**20.0%**
2002	**-4.4%**	-22.1%	**17.7%**
2003	**31.6%**	28.7%	**2.9%**
2004	**9.3%**	10.9%	**-1.6%**
2005	**12.5%**	4.9%	**7.5%**
2006	**3.3%**	15.8%	**-12.4%**
2007	**-1.7%**	5.5%	**-7.2%**
2008	**-24.3%**	-37.0%	**12.7%**
2009	**28.7%**	26.5%	**2.3%**
2010	**21.9%**	15.1%	**6.9%**
2011	**4.7%**	2.1%	**2.6%**
2012	**22.3%**	16.0%	**6.3%**
2013	**40.6%**	32.4%	**8.2%**
2014	**18.0%**	13.7%	**4.3%**
2015	**1.7%**	1.4%	**0.4%**
2016	**7.5%**	12.0%	**-4.5%**
2017	**19.7%**	21.8%	**-2.1%**
Total	**2979.8%**	**863.2%**	**2116.7%**
Annualized	**15.0%**	**9.7%**	**5.3%**

Refer to Appendix B for disclosure statements on the Rochon portfolios.

No individual holding contributed significantly to this underperformance. Many stocks that were all-stars within the S&P 500 in 2017 were not in our portfolio and the slight relative underperformance of the Rochon US Portfolio this year can be primarily explained by this factor.

You will note that the Rochon US Portfolio underperformed the S&P 500 on eight occasions (or roughly 33% of the time) over 24 years. This is very much in line with our "rule of three" where we anticipate underperforming the indices at least one year out of three on average. Such an average, if we can maintain it, is much better than that of the average fund manager.

We accept in advance that we will sometimes underperform the S&P 500 in the short term when our style and/or our companies are out of favor (and sometimes for no reason). While it is not always easy, we try to remain impervious to short-term results, both in good and not-so-good times.

Rochon Canada Portfolio

We introduced a portfolio that is 100% focused on Canadian equities in 2007. This corresponds approximately to the Canadian portion of the Rochon Global Portfolio. In 2017, the Rochon Canada Portfolio returned 27.4% versus 9.1% for the S&P/TSX, therefore overperforming its index by 18.3%.

Since 2007, the Rochon Canada Portfolio has returned 509%, or 17.8% on an annualized basis. During this same period, our benchmark had a gain of 73%, or 5.1% on an annualized basis. Our annual added value was therefore 12.7%.

Year	Giverny Canada	S&P/TSX	+/-
2007	**19.7%**	9.8%	**9.9%**
2008	**-24.6%**	-32.9%	**8.3%**
2009	**28.2%**	33.1%	**-4.9%**
2010	**26.7%**	17.6%	**9.1%**
2011	**13.5%**	-8.7%	**22.2%**
2012	**24.0%**	7.2%	**16.8%**
2013	**49.4%**	13.0%	**36.4%**
2014	**20.3%**	10.6%	**9.7%**
2015	**16.0%**	-8.3%	**24.3%**
2016	**11.0%**	21.1%	**-10.1%**
2017	**27.4%**	9.1%	**18.3%**
Total	**508.8%**	**73.1%**	**435.7%**
Annualized	**17.8%**	**5.1%**	**12.7%**

Refer to Appendix B for disclosure statements on the Rochon portfolios.

Over 11 years, the performance of our Canadian securities has been significantly higher than that of the S&P/TSX and even higher than that of our US stocks. A concentrated portfolio can drastically exceed the performance of the indices but the risks inherent to high concentration is not appropriate for a portfolio that is to be managed prudently. In fact, we consider that a portfolio of about 20 securities is the right balance between having a minimum diversification level to reduce company-specific risk while also having few enough companies to improve the odds of beating the market indices. Since this portfolio represents only a portion (approximately 15%) of the Rochon Global Portfolio, our diversification requirements are met.

The three most important Canadian companies we own in this portfolio are of the utmost quality and all have one thing in common: they are led by exceptional CEOs.

2017

2017 was a year of strong economic growth, with profits for the companies making up the S&P 500 rising by nearly 12%.

The American tech giants (Apple, Facebook, Amazon, etc.) continued to carry the US stock market in 2017. The five stocks in the table below rose by 47% during the year, or more than twice the return of the S&P 500. Furthermore, these five stocks are the five most important weights within the S&P 500. So it was hard to beat the S&P 500 in 2017 without these stocks in a portfolio (Alphabet is the only one in ours).

Stock	**2017 Gain**
Apple	48%
Microsoft	40%
Amazon.com	56%
Facebook	53%
Alphabet	36%
Average	**47%**

Tax Reform in the US

The American president managed to pass his tax reforms at the end of the year. So in addition to benefiting from an environment of GDP growth, US companies will see their tax rates drop substantially in 2018. We believe that the estimates for profit growth for companies in the S&P 500, which are in the neighborhood of 15% to 18%, could even be conservative given these reforms.

Roughly 80% of our portfolio is invested in the United States. Additionally, our US companies will likely see their corporate tax rates drop in a manner that is even greater than the average company in the S&P 500. Indeed, we have always been wary of investing in companies with low tax rates for the simple reason that we have always feared that governments could change the rules. Our past conservatism will be rewarded in 2018: the majority of our American companies pay significant taxes and will be greatly favored by the lower corporate rate. Considering all factors, we estimate that the profit growth prospects for our companies are above the 20% mark for 2018. The tax reform will even help our Canadian companies, such as , which generate a large share of their profits from the United States.

Meanwhile in Canada

It was a quiet year in Canada. The Canadian stock market did well with the S&P/TSX posting gains of 9%, though below the US stock market. The price of oil dropped from $56 a barrel early in the year to a low of $44, ending the year at $60. This price is still below the total cost of production for several Canadian oil companies, especially those operating in the oil sands. The growing popularity of electric cars is also not a good omen for the oil industry in general.

Canadian residential real estate continued to hold up despite various new and more restrictive rules put in place by governments. The average price of a house in Canada is roughly $500,000, or about 5% more than in 2016. This level seems unsustainable, in our opinion, compared to the current GDP per capita of Canadian households. The level of indebtedness of Canadian has become the highest of the

OECD countries (101% of GDP per capita compared to the average of 80%). When this returns to normal ("when" and not "if" in our opinion) it will likely be difficult for the Canadian economy to absorb without creating additional aftershocks to various segments of the economy.

As a result of US tax reforms, Canadian corporations may well become less competitive relative to their American counterparts. Regardless of what politicians say, a high level of taxation has the same effect on investors as the cold on the geese: they fly off towards more favorable climate.

New segments of the Canadian industry have done particularly well in 2017: artificial intelligence and cannabis agriculture. It seems early to assess the business model and the long-term financial potential of AI-related companies. As for the cannabis industry, it is quickly becoming a major business. Of course, speculators have already taken notice (we can smell it!) and companies in this sector are trading at high valuations which seem to have already discounted many years of future growth.

You likely concluded, if you're reading between the lines, that our philosophy of selecting companies with a strong track record of high profitability and a reasonable stock market valuation keeps us away from these types of industries.

A Few Words on the United Kingdom

As for the United Kingdom in 2017, predictions of economic apocalypses following Brexit did not materialize. GDP growth was close to 1.5% for the year, which is lower than the European average (around 2.4%) but still acceptable given the circumstances. We took advantage of the stock market gloominess that prevailed to buy two British companies for our portfolio.

The Flavor of the Day for 2017: Bitcoin

Every year, we present to you what we consider the "flavor of the day" from the financial world. In our opinion, the top prize for 2017 goes to bitcoin.

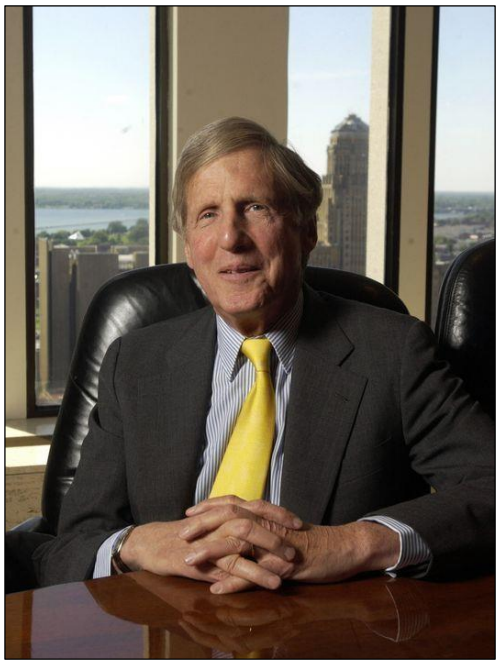
Several people asked us throughout the year what we thought about bitcoin, the most popular cryptocurrency. We recognize that this new way of transmitting money is difficult to fully understand. We quote Warren Buffett, who explained that bitcoin is "*…a very effective way of transmitting money and you can do it anonymously and all that. A check is a way of transmitting money too. Are checks worth a whole lot of money?*"

Such a rational statement does not hinder the innate nature of the human being from being seduced by speculative activities. Things ends badly whenever a speculative fever sets in, with those who are burnt by it swearing to never get caught again.

But mix a new generation of humans with a new form of speculation and you get a brand new explosive cocktail. The bitcoin cocktail is spiced with brilliant marketing: it is aimed at those who want to rebel against the system (oh so seductive is this idea!) while also using their intelligence to understand a complex cyber currency concocted by other people just as smart. But intelligence and rationality are two different qualities.

In our opinion, reason and experience dictate avoiding this trend.

Robert Wilmers (1934-2017)



We unfortunately lost Robert Wilmers, CEO of M&T Bank, in December. He had been head of this Buffalo-based bank since 1983, and we have been shareholders M&T for more than 18 years.

I have in my archives the 1993 annual report for the First Empire State Bank (before the name of the bank was changed to M&T). It was the first of many annual reports written by Bob that I read over the years. I became a great admirer of not only of Bob as a banker but also as an incredibly generous human being.

We bought our first shares in M&T in 1998. Then we added to our position at the beginning of the 2000, while Wall Street seemed only interested in tech stocks. M&T's stock did very well during the 2000-2002 market correction and it became our biggest holding. Bob always managed the company extremely cautiously while maintaining a high rate of growth in the company's intrinsic value. We slept peacefully with Bob at the helm.

In 2007, at the age of 73, Bob decided to retire. We met with the company and weren't as comfortable with the bank's new management team and we sold our shares (at around $100).

Then came the great crisis of 2008 and Bob decided to return to run M&T. JP and I met him in August 2008 and bought shares again a few months later, in February 2009, for about $36 a share. The stock is currently trading at $190. There is no doubt whatsoever that Giverny's partners owe Bob a huge debt of gratitude. We are all richer because of his boundless devotion to M&T's customers, employees and shareholders.

I would like to add a personal note about another form of enrichment that Bob indirectly gave me, which is a cultural enrichment. It was a Monday when we travelled to Buffalo in 2008 and the famous Albright-Knox museum was closed. I asked Bob if he knew anyone at the museum who could open its doors. When we arrived at Bob's office, his assistant said: "After the meeting, the museum director

will be waiting for you to take a guided tour." I then met Louis Grachos, the then director of the Albright-Knox, who gave us a very memorable visit. When I told him about my passion for collecting contemporary art, Louis confided in me his admiration for an Italian collector, Count Giuseppe Panza di Biumo.

The first thing I did after the meeting was order Count Panza's autobiography on Amazon and I devoured it in a few days. In my opinion, Count Panza was the greatest collector of contemporary art in history. He quickly became a mentor for me through his writings. Louis then put me in touch with the count and a few months later, in November 2009, I went to meet him at his home in Varese, in northern Italy. It was a wonderful meeting. Six months later, Count Panza died.

I saw Louis a few times afterwards. He also introduced me to some people of the Albright-Knox Museum Board of Directors. Without the great generosity of Bob Wilmers, I would have never met Count Panza or known several very warm people in Buffalo who have become good friends.

I owe a lot of marvelous things in my life to Bob and I will miss him very much.

Five-year Post-mortem: 2012

Like we do every year, we go through a five-year post-mortem analysis. We believe that studying our decisions in a systematic manner, and with the benefit of hindsight, enables us to learn from both our achievements and our errors. We wrote in our 2012 annual letter: "*We believe that equities will be the best asset class in the coming years for the simple reason that it seems to be the most undervalued.*" Over five years, the S&P 500 has risen more than 87% (it has doubled if we include dividends).

In 2012, we acquired shares in LKQ and Union Pacific (UP). We still hold these two companies in our portfolio. To assess these investments, here is a table measuring their performance, in absolute terms, relative to the S&P 500.

Stock	Date of 1st Purchase	2012 EPS	2017 EPS	Growth Rate	Price at 1st Purchase	Price at end of 2017	Avg. Div.	Annualized Return	S&P 500 Annualized	+/-
LKQ	Apr-12	0.87 $	1.88 $	17%	15.0 $	40.7 $	0%	19%	15%	4%
UP	Jul-12	4.13 $	5.79 $	7%	60.0 $	134.1 $	2%	18%	14%	3%
S&P 500		104	133	5%	-	2674	2%			

Both stocks did very well, with LKQ and UP generating annualized returns of 19% and 18%, respectively, or about 3 to 4% better than the S&P 500 during the same period. LKQ grew its EPS by 17% from 2012 to 2017 and the stock has broadly followed the growth in its intrinsic value. Although we believe that the company will have difficulty maintaining this rate of growth in the future, we are of course satisfied with this investment so far.

On the other hand, UP has grown its EPS by only 7% per year, a rate that is slightly higher than that of the companies in the S&P 500. The strong performance of the stock therefore originates from a significant increase in its P/E multiple over the last five years (just like the S&P 500, by the way). We believe that UP's valuation premium is justified by its excellent long-term fundamentals (it must also be taken into account that EPS will likely increase sharply in 2018). Our opinion, however, is that we will no longer count on such a stock market revaluation in the years to come.

Owner's Earnings

At Giverny Capital, we do not evaluate the quality of an investment by the short-term fluctuations in its stock price. Our wiring is such that we consider ourselves owners of the companies in which we invest. Consequently, we study the growth in earnings of our companies and their long-term outlook. Since 1996, we have presented a chart depicting the growth in the intrinsic value of our companies using a measurement developed by Warren Buffett: "owner's earnings". We arrive at our estimate of the increase in intrinsic value of our companies by adding the growth in earnings per share (EPS) and the average dividend yield of the portfolio. We believe that analysis is not exactly precise but approximately correct. In the non-scientific world of equity investing, we believe in the old saying: "It is better to be roughly right than precisely wrong."

This year, the intrinsic value of our companies, as a whole, rose by about 14% (13% from the growth in earnings and around 1% from the average dividend). Despite some of the changes to our portfolio during the year, we consider the estimate of the EPS growth at our companies during 2017 to adequately reflect their economic reality. The performance of our portfolio in terms of market value was a gain of roughly 20% (net of any currency effect).

The companies in the S&P 500 also saw strong growth, with growth in the order of 12% (about 14% when we add the dividend). The S&P 500 had a total performance figure of 22% (in $USD).

	Rochon Global Portfolio			S&P 500		
Year ***	Value *	Market **	Difference	Value *	Market **	Difference
1996	14%	29%	15%	13%	23%	10%
1997	17%	35%	18%	11%	33%	22%
1998	11%	12%	1%	-1%	29%	30%
1999	16%	12%	-4%	17%	21%	4%
2000	19%	10%	-9%	9%	-9%	-18%
2001	-9%	10%	19%	-18%	-12%	6%
2002	19%	-2%	-21%	11%	-22%	-33%
2003	31%	34%	3%	15%	29%	14%
2004	21%	8%	-12%	21%	11%	-10%
2005	14%	15%	0%	13%	5%	-8%
2006	14%	3%	-11%	15%	16%	1%
2007	10%	0%	-10%	-4%	5%	9%
2008	-3%	-22%	-19%	-30%	-37%	-7%
2009	0%	28%	28%	3%	26%	23%
2010	22%	22%	0%	45%	15%	-30%
2011	17%	6%	-11%	17%	2%	-15%
2012	19%	23%	4%	7%	16%	9%
2013	16%	42%	26%	9%	32%	23%
2014	13%	19%	6%	9%	14%	5%
2015	11%	4%	-7%	1%	1%	0%
2016	9%	10%	1%	3%	12%	9%
2017	14%	20%	7%	14%	22%	8%
Total	1391%	1544%	153%	365%	552%	188%
Annualized	13.1%	13.6%	0.5%	7.2%	8.9%	1.7%

* Estimated growth in earnings plus dividend yield
** Market performance, inclusive of dividends (refer to Appendix B for disclosure statements on our returns)
*** Results estimated without currency effects

Over 22 years, we believe our companies have grown their intrinsic value by about 1391%; and their stocks have achieved a total return of approximately 1544%. On an annualized basis, we achieved an intrinsic performance of 13.1% versus 13.6% for their stock market performance (dividend included in both cases). The correlation between the two figures over a long period is not accidental since the stock market always reflects the fair value of companies over the long term.

Our stocks have outperformed the S&P 500 by 4.7% annually over the last 22 years for the simple reason that our companies grew their intrinsic values at a rate that was 5% greater than that of the companies that make up the S&P 500.

Our Companies

"It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent."

- Charlie Munger (Vice Chairman of Berkshire Hathaway)

Section for Giverny Capital's partners only

The Podium of Errors

"The man who does things makes many mistakes, but he never makes the biggest mistake of all—doing nothing."

- Benjamin Franklin

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2014 (or from past years). It is with a constructive attitude, in order to always improve as investors, that we provide this detailed analysis. As is often the case with stocks, errors from omission (non-purchases) are often more costly than errors from commission (purchases)… even if we don't see those on our statements.

Bronze Medal: Knight Transportation

Our older partners will remember that we were shareholders of Knight Transportation for several years, from 2003 to 2011. Knight Transport is a large truck transportation company located in Phoenix, Arizona. We sold our shares in 2011 to buy another stock that seemed more undervalued.

In early 2015, the company appointed a new CEO, David A. Jackson, and we met with him. Mr. Jackson was previously CFO of the company and reinvigorated Knight's growth plans. We were very impressed by this young leader (40 years old at that time) and decided to become shareholders again. Then in March of 2017, after holding the stock for about two years, we sold our shares for about $33, netting a small gain. Once again, I preferred to invest our capital in another stock that seemed more interesting.

It seems like it was a mistake. Shortly after our sale, David Jackson led the company in its acquisition of Swift Transportation which, at first glance, seems very promising. The growth outlook for 2018 is excellent and we expect a 58% increase in EPS. The stock did well on the stock market, climbing nearly 50% after we sold it. It looks like I lacked patience.

Silver Medal: Intuit

I discovered Intuit and its Quicken software about 25 years ago. I found the product excellent and very practical. I knew that the company was listed on the stock market but found the stock too expensive. In October 1994, Microsoft announced a takeover bid for Intuit for $1.5 billion. From memory, it was the equivalent of around 30 times the profits of that time—a level that I found exorbitant (I was still quite inexperienced). In April 1995, the US Department of Justice opposed the transaction for antitrust reasons and Intuit's stock dropped to less than $5 (adjusted for subsequent splits).

I decided to follow Intuit more closely after this failed acquisition. I liked the product and I thought that if Microsoft saw so much value in it that the company certainly deserved my attention. Obviously, I always found the stock too expensive because I never bought any shares of the company. I only admired the company from the bleachers.

A few years later, the company launched a second flagship product: Quickbook (bookkeeping software). We even started using this product a few years ago at Giverny. I could not be more in the front row! Today, the stock is trading at $164. Yes, you calculated correctly: the stock has risen 3200% since 1995, or the equivalent of an annualized return of 17%.

Gold Medal: FactSet Research Systems

This year's gold medal is one of high caliber and one that was many years in the making. It is necessary to return to 1998 to find the origin of this error. In early 1998 (a few months before founding Giverny Capital), I went to a high-tech conference in San Francisco. No need to tell you that the word on everyone's lips was: "Internet". The young business leaders were daring, flashy and excellent presenters with beautiful computer presentations. The sole exception to this was the president of FactSet Research.

I had never heard of this company but I looked at its numbers in the documents provided to conference attendees. The company was very profitable (one of the few in the group) and I went to the company's presentation. The president and co-founder was the speaker and he must have been about 70 years old and had no computer or projector. Near the end of his presentation, he pulled out sheets of paper taped together (yes, I was wondering "what are these strange things?"). In this stack of unfolded sheets, one could see the sales and profit growth of the company over 20 years (the company was founded in 1978). Of course, from my seat in the audience, I couldn't really see anything. But I liked the old fashioned manner of the president and took the time to study the company in detail upon my return to Montreal.

FactSet sells financial information software and competes with giants like Bloomberg and Thomson Reuters. The company has a successful product, a loyal customer base and is continually gaining market share. It has exceptional profitability and an exemplary balance sheet.

After following the company a few years, we bought shares of FactSet in 2003. Then we sold them after a slight increase. We briefly rode on the same carousel in 2006. The reason that made me sell was always the same: after a small rise, I found the stock's valuations too expensive. In fact, the market valuation, without being exaggerated, always seemed too high and that is the main reason we did not have this company in the portfolio for longer periods of time. Yet the company continued to generate exceptional results and the company continued to grow its profits even during the great recession of 2008-2009.

At the beginning of 1998, the stock traded at less than $8. The stock hit the $200 level twenty years later. We could have made more than 25 times our money over two decades (an annual return of 18%).

What makes me to blame even more is that we are loyal customers of FactSet Research at Giverny Capital. I love to use this product! Our familiarity with the product and our loyalty to the company should have turned the light on in my brain!

Conclusion: it was 10 years ago

A decade ago, in 2007, Giverny Capital had a difficult year. The only sectors that were "working" were those related to natural resources (with oil leading the way). As you know, we avoid this universe because, in our opinion, it is extremely difficult to have a competitive advantage. In addition, the sharp rise in the Canadian dollar at that time also decreased our short-term results. The Canadian stock market (especially the sectors linked to natural resources) was then at its peak of popularity.

We stayed the course on our stock selection process as we knew that our philosophy of selecting high quality companies was sound. We also believed that the level of the Canadian dollar, at par with its American counterpart at the time, did not make sense. We wrote at the time: "Patience is in order."

This patience was rewarding for us and our partners. The following is a chart of the performance of the Rochon Global Portfolio (in Canadian dollars and without currency effect) compared to our benchmark, the S&P 500 and the S&P/TSX (in Canadian dollars and without currency effect) for the 10-year period, beginning January 1, 2008.

2008-2017 Period	In $CAD		Estimated w/o currency	
Return	Total	Annualized	Total	Annualized
Rochon Global	351.0%	16.3%	271.6%	14.0%
Index **	159.4%	10.0%	111.0%	7.8%
S&P 500	186.1%	11.1%	126.0%	8.5%
S&P/TSX	58.1%	4.7%	58.1%	4.7%

** "Index" is a hybrid index (S&P/TSX, S&P 500, Russell 2000) which reflects the weight of the underlying assets at the beginning of the year.

Refer to Appendix B for disclosure statements on the Rochon portfolios.

The Rochon Global portfolio thus achieved a total return of 351% (16.3% on an annualized basis) compared to 186% for the S&P 500 in Canadian dollars (11.1% annualized). The S&P/TSX Canadian Index returned 58% over 10 years (4.7% annualized). The Canadian dollar lost 21% of its value over the decade and returned to a level we consider normal. Without currency effect, we estimate the total return of the Rochon Global portfolio at 272% (14.0% annualized) and 126% (8.5% annualized) for the S&P 500.

It should be noted that these returns were obtained by starting the clock at the BEGINNING of 2008, so BEFORE the big fall of the stock market that followed. Our companies are not immune to recessions but have had the strength to go through hard times.

Two ingredients are therefore necessary to succeed on the stock market: a rational stock selection process and patience (often, a good dose of it).

I would add that the first ingredient is futile without the second.

To Our Partners

We believe that the companies we own are exceptional, led by top-notch people, and destined for a great future. They should continue to prudently navigate the often troubled waters of the global economy. Furthermore, the valuation assigned by the market to these outstanding companies is very similar to the valuation of an average company in the S&P 500, despite the fact that we believe our companies have better growth prospects than average. Therefore we consider the appreciation potential for our portfolio, both in absolute and relative terms, to be well above average, especially when compared to other alternative asset classes, such as bonds.

We also want you to know that we are fully aware of and grateful for your votes of confidence. It is imperative for us to not only select outstanding companies for our portfolios, but to also remain outstanding stewards of your capital. We certainly like to achieve good returns and have developed a taste for it, but it must not come at the cost of taking undue risk. Our philosophy to favor companies with solid balance sheets and dominant business models, along with purchasing these companies at reasonable valuations, is central to the risk management of our portfolios.

Thank you from the entire Giverny Capital team and we wish a great 2018 to all our partners.



François Rochon and the Giverny Capital team

APPENDIX A

Investment philosophy

Note: This section is repeated from prior annual letters and is aimed at new partners.

In 2017, we saw a large increase in the number of Giverny Capital partners (the term we use for our clients). With all these newcomers, it is imperative that we write again (and again) about our investment philosophy.

Here are the key points:

- We believe that over the long run, stocks are the best class of investments.
- It is futile to predict when it will be the best time to begin buying (or selling) stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity).
- We choose companies that have high (and sustainable) margins and high returns on equity, good long term prospects and are managed by brilliant, honest, dedicated and altruistic people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be approximately assessed.
- The stock market is dominated by participants that perceive stocks as casino chips. With that knowledge, we can then sometimes buy great businesses well below their intrinsic values.
- There can be quite some time before the market recognizes the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

Experience and common sense teach us that an investment philosophy based on buying shares in companies that are undervalued, and holding these companies for several years, will not generate linear returns. Some years, our portfolio will have a return that is below average. This is a certainty that we must accept.

Another important point: the significant volatility of the market is often perceived negatively by many investors. It's actually the contrary. When we see stock prices as *"what other people believe the company is worth"* rather than the real value (at least in the short term), these fluctuations become our allies in our noble quest for creating wealth. Instead of fearing them, we can profit from them by acquiring superb businesses at attractive prices. The more that markets (the "other" participants) are irrational, the more likely we are to reach our ambitious performance objectives.

Benjamin Graham liked to say that the irrationality of the market provides an extraordinary advantage to the intelligent investor. The person, however, who becomes affected by short-term market fluctuations (less than 5 years) and who makes decisions based on them transforms this advantage into a disadvantage. His or her own perception of stock quotes becomes their own worst enemy. Our approach at Giverny Capital is to judge the quality of an investment over a long period of time.

So patience – ours AND that of our partners – becomes the keystone for success.

APPENDIX B

Notes on the returns of the Rochon portfolios

- The Rochon portfolio is a private family group of accounts managed by François Rochon since 1993. The returns of the period from 1993 to 1999 were realized before registration of Giverny Capital Inc. at the AMF in June of 2000.
- The Rochon Global portfolio serves as a model for Giverny Capital's clients, but returns from one client to the other can vary depending on a multitude of factors. The returns indicated include trading commissions, dividends (including foreign withholding income taxes) and other income but do not include management fees. Portfolio returns of the Rochon Global portfolio have been generated in a different environment than Giverny Capital's clients and this environment is considered controlled. For example, cash deposits and withdrawals can increase the returns of the Rochon Global portfolio. Thus, the portfolio returns of the Rochon Global portfolio are often higher than the returns realized by clients of Giverny Capital.
- Past results do not guarantee future results.
- The Rochon Canada and Rochon US portfolios are parts of the Rochon Global portfolio.
- The index benchmark group is selected at the beginning of the year and tends to be a good reflection of the asset composition of the portfolio. Weighted indices presented may not be representative of the Rochon Global portfolio. In 2017 :

    - Giverny Global Portfolio: TSX 14% Russell 2000 43% S&P 500 43%
    - Giverny US Portfolio : S&P 500 100%
    - Giverny Canada Portfolio : S&P/TSX 100%

- The returns for the S&P 500 (in $USD) are provided by Standard & Poors.
- The returns for the various indices used for comparable purposes are deemed reliable by Giverny Capital.
- It should be noted that currency effects on the returns of the Rochon portfolio and indices are estimated to our best effort.
- The custodian of our client portfolios is National Bank Independent Network (NBIN) in Canada and TD Ameritrade Institutional in the US.
- The financial statements of the three portfolios are audited at the end of each year. The auditor's data are those provided by our custodian (NBIN). The auditor's annual reports are available upon request.
- For more information, please see the "returns" section of our website.

GIVERNY CAPITAL

Annual Letter to our Partners 2018

ROCHON GLOBAL PORTFOLIO

25 years



Gabor Szilasi
Monet's garden in Giverny; the water garden in summer, Giverny, 1998
Giverny Capital Collection

Historical Summary

It has been more than 25 years since I discovered the writings of Warren Buffett, Benjamin Graham, John Templeton, Philip Fisher and Peter Lynch. I then decided to begin managing a family portfolio based on an investment approach synthesized from these great money managers. By the end of 1998, after five years of satisfactory results, I decided to launch an investment management firm offering asset management services aligned with my own investment philosophy. Giverny Capital Inc. came into existence.

In 2002, Giverny hired its first employee: Jean-Philippe Bouchard (JP for those who know him well). A few years later, JP became a partner and participates actively in the investment selection process for the Giverny portfolio. In 2005, two new persons joined the firm who eventually became partners: Nicolas L'Écuyer and Karine Primeau. Finally, in 2009, we launched a US office in Princeton, New Jersey. The director of our Princeton office, Patrick Léger, shares in the culture and long-term time horizon inherent to Giverny.

We are Partners!

From the very first days of Giverny, the cornerstone of our portfolio management philosophy was to manage client portfolios in the same way that I was managing my own money. Thus, the family portfolio I've managed since 1993 (the "Rochon Global Portfolio") serves as a model for our client accounts. It is crucial to me that clients of Giverny and its portfolio managers are in the same boat! That is why we call our clients "partners".

The Purpose of our Annual Letter

The primary objective of this annual letter is to discuss the results of our portfolio companies over the course of the prior year. But even more important, our goal is to explain in detail the long-term investment philosophy behind the selection process for the companies in our portfolio. Our wish is for our partners to fully understand the nature of our investment process since long-term portfolio returns are the fruits of this philosophy. Over the short term, the stock market is irrational and unpredictable (though some may think otherwise). Over the long term, however, the market adequately reflects the intrinsic value of companies. If the stock selection process is sound and rational, investment returns will eventually follow. Through this letter, we provide you with the information required to understand this process. You will hopefully notice that we are transparent and comprehensive in our discussion. The reason for this is very simple: we treat you the way we would want to be treated if our roles were reversed.

The Artwork on Our 2018 Letter

Since 2004, we have illustrated the cover of our letters with a copy of an artwork from our corporate collection. This year we selected an artwork by the Quebec artist Gabor Szilasi. It is a photography taken at Giverny in 1998.

For the year ending December 31st 2018, the return for the Rochon Global Portfolio was -0.6% versus -1.4% for our benchmark, which represents a relative outperformance of 0.8%. The return of the Rochon Global Portfolio and the one of our benchmark include a gain of approximately 6.7% due to fluctuations in the Canadian currency.

Since its inception on July 1st 1993, our compounded annual growth rate has been 15.1% versus 8.8% for our weighted benchmark, representing an annualized outperformance of 6.3% over this period. It's worth noting that the effect of the fluctuations in the value of the US Dollar has been nearly nonexistent on our returns. Over 25 years, the US currency has appreciated by 6.5% relative to the Canadian Dollar, which corresponds to an effect of 0.2% on our annualized returns. Our long-term (and ambitious) objective is to maintain an annual return 5% higher than our benchmark.

The Rochon Global Portfolio: Returns since July 1st 1993

Year *	Rochon	Index **	+ / -	$ US/Can ***
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	3.3%
1994	**16.5%**	3.7%	**12.7%**	6.0%
1995	**41.2%**	24.0%	**17.2%**	-2.7%
1996	**28.0%**	22.8%	**5.2%**	0.3%
1997	**37.8%**	28.6%	**9.2%**	4.3%
1998	**20.6%**	18.8%	**1.8%**	7.1%
1999	**15.1%**	16.3%	**-1.2%**	-5.7%
2000	**13.4%**	3.2%	**10.2%**	3.9%
2001	**15.1%**	-0.4%	**15.5%**	6.2%
2002	**-2.8%**	-18.3%	**15.6%**	-0.8%
2003	**13.6%**	14.0%	**-0.4%**	-17.7%
2004	**1.6%**	6.2%	**-4.5%**	-7.3%
2005	**11.5%**	3.6%	**7.9%**	-3.3%
2006	**3.5%**	17.0%	**-13.5%**	0.2%
2007	**-14.4%**	-11.6%	**-2.8%**	-14.9%
2008	**-5.5%**	-22.0%	**16.5%**	22.9%
2009	**11.8%**	12.2%	**-0.4%**	-13.7%
2010	**16.1%**	13.8%	**2.3%**	-5.3%
2011	**7.6%**	-1.1%	**8.7%**	2.2%
2012	**21.2%**	12.5%	**8.7%**	-2.2%
2013	**50.2%**	38.9%	**11.3%**	6.9%
2014	**28.1%**	17.8%	**10.2%**	9.1%
2015	**20.2%**	13.4%	**6.8%**	19.3%
2016	**7.3%**	14.3%	**-7.0%**	-3.0%
2017	**13.1%**	10.3%	**2.9%**	-6.6%
2018	**-0.6%**	-1.4%	**0.8%**	8.7%
Total	**3477.1%**	**755.2%**	**2722.0%**	**6.5%**
Annualized	**15.1%**	**8.8%**	**6.3%**	**0.2%**

* All returns are adjusted to Canadian dollars
** Index is a hybrid index (S&P/TSX, S&P 500, Russell 2000) which reflects the weight of the underlying assets at the beginning of the year.
*** Variation of the US dollar compared to the Canadian dollar

Refer to Appendix B for disclosure statements on the Rochon portfolios.

The Rochon US Portfolio

We have been publishing the returns of the Rochon US Portfolio, which is entirely denominated in US dollars, since 2003. The Rochon US Portfolio corresponds to the American portion of the Rochon Global Portfolio. In 2018, it realized a return of -8.3% compared to -4.4% for our benchmark, the S&P 500. The Rochon US Portfolio therefore underperformed the S&P 500 by 3.9%.

Since its inception in 1993, the Rochon US Portfolio has returned 2724%, or 14.0% on an annualized basis. During this same period, the S&P 500 has returned 821%, or 9.1% on an annualized basis. Our added value has therefore been 4.9% annually.

Year	Rochon US	S&P 500	+/-
1993 (Q3-Q4)	**32.7%**	5.0%	**27.7%**
1994	**9.9%**	1.3%	**8.6%**
1995	**54.8%**	37.6%	**17.2%**
1996	**27.0%**	23.0%	**4.1%**
1997	**32.9%**	33.4%	**-0.4%**
1998	**11.0%**	28.6%	**-17.6%**
1999	**15.9%**	21.0%	**-5.1%**
2000	**11.3%**	-9.1%	**20.4%**
2001	**8.1%**	-11.9%	**20.0%**
2002	**-4.4%**	-22.1%	**17.7%**
2003	**31.6%**	28.7%	**2.9%**
2004	**9.3%**	10.9%	**-1.6%**
2005	**12.5%**	4.9%	**7.5%**
2006	**3.3%**	15.8%	**-12.4%**
2007	**-1.7%**	5.5%	**-7.2%**
2008	**-24.3%**	-37.0%	**12.7%**
2009	**28.7%**	26.5%	**2.3%**
2010	**21.9%**	15.1%	**6.9%**
2011	**4.7%**	2.1%	**2.6%**
2012	**22.3%**	16.0%	**6.3%**
2013	**40.6%**	32.4%	**8.2%**
2014	**18.0%**	13.7%	**4.3%**
2015	**1.7%**	1.4%	**0.4%**
2016	**7.5%**	12.0%	**-4.5%**
2017	**19.7%**	21.8%	**-2.1%**
2018	**-8.3%**	-4.4%	**-3.9%**
Total	**2724.2%**	**821.0%**	**1903.2%**
Annualized	**14.0%**	**9.1%**	**4.9%**

Refer to Appendix B for disclosure statements on the Rochon portfolios.

After eight years of consecutive outperformance (a statistical event unlikely to reoccur), the Rochon US Portfolio underperformed the S&P 500 for the third year in a row. Once again this year, a few of the all-star stocks in the S&P 500 contributed in an outsized manner to the performance of the index. Relative to the Russell 2000 (an index composed of smaller cap companies), the S&P 500 was up 6.6%

in 2018. In fact, over the last five years, the S&P 500 has achieved an annual return of 8.5% vs. 4.4% for the Russell 2000.

Over a long period of time, the returns of the S&P 500 and Russell 2000 tend to be similar. Since 1993, the S&P 500 generated annual returns of 9.1% versus 8.7% for the Russell 2000. The stock market tends to accurately reflect the intrinsic value of companies, whether large or small.

We accept in advance that we will sometimes underperform the S&P 500 in the short term when our style and/or our companies are out of favor (and sometimes for no reason). While it is not always easy, we try to remain impervious to short-term results, both in good and not-so-good times.

Rochon Canada Portfolio

We introduced a portfolio that is 100% focused on Canadian equities in 2007. This corresponds approximately to the Canadian portion of the Rochon Global Portfolio. In 2018, the Rochon Canada Portfolio returned -7.6% versus -8.9% for the S&P/TSX, therefore outperforming its index by 1.3%.

Since 2007, the Rochon Canada Portfolio has returned 462%, or 15.5% on an annualized basis. During this same period, our benchmark had a gain of 58%, or 3.9% on an annualized basis. Our annual added value was therefore 11.6%.

Year	Giverny Canada	S&P/TSX	+/-
2007	**19.7%**	9.8%	**9.9%**
2008	**-24.6%**	-32.9%	**8.3%**
2009	**28.2%**	33.1%	**-4.9%**
2010	**26.7%**	17.6%	**9.1%**
2011	**13.5%**	-8.7%	**22.2%**
2012	**24.0%**	7.2%	**16.8%**
2013	**49.4%**	13.0%	**36.4%**
2014	**20.3%**	10.6%	**9.7%**
2015	**16.0%**	-8.3%	**24.3%**
2016	**11.0%**	21.1%	**-10.1%**
2017	**27.4%**	9.1%	**18.3%**
2018	**-7.6%**	-8.9%	**1.3%**
Total	**462.4%**	**57.7%**	**404.6%**
Annualized	**15.5%**	**3.9%**	**11.6%**

Refer to Appendix B for disclosure statements on the Rochon portfolios.

The holding that contributed most significantly to our loss in 2018 was Dollarama. Despite its sharp decline in 2018, we have had a cumulative gain of more than 700% on this stock since our initial purchase in 2010. We will go in more detail regarding Dollarama in our "company" section below.

Over 12 years, the performance of our Canadian securities has been significantly higher than that of the S&P/TSX. A concentrated portfolio can drastically exceed the performance of an index but the risks inherent to high concentration is not appropriate for a portfolio that is to be managed prudently. In fact, we consider that a portfolio of about 20 securities is the right balance between having a minimum diversification level to reduce company-specific risk while also having few enough

companies to improve the odds of beating the market indices. Since this portfolio represents only a portion (approximately 15%) of the Rochon Global Portfolio, our diversification requirements are met.

2018

The year unfolded in two parts. Over the first two quarters, the US market did very well and reflected a sharp increase in corporate profits bolstered by a significant drop in corporate tax rates. The rest of the world, however, did not have the same experience and had marked stagnation in places such as Canada, Europe and Asia.

Then in the fall, the sentiment of US investors turned 180 degrees and the S&P 500 and the Russell 2000 fell by 20% and 27%, respectively, from their high of September to their low of December 24th. The sharp decline in December resulted in a bear market (a drop of more than 20%) which was the fifth since my debut in 1993, some 25 years ago.

We've been around the block!

We've known for a long time that the stock market, in the short term, behaves like a manic-depressive entity. No medicine can cure it or even stabilize it. The market is a network of millions of emotional human beings interacting with each other (imagine millions of people trying to predict what the other millions of people will do and vice versa).

Increased transaction efficiency and near instantaneous access to information has dramatically changed the way in which the investors approach the market since 1993, just before the large-scale implementation of the Internet. But what has not changed is human nature. When it comes to money, humans over and over flip flop from fear to greed like wind vanes armed with cell phones.

Here are the 2018 returns for different indices around the world and annualized over 5 years:

Return (in $US)	2018	2018 $Can	5 year
Russell 2000	-11.0%	-3.2%	4.4%
S&P 500	-4.4%	4.0%	8.5%
MSCI EAFE	-13.8%	-6.3%	0.5%
MSCI Europe	-14.9%	-7.5%	-0.6%
MSCI China + HK + Taiwan	-22.4%	-15.6%	2.9%
MSCI AC Asia	-13.7%	-6.2%	3.6%
Average	**-13.4%**	**-5.8%**	**3.2%**

S&P/TSX (in $Can)	-8.9%	-8.9%	4.1%

With a fall of 4% for 2018, the S&P 500 was the index that performed best among the main indices of the World. Furthermore, over the past three years, the S&P 500's returns have been extremely polarized, with software and internet-related stocks increasing by about 60% while those related to more traditional industries increasing by about 20%. In other words, if you had been underweighted the software and internet segments over the last few years, it would have been very difficult to achieve the S&P 500's performance.

Some of the companies in these sectors are clearly exceptional and have drastically changed the world we live in just a few years. On the other hand, one must bear in mind that all companies have an intrinsic value and that it can be risky to pay too much for even the best of companies.

A few words about big American banks

Many companies have slowly increased their debt levels during this economic cycle. The reason is very simple—the very low cost of capital (low interest rates). This prevailing appetite for debt is also very present in the world of private equity, as they have a business model which requires significant leverage.

We believe that it is not the big American banks that are financing the current level of leveraged loans. If we go back 25 years, about 30% of leveraged loans were owned by US banks and 40% by institutional investors. Recently, this ratio is about 5% for US banks and more than 85% for institutional investors (Source: S&P, Goldman Sachs).

Most major US banks, still scalded by the 2008 financial crisis, are stronger than ever and their stock market valuations seem very attractive to us. That's why we own shares in four US banks at the time of writing this letter.

Outlook for 2019

The prospects for earnings growth could certainly be much lower in 2019 than in 2018. We believe that US companies could increase their earnings per share (EPS) by an average of about 4% this year.

Even in the event of a more pronounced slowdown, the growth of corporate profits will eventually pick up again. Over the long run, stocks remain the best asset class to own for the simple reason that corporate profits are always growing (albeit not linearly).

If the stock market continues to behave like a manic-depressive entity in the short term (as 2018 so eloquently demonstrated), it nonetheless still always accurately reflects the intrinsic value of companies over the long term. Is this not a good premise for investing our savings?

The popularity of index funds

> *"....The idea behind buying an index fund is that the average manager - by definition - gets an average performance. But because of the management fees and transaction costs, their collective result can only be lower than the indices (which incur only little expense)... Many investors have concluded that investing in an index fund is statistically the best option for someone who cannot distinguish a good investment from another or a good manager from another... Thus, in recent years, capital has gradually shifted from active management to passive management. The side effect of this is that money moves to the largest companies that have the most weight in the index (the S&P 500). This movement of capital has had the effect of pushing the S&P 500 higher, which has the effect of making active management look even worse, which has the effect of transferring even more money from active to passive strategies. Some managers see the threat of not owning the largest stocks for their performance and they therefore make sure to have these securities with at*

least the weight of the S&P 500 in their portfolios (which has the effect of driving up these few securities once again). As one well-known manager said: "Many have capitulated". "

Do you think this is a good summary for 2018? And yet, I wrote these words 20 years ago for the 1998 annual letter. I then explained in detail the significant difference in valuation between large cap stocks (bought massively by index funds) and all others. I then added these sentences:

"…In the long run, the stock market reflects the intrinsic value of companies - large and small - and this imbalance between larger companies and smaller ones should be rectified on its own in the future.... In the stock exchange, as in life, common sense ends up triumphing even if it can test the patience of the wise man…"

What happened in the two decades that followed this text?

From 1999 to 2018, the S&P 500 achieved an annual return of 5.6%, while the Russell 2000 achieved an annual return of 7.4%. So, as I predicted, the S&P 500 returned to normal and smaller cap stocks did better than larger ones (a total return of 317% for the Russell 2000 vs. 197% for the S&P 500).

In 1998, many managers (and their clients) threw in the towel and resorted to index funds. Many observers argued that it was almost impossible to beat the S&P 500 over a long period. From this perspective, what was the performance of the Rochon Global Portfolio for the same period of 20 years? Here is a summary table:

Return in $Can	S&P 500	Russell 2000	S&P / TSX	**Rochon Global**	**Added value**
1999-2018	5.0%	6.8%	6.6%	**10.6%**	**4.6%**

Refer to Appendix B for disclosure statements on the Rochon portfolios.

You will note that the Canadian dollar appreciated from 1998 to 2018 and had the effect of reducing the annual return of US indices by 0.6% when presented in Canadian currency. The Rochon Global Portfolio results are calculated in Canadian dollars. As you can see, our annual return of 10.6% outperformed the S&P 500 by 5.6% annually, the Russell 2000 by 3.8% annually and the TSX by 4.0% on the same basis. This gives a weighted annual added value of 4.6% by combining the three indices (with 43% / 43% / 14% of respective weight).

As in 1998, I do not want to denigrate an investment approach based on indexing. For the vast majority of investors, this is a winning solution since most managers (amateurs and professionals) do not outperform the indices over the long term.

On the other hand, I have observed some investors generate returns that were much higher than the indices over the long term (such as Ben Graham, Peter Lynch, Lou Simpson, Warren Buffett, Charlie Munger, Bill Ruane, John Neff, Philip Carret, John Templeton, etc.) So I took the time to study the source of their outperformance and they all had one thing in common: they considered buying a stock as the purchase of a business and were all trying to buy these businesses at a meaningful discount to their intrinsic values.

I adopted this approach right from the start in 1993 and we have been validated (and rewarded) by this value investing philosophy so far.

A great quote from Ben Graham from 1958

I read Ben Graham's *The Intelligent Investor* late in 1992—this was the book that converted a young Warren Buffett in 1949 to value investing. For Buffett, this was the starting point for his immense success as an investor. I also read at the time the appendices of the book (the fourth revised edition) which includes a transcription of a speech by Ben Graham of 1958 entitled *The New Speculation in Common Stocks*. I found this text arid and of little interest at the time.

Although I've been reading *The Intelligent Investor* on a regular basis over the years, I never reread the 1958 speech, until I came across a Latin quote from Ben Graham and searched far and wide for its origin. I finally found the quote and its context in this speech from 1958. In my rereading, and also now armed with 25 years of new perspectives, I realized the profound nature of this quote and the highly nuanced writing ability of Ben Graham (a trait that seems extremely rare in the clouds of the social cyberworld of the 21st century).

This famous quote comes from Ovid's Metamorphoses (a classical author from 2000 years ago). Phaeton was the son of the sun god Phoebus—the god flying across the sky in his solar chariot. One day, Phaeton asked his father for permission to drive the famous chariot himself. Phoebus warned him to stay well in the middle of his trajectory—too low and he would ignite the Earth and too high he would ignite the heavens. Phaeton showed little prudence and lost control of his horses and crashed down to Earth in a fiery hell, nearly setting the World on fire.



Peter Paul Rubens, The fall of Phaeton (c 1636)
Musées royaux des Beaux-Arts de Belgique, Bruxelles / photo : F. Maes (MRBAB)

The words of caution which Phoebus spoke to Phaeton were:

medius tutissimus ibis
you will go safer in the middle road

As we mark the 25th anniversary of the beginning of the Rochon Global Portfolio and the 20th anniversary of the founding of Giverny Capital, I think it is worth reconsidering these words of wisdom that have survived since Roman times. Consciously or not, I realize that we have consistently followed the middle road in investing and assimilated the teachings of Ben Graham. At Giverny Capital, we have an approach that could be summarized as follows:

- We have an open mind but at the same time an independence of thought. We try to maintain a balance between humility and confidence in our judgment.
- We like to invest in companies that are growing quickly but not too quickly (knowing the dangers of growing too fast or falling prey to shifting trends).
- We understand the economic benefits of using some debt, but we stay away from companies that use it too aggressively.
- We can invest in companies related to new technologies but not in their very beginnings (we want to make sure that the business model is sound and sustainable).
- We are willing to pay a higher P/E multiple than when we began investing but there is a limit we are not ready to cross.
- We are patient but also know that there is a difference between being patient and stubborn.

We have very ambitious long-term performance targets that have been achieved so far. But we have always wanted to reach them without taking on inappropriate level of risk. We want to be good stewards of our capital and that of our partners. To constantly keep in mind the wisdom of Phoebus is the equivalent of having a lighthouse illuminating the path to enrichment in the stock market while also remaining cautious.

Owner's Earnings

At Giverny Capital, we do not evaluate the quality of an investment by the short-term fluctuations in its stock price. Our wiring is such that we consider ourselves owners of the companies in which we invest. Consequently, we study the growth in earnings of our companies and their long-term outlook.

Since 1996, we have presented a chart depicting the growth in the intrinsic value of our companies using a measurement developed by Warren Buffett: "owner's earnings". We arrive at our estimate of the increase in intrinsic value of our companies by adding the growth in EPS and the average dividend yield of the portfolio. We believe that analysis is not exactly precise but approximately correct. In the non-scientific world of the stock market, we believe in the old saying: "It is better to be roughly right than precisely wrong."

This year, the intrinsic value of our companies, as a whole, rose by about 22% (21% from the growth in earnings and 1% from the average dividend). Despite some of the changes to our portfolio during the year, we consider the estimate of the EPS growth at our companies during 2018 to adequately reflect their economic reality.

The market performance of the Rochon Global portfolio in 2018 was a decline of roughly 7% (estimated without currency effects). Our stocks therefore realized a price performance that was far less than their underlying economic performance.

In fact, in 23 years of tracking owner earnings, this is the most significant disparity between the estimated increase in intrinsic value and the stock market value we have experienced. There are two

possibilities that present themselves: either our securities were overvalued at the beginning of 2018 (and therefore already factored in the rise in the upcoming growth of their intrinsic value) or that our securities at the end of the year were more undervalued than in beginning of the year. We believe the latter to be the case.

The companies in the S&P 500 also saw strong growth, with growth in the order of 21% (about 23% when we add the dividend). The S&P 500 had a total performance of -4% (in $USD).

	Rochon Global Portfolio			S&P 500		
Year ***	Value *	Market **	Difference	Value *	Market **	Difference
1996	14%	29%	15%	13%	23%	10%
1997	17%	35%	18%	11%	33%	22%
1998	11%	12%	1%	-1%	29%	30%
1999	16%	12%	-4%	17%	21%	4%
2000	19%	10%	-9%	9%	-9%	-18%
2001	-9%	10%	19%	-18%	-12%	6%
2002	19%	-2%	-21%	11%	-22%	-33%
2003	31%	34%	3%	15%	29%	14%
2004	21%	8%	-12%	21%	11%	-10%
2005	14%	15%	0%	13%	5%	-8%
2006	14%	3%	-11%	15%	16%	1%
2007	10%	0%	-10%	-4%	5%	9%
2008	-3%	-22%	-19%	-30%	-37%	-7%
2009	0%	28%	28%	3%	26%	23%
2010	22%	22%	0%	45%	15%	-30%
2011	17%	6%	-11%	17%	2%	-15%
2012	19%	23%	4%	7%	16%	9%
2013	16%	42%	26%	9%	32%	23%
2014	13%	19%	6%	9%	14%	5%
2015	11%	4%	-7%	1%	1%	0%
2016	9%	10%	1%	3%	12%	9%
2017	14%	20%	7%	14%	22%	8%
2018	22%	-7%	-29%	23%	-4%	-27%
Total	1723%	1424%	-298%	474%	524%	50%
Annualized	13.5%	12.6%	-0.9%	7.9%	8.3%	0.4%

* Estimated growth in earnings plus dividend yield
** Market performance, inclusive of dividends (refer to Appendix B for disclosure statements on our returns)
*** Results estimated without currency effects

Since 1996, our companies have grown their value by about 1723% and their stocks have achieved a total return of approximately 1424%. On an annualized basis, we achieved an intrinsic performance of 13.5% versus 12.6% for their stock market performance (dividend included in both cases). The correlation between the two figures over a long period is not accidental since the stock market always reflects the fair value of companies over the long term.

Our stocks have outperformed the S&P 500 by 4.3% annually over the last 23 years for the simple reason that our companies grew their intrinsic values at a rate that was around 5% greater than that of the companies that make up the S&P 500.

Five-year Post-mortem: 2013

Like we do every year, we go through a five-year post-mortem analysis. We believe that studying our decisions in a systematic manner, and with the benefit of hindsight, enables us to learn from both our achievements and our errors.

We made few changes to the portfolio in 2013, but here are a few remarks from reviewing the annual letter from that year.

- In 2013, we acquired shares in Cabela's, a chain of outdoor, hunting and fishing stores. It was a disappointing investment. In 2013, we wrote that the "the company recently adopted a more high-performing business model which grabbed our attention." But in the end, the financial performance of these retail stores did not live up to our expectations and we resigned ourselves to selling our investment at a loss.
- In 2013, we invested in Precision Castparts. We liked the management of the company and the significant competitive advantages of its products. Berkshire Hathaway acquired the business in 2015 and this investment proved very rewarding over a relatively short period.
- In 2013, I gave a gold medal to the mistake of not buying shares in Church & Dwight. I explained that I had studied the stock in 2003 and that it had risen by 455% during those ten years. The growth rate of this company slowed afterwards but, during the five years that followed, the stock returned 93% versus 34% for the S&P 500 (gross of dividends).

Frutarom Acquisition

We purchased shares in the Israeli company Frutarom in 2017. This company specializes in the manufacturing of essences and flavors with a focus on natural-based flavors. It is an industry that we have always appreciated because of its great stability. Moreover, Frutarom had an exceptional track record, maintaining a growth rate of more than 20% over the last decade.

During the year, Frutarom was acquired by the American company International Flavors & Fragrances, a leader in this sector. We achieved a gain of about 45% over a period of just over a year.

<u>Our Companies</u>

" Trees with deep roots are those that grow higher "

- Frédéric Mistral (Les îles d'or)

Section for Giverny Capital's partners only

The Podium of Errors

" How do you become better tomorrow? By improving yourself, the world is made better. Forget your mistakes, but remember what they taught you. "

- Benjamin Franklin

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2018 (or from past years). It is with a constructive attitude, in order to always improve as investors, that we provide this detailed analysis. As is often the case with stocks, errors from omission (non-purchases) are often more costly than errors from commission (purchases)… even if we don't see those on our statements.

Bronze Medal: Lululemon

I've followed the Canadian company Lululemon since its IPO in 2007. I admire the quality of their products, their marketing strategies and the loyalty of their customers. Lululemon addresses, among others, the yoga clothing market. I'm not a fan of this activity (I prefer to go to museums to recharge my battery) but I can see that Lululemon is dominant in this market segment. The stock has often commanded a high P/E so I followed its performance from afar.

The company had issues with some of its products a few years ago and also made management changes. In 2017, the issues seemed to have been addressed and the prospects for growth and profitability had greatly improved. The stock market did not reflect, in our opinion, these better prospects. So we decided to become shareholders in early 2018.

But the day we were about to buy, the CEO resigned for "lack of leadership". So I opted to wait to see who the new appointee would be. Meanwhile, financial results came out and were very strong. The share price then climbed quickly and I decided to wait for a better price. At the time of writing this, the stock is 88% higher.

Silver Medal: Boyd Group

We starting paying attention to the Canadian company Boyd Group in July 2011 when the stock was trading for around $14. Boyd Group has a network of 575 body shops. Its collision repair centers are located in Canada and the United States mainly under the respective names of Boyd and Gerber. Boyd's beautiful track record and attractive growth prospects caught our attention.

We were also attracted by the inherent characteristics of the industry in which Boyd operated. It's a highly fragmented industry with many small independent local players which created an opportunity for consolidation for a company like Boyd. The stock then traded at a reasonable multiple, about 14-15 times the estimated profits for 2011. At about the same time, we were also studying LKQ, a

distributor of refurbished body parts. LKQ seemed to have greater competitive advantages than Boyd. So we eventually decided to invest in LKQ in 2012.

We also chose to pass on Boyd because we found it odd that the company was structured as a corporate income trust (a patently simplistic excuse). From 2012 to 2018, LKQ increased its EPS by 17% annually but the stock did not follow suit (rightly or wrongly, the P/E decreased). As for Boyd, EPS has grown by 32% annually and the stock is now trading around $125—it has appreciated by nine times.

Gold Medal: Bright Horizons Family

We discovered Bright Horizons Family about fifteen years ago. The company operates private daycare facilities within companies. It responds to a vital need of our era. Bright Horizons had strong growth (in the 25% range) and seemed to have strong competitive advantages. Because of its high valuation (often trading at 25 to 30 times earnings), we never became shareholders. In early 2008, the company was privatized by a private equity fund at about three times the price I had considered investing five years prior.

But we must always keep our eyes open: the company went public again in 2013. Unfortunately, the company had a lot of debt at the time. The stock was issued at approximately $28 and the company only earned $0.80 per share. I knew, however, that the company could increase its profit margins and certainly improve its balance sheet. I told myself that I would not miss my chance a second time and I have followed the company very closely since.

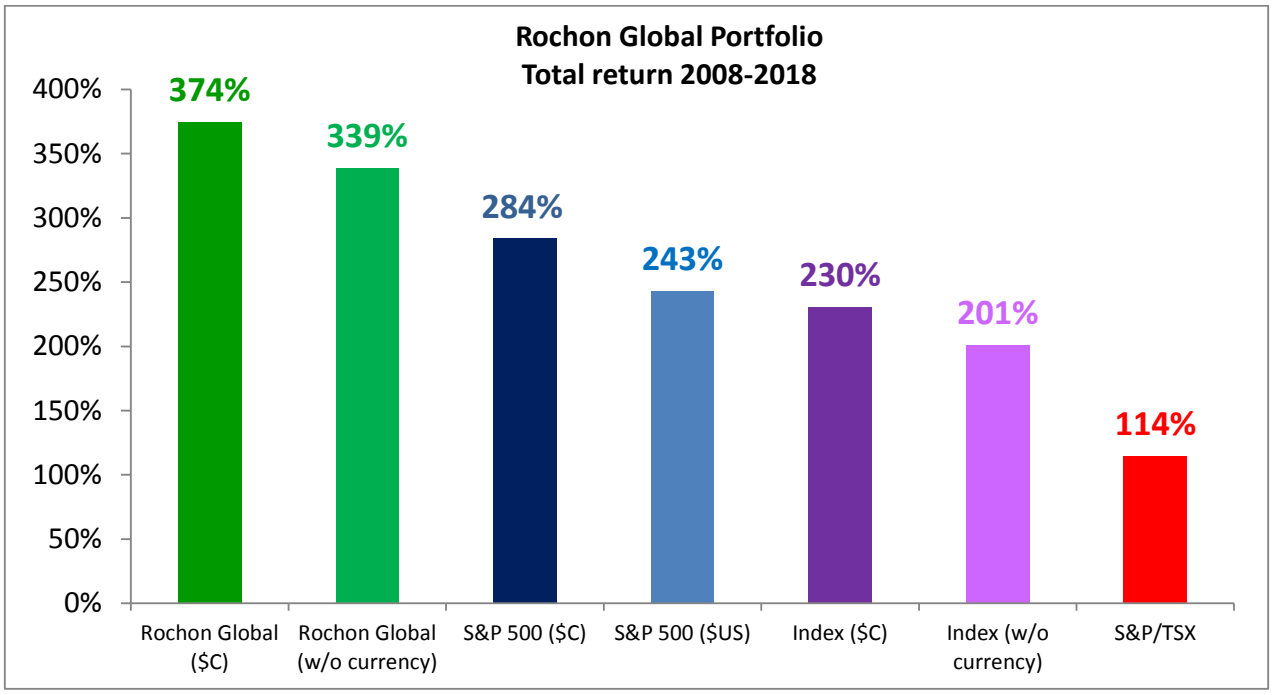
The stock never truly corrected on the stock market (even late last year) and the company realized EPS of $3.15 in 2018. The stock traded at the end of the year at $111, (i.e. at a P/E of 31x EPS forecast for 2019). This is a high valuation but justified by their impressive track record. We could have made four times our money in five years (in addition to the first triple from 2003 to 2008). As we have stated on a regular basis, we want to be cautious by waiting for a price for a stock that allows for a sufficient margin of safety. But wisdom is knowing how to discern when a high price is really justified. And in this case, we should have shown more wisdom. We even had two chances!

Conclusion: The 10th anniversary of "The opportunity of a generation"

A decade ago, I added a special page at the beginning of our annual letter which explained that we believed that the sharp drop in the market during 2008 and early 2009 represented “The opportunity of a generation”.

Is is true that the economic situation in 2008-2009 was quite worrisome. A time horizon of a few years was needed to see beyond the grey clouds. While many investors were paralyzed in the face of the financial market meltdown, we saw it as a fantastic opportunity. We did everything we could to spread the word. I went on CBC television. I was also interviewed in the newspaper La Presse (February 14, 2009) and we even created a website (it still exists: www.occasiongeneration.com). We also organized a series of conferences throughout Quebec in early 2009. But we had to cancel several for lack of participants.

Ultimately, the capitalist world did not collapse and our portfolio did very well. Here are the returns of the Rochon Global Portfolio for the 10 years from January 1, 2009 to December 31, 2018:



Refer to Appendix B for disclosure statements on the Rochon portfolios. Index is a hybrid index (S&P/TSX, S&P 500, Russell 2000) which reflects the weight of the underlying assets at the beginning of the year.

Over 10 years, the Rochon Global portfolio generated a total return of 374% (16.8% on an annualized basis). Our comparative index group generated 230%, adjusted in Canadian currency, during the same period (12.7% annualized).

It was necessary to be optimistic vis-à-vis the capitalist system in late 2008 to invest in the stock market (or even just remain invested). But this optimism has been rewarded.

To Our Partners

We believe that the companies we own are exceptional, led by top-notch people, and destined for a great future. They should continue to prudently navigate the often troubled waters of the global economy. Furthermore, the valuation assigned by the market to these outstanding companies is very similar to the valuation of an average company in the S&P 500, despite the fact that our companies have better growth prospects than average in our opinion. Therefore we consider the appreciation potential for our portfolio, both in absolute and relative terms, to be well above average, especially when compared to other alternative asset classes, such as bonds.

We also want you to know that we are fully aware of and grateful for your votes of confidence. It is imperative for us to not only select outstanding companies for our portfolios, but to also remain outstanding stewards of your capital. We certainly like to achieve good returns and have developed a

taste for it, but it must not come at the cost of taking undue risk. Our philosophy to favor companies with solid balance sheets and dominant business models, along with purchasing these companies at reasonable valuations, is central to the risk management of our portfolios.

Thank you from the entire Giverny Capital team and we wish a great 2019 to all our partners.



François Rochon and the Giverny Capital team

APPENDIX A

Investment philosophy

Note: This section is repeated from prior annual letters and is aimed at new partners.

In 2018, we saw a large increase in the number of Giverny Capital partners (the term we use for our clients). With all these newcomers, it is imperative that we write again (and again) about our investment philosophy.

Here are the key points:

- We believe that over the long run, stocks are the best class of investments.
- It is futile to predict when it will be the best time to begin buying (or selling) stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity).
- We choose companies that have high (and sustainable) margins and high returns on equity, good long term prospects and are managed by brilliant, honest, dedicated and altruistic people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be approximately assessed.
- The stock market is dominated by participants that perceive stocks as casino chips. With that knowledge, we can then sometimes buy great businesses well below their intrinsic values.
- There can be quite some time before the market recognizes the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

Experience and common sense teach us that an investment philosophy based on buying shares in companies that are undervalued, and holding these companies for several years, will not generate linear returns. Some years, our portfolio will have a return that is below average. This is a certainty that we must accept.

Another important point: the significant volatility of the market is often perceived negatively by many investors. It's actually the contrary. When we see stock prices as *"what other people believe the company is worth"* rather than the real value (at least in the short term), these fluctuations become our allies in our noble quest for creating wealth. Instead of fearing them, we can profit from them by acquiring superb businesses at attractive prices. The more that markets (the "other" participants) are irrational, the more likely we are to reach our ambitious performance objectives.

Benjamin Graham liked to say that the irrationality of the market provides an extraordinary advantage to the intelligent investor. The person, however, who becomes affected by short-term market fluctuations (less than 5 years) and who makes decisions based on them transforms this advantage into a disadvantage. His or her own perception of stock quotes becomes their own worst enemy. Our approach at Giverny Capital is to judge the quality of an investment over a long period of time.

So patience – ours AND that of our partners – becomes the keystone for success.

APPENDIX B

Notes on the returns of the Rochon portfolios

- The Rochon portfolio is a private family group of accounts managed by François Rochon since 1993. The returns of the period from 1993 to 1999 were realized before registration of Giverny Capital Inc. at the AMF in June of 2000.
- The Rochon Global portfolio serves as a model for Giverny Capital's clients, but returns from one client to the other can vary depending on a multitude of factors. The returns indicated include trading commissions, dividends (including foreign withholding income taxes) and other income but do not include management fees. Portfolio returns of the Rochon Global portfolio have been generated in a different environment than Giverny Capital's clients and this environment is considered controlled. For example, cash deposits and withdrawals can increase the returns of the Rochon Global portfolio. Thus, the portfolio returns of the Rochon Global portfolio are often higher than the returns realized by clients of Giverny Capital.
- Past results do not guarantee future results.
- The Rochon Canada and Rochon US portfolios are parts of the Rochon Global portfolio.
- The index benchmark group is selected at the beginning of the year and tends to be a good reflection of the asset composition of the portfolio. Weighted indices presented may not be representative of the Rochon Global portfolio. In 2018 :

  - Giverny Global Portfolio: TSX 16% Russell 2000 40% S&P 500 40% MSCI EAFE 4%
  - Giverny US Portfolio : S&P 500 100%
  - Giverny Canada Portfolio : S&P/TSX 100%

- The returns for the S&P 500 (in $USD) are provided by Standard & Poors.
- The returns for the various indices used for comparable purposes are deemed reliable by Giverny Capital.
- It should be noted that currency effects on the returns of the Rochon portfolio and indices are estimated to our best effort.
- The custodian of our client portfolios is National Bank Correspondent Network (NBCN) in Canada and TD Ameritrade Institutional in the US.
- The financial statements of the three portfolios are audited at the end of each year. The auditor's data are those provided by our custodian (NBCN). The auditor's annual reports are available upon request.
- For more information, please see the "returns" section of our website.

GIVERNY CAPITAL

Annual Letter to our Partners 2019



Ice Shelf, 2013 © Wanda Koop,
license issued by Copyright Visual Arts - CARCC, 2020.
Giverny Capital Collection

Historical Summary

It has been more than 27 years since I discovered the writings of Warren Buffett, Benjamin Graham, John Templeton, Philip Fisher and Peter Lynch. I then decided to begin managing a family portfolio based on an investment approach synthesized from these great money managers. By the end of 1998, after five years of satisfactory results, I decided to launch an investment management firm offering asset management services aligned with my own investment philosophy. Giverny Capital Inc. came into existence.

In 2002, Giverny hired its first employee: Jean-Philippe Bouchard (JP for those who know him well). A few years later, JP became a partner; he participates actively in the investment selection process for the Giverny portfolio. In 2005, two new persons joined the firm who eventually became partners: Nicolas L'Écuyer and Karine Primeau. In 2009, we launched a US office in Princeton, New Jersey. Moreover, in early 2020, we established a partnership with a portfolio manager based in New York City who will head the office of the firm Giverny Capital Asset Management LLC in Manhattan. The directors of the US offices, Patrick Léger and David Poppe, share in the culture and long-term time horizon inherent to Giverny.

We are Partners!

From the very first days of Giverny, the cornerstone of our portfolio management philosophy was to manage client portfolios in the same way that I was managing my own money. Thus, the family portfolio I've managed since 1993 (the "Rochon Global Portfolio") serves as a model for our client accounts. It is crucial to me that clients of Giverny and its portfolio managers are in the same boat! That is why we call our clients "partners".

The Purpose of our Annual Letter

The primary objective of this annual letter is to discuss the results of our portfolio companies over the course of the prior year. But even more importantly, our goal is to explain in detail the long-term investment philosophy behind the selection process of the companies in our portfolio. Our wish is for our partners to fully understand the nature of our investment process since long-term portfolio returns are the fruits of this philosophy. Over the short term, the stock market is irrational and unpredictable (though some may think otherwise). Over the long term, however, the market adequately reflects the intrinsic value of companies. If the stock selection process is sound and rational, investment returns will eventually follow. Through this letter, we provide you with the information required to understand this process. You will hopefully notice that we are transparent and comprehensive in our discussion. The reason for this is very simple: we treat you the way we would want to be treated if our roles were reversed.

The Artwork on Our 2019 Letter

Since 2004, we have illustrated the cover of our letters with a copy of artwork from our corporate collection. This year we selected a 2013 painting by the Canadian artist, Wanda Koop, entitled "*Ice Shelf*".

For the year ending December 31st 2019, the return for the Rochon Global Portfolio was 25.6% versus 22.3% for our benchmark, which represents a relative outperformance of 3.3%. The return of the Rochon Global Portfolio and the one of our benchmark include a loss of approximately 5% due to fluctuations in the Canadian currency.

Since its inception on July 1st 1993, the compounded annual return of the Rochon Global Portfolio has been 15.4% versus 9.3% for our weighted benchmark, representing an annualized outperformance of 6.2% over this period. It's worth noting that the effect of the fluctuations in the value of the US Dollar has been nearly nonexistent on our returns. Over 26 years, the US currency has appreciated by 1.4% relative to the Canadian Dollar, which corresponds to an effect of 0.1% on our annualized returns. Our long-term and ambitious objective is to maintain an annual return 5% higher than our benchmark.

The Rochon Global Portfolio: Returns since July 1st 1993

Year *	Rochon	Index **	+ / -	$ US/Can ***
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	3.3%
1994	**16.5%**	3.7%	**12.7%**	6.0%
1995	**41.2%**	24.0%	**17.2%**	-2.7%
1996	**28.0%**	22.8%	**5.2%**	0.3%
1997	**37.8%**	28.6%	**9.2%**	4.3%
1998	**20.6%**	18.8%	**1.8%**	7.1%
1999	**15.1%**	16.3%	**-1.2%**	-5.7%
2000	**13.4%**	3.2%	**10.2%**	3.9%
2001	**15.1%**	-0.4%	**15.5%**	6.2%
2002	**-2.8%**	-18.3%	**15.6%**	-0.8%
2003	**13.6%**	14.0%	**-0.4%**	-17.7%
2004	**1.6%**	6.2%	**-4.5%**	-7.3%
2005	**11.5%**	3.6%	**7.9%**	-3.3%
2006	**3.5%**	17.0%	**-13.5%**	0.2%
2007	**-14.4%**	-11.6%	**-2.8%**	-14.9%
2008	**-5.5%**	-22.0%	**16.5%**	22.9%
2009	**11.8%**	12.2%	**-0.4%**	-13.7%
2010	**16.1%**	13.8%	**2.3%**	-5.3%
2011	**7.6%**	-1.1%	**8.7%**	2.2%
2012	**21.2%**	12.5%	**8.7%**	-2.2%
2013	**50.2%**	38.9%	**11.3%**	6.9%
2014	**28.1%**	17.8%	**10.2%**	9.1%
2015	**20.2%**	13.4%	**6.8%**	19.3%
2016	**7.3%**	14.3%	**-7.0%**	-3.0%
2017	**13.1%**	10.3%	**2.9%**	-6.6%
2018	**-0.6%**	-1.4%	**0.8%**	8.7%
2019	**25.6%**	22.3%	**3.3%**	-4.8%
Total	**4391.2%**	**945.8%**	**3445.4%**	**1.4%**
Annualized	**15.4%**	**9.3%**	**6.2%**	**0.1%**

* All returns are adjusted to Canadian dollars
** Index is a hybrid index (S&P/TSX, S&P 500, Russell 2000) which reflects the weight of the underlying assets at the beginning of the year.
*** Variation of the US dollar compared to the Canadian dollar
Refer to Appendix B for disclosure statements on the Rochon portfolios.

The adjective "ambitious" in relation to of our performance objectives is chosen with care. A very small number of managers succeed over a very long period (say 20 years) in outperforming the indices. Maintaining such a goal will remain difficult. In Alexandre Dumas' famous novel, *The Count of Monte Cristo*, the author states that the expression that defines him is *cupitor impossibilium*. At Giverny, our ambitions for outperformance are cut from the same cloth: to desire the impossible.

The Rochon US Portfolio

We have been publishing the returns of the Rochon US Portfolio, which is entirely denominated in US dollars, since 2003. The Rochon US Portfolio corresponds to the American portion of the Rochon Global Portfolio. In 2019, it realized a return of 32.1% compared to 31.5% for our benchmark, the S&P 500. The Rochon US Portfolio therefore outperformed the benchmark by 0.6%.

Since its inception in 1993, the Rochon US Portfolio has returned 3631%, or 14.6% on an annualized basis. During this same period, the S&P 500 has returned 1111%, or 9.9% on an annualized basis. Our added value has therefore been 4.8% annually.

Year	Rochon US	S&P 500	+/-
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	37.6%	17.2%
1996	27.0%	23.0%	4.1%
1997	32.9%	33.4%	-0.4%
1998	11.0%	28.6%	-17.6%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-9.1%	20.4%
2001	8.1%	-11.9%	20.0%
2002	-4.4%	-22.1%	17.7%
2003	31.6%	28.7%	2.9%
2004	9.3%	10.9%	-1.6%
2005	12.5%	4.9%	7.5%
2006	3.3%	15.8%	-12.4%
2007	-1.7%	5.5%	-7.2%
2008	-24.3%	-37.0%	12.7%
2009	28.7%	26.5%	2.3%
2010	21.9%	15.1%	6.9%
2011	4.7%	2.1%	2.6%
2012	22.3%	16.0%	6.3%
2013	40.6%	32.4%	8.2%
2014	18.0%	13.7%	4.3%
2015	1.7%	1.4%	0.4%
2016	7.5%	12.0%	-4.5%
2017	19.7%	21.8%	-2.1%
2018	-8.3%	-4.4%	-3.9%
2019	32.1%	31.5%	0.6%
Total	3631.2%	1111.0%	2520.2%
Annualized	14.6%	9.9%	4.8%

Refer to Appendix B for disclosure statements on the Rochon portfolios.

In 2019, the Rochon US portfolio slightly outperformed the S&P 500. This was despite the significant underperformance of our shares in Berkshire Hathaway, the largest weight in our portfolio.

It has been difficult to outperform the S&P 500 in recent years, probably one of the best performing indices in the world over the past five years. The all-stars of the S&P (Apple and Amazon, for example) played a major role in this polarized performance. In addition, the tremendous popularity of index funds also contributed to the outperformance of the S&P 500. Indeed, indices that have performed the best over the short term tend to attract the most capital from passive investors and are further bolstered.

This is the nature of short-term stock market behavior: recent past outperformance propels current outperformance. But, without exception, the stock market always ends up eventually reflecting the intrinsic value of companies.

Rochon Canada Portfolio

We introduced a portfolio that is 100% focused on Canadian equities in 2007. This corresponds approximately to the Canadian portion of the Rochon Global Portfolio. In 2019, the Rochon Canada Portfolio returned 29.0% versus 22.9% for the S&P/TSX, therefore outperforming its index by 6.1%.

Over 13 years, the Rochon Canada Portfolio has returned 625%, or 16.5% on an annualized basis. During this same period, our benchmark had a gain of 94%, or 5.2% on an annualized basis. Our annual added value was therefore 11.2%.

Year	Rochon Canada	S&P/TSX	+/-
2007	**19.7%**	9.8%	**9.9%**
2008	**-24.6%**	-32.9%	**8.3%**
2009	**28.2%**	33.1%	**-4.9%**
2010	**26.7%**	17.6%	**9.1%**
2011	**13.5%**	-8.7%	**22.2%**
2012	**24.0%**	7.2%	**16.8%**
2013	**49.4%**	13.0%	**36.4%**
2014	**20.3%**	10.6%	**9.7%**
2015	**16.0%**	-8.3%	**24.3%**
2016	**11.0%**	21.1%	**-10.1%**
2017	**27.4%**	9.1%	**18.3%**
2018	**-7.6**	-8.9%	**1.3%**
2019	**29.0%**	22.9%	**6.1%**
Total	**625.3%**	**93.8%**	**531.4%**
Annualized	**16.5%**	**5.2%**	**11.2%**

Refer to Appendix B for disclosure statements on the Rochon portfolios.

Since 2007, the performance of our Canadian securities has been significantly higher than that of the S&P/TSX. We would like to repeat, once again this year, that a concentrated portfolio can drastically exceed the performance of the indices.

However, in our opinion, the risk inherent to high concentration is not appropriate for a portfolio that is to be managed prudently. In fact, we consider that a portfolio of about 20 securities is the right balance between having a minimum diversification level to reduce company-specific risk while also owning a low enough number of companies to improve the odds of beating the market indices. Since this portfolio represents only a portion (approximately 14%) of the Rochon Global Portfolio, our diversification requirements are met.

2019

Years follow each other but are never alike.

In 2018, American companies had greatly improved their level of profitability (thanks to, among other things, the reduction in corporate tax rates). However, the stock market experienced a decline that year. It was the opposite in 2019: for most compagnies, profits stagnated but the stock market did very well. One could therefore conclude that stock prices in 2019 caught up with the undervaluation created in 2018.

Over the long run, stocks inevitably reflect increased corporate profits. A certain synchronicity between the underlying intrinsic performance of companies and their stock prices therefore always eventually materializes.

The temporality of this stock market justice, on the other hand, is completely unpredictable. Of course, that doesn't stop numerous Wall Street strategists from venturing their predictions, as random as they may be. The reason is simple: their customers keep asking for such predictions despite all the historical data that demonstrate their futility.

Trade disputes

Trade tensions between the United States and China continued to feed the media. We obviously have no idea the outcome or consequences of these tensions, but in general, we are for the free movement of goods and services and a market unshackled from various government interventions. But we also realize that we live in a complex world where there are various parameters which interact on many levels. If it were simple to solve, our civilization would have already found the solution. This line of thinking also applies to many facets of humanity.

Our investment approach is therefore to not try to predict macroeconomics (and the even less predictable political world) but rather to focus on the activity of selecting high quality companies.

The last decade: 2010-2019

10 years ago, we emerged (with a few scars) from the financial crisis of 2008-2009. Few investors liked the idea of investing in stocks and everything seemed like a good reason to stay away from the stock market. Here are some of the geopolitical and macroeconomic events that took place during the last decade:

- The anti-stock-market movement of “Occupy Wall Street” (2011)
- The downgrade of American bonds (2011)
- Financial crisis in Europe, particularly in Greece (2011)
- The debt ceiling crisis with the US government (2012)

- The "fiscal cliff" in the US (2012)
- The start of the conflict between Russia and Ukraine (2013)
- Lawsuits by the US government against large banks (2013)
- Oil price collapse (2014)
- Economic slowdown in China (2015)
- Brexit (2016)
- The trade conflict with China (2018)

If they had known in advance everything that had happened in the past 10 years, many investors would have waited on the sidelines before investing in the stock market... and many did. We can even read everywhere that we had not had a bear market over the decade (another excuse to sell shares!) Strangely, the two bear markets - a 20% drop in the stock market in 2011 and 2018 are often overlooked. I called these "ghost bear markets".

From 2010 to 2019, the return on the Rochon Global portfolio was 18.2% on an annualized basis, or a total return of 433%. Imagine the opportunity cost if we had let fears of the future hold us back in our business of acquiring high quality companies.

We can break down our annual performance for the decade into three parts:

Growth in corporate profits (including dividends)	+15.0%
Increase in P/E ratio of our holdings	+1.0%
Foreign currency gain related to $CAD depreciation	+2.2%
Total annual return for Rochon Global portfolio	**+18.2%**

Refer to Appendix B for disclosure statements on the Rochon portfolios.

As you can see, most of our performance resulted from the growth in underlying profits from the companies in our portfolio. Over the long term, in our view, owning stocks of above-average companies remains the key to success in the investment world.

What does the next decade hold for us? Obviously, we are not soothsayers. We believe that growth in corporate profits will be weaker in the years to come as we estimate that after-tax profit margins are at a level that will be difficult to improve. For the companies making up the S&P 500, we believe that profit growth will be around 5 to 6% per year in the years to come.

If we continue to own companies that, as a whole, increase earnings per share (EPS) by more than 10% per year on average, over many years, we believe that our overall portfolio will generate an annual return of this magnitude.

In order to reap such return, however, it is essential to remain undistracted by the various headlines of the media. To obtain the strong long-term results of equities, one has to stay invested in equities.

An energy revolution in the United States (part two)

Seven years ago, in the 2012 annual letter, I presented a section on the energy revolution in the United States. I was explaining that new discoveries of shale gas and oil in the western United States (and, most importantly, the technology to extract them) had completely changed the energy balance in the US. I noted that the US appeared poised to dramatically improve the dynamics of its energy trade.

But I took the trouble to add: "despite the optimistic tone of this section, none of this changes the fact that the energy industry is – to us – difficult to predict… this simply means that companies that operate in the energy industry are difficult for us to evaluate."

What has happened since? The energy revolution in the United States continued to the point that in 2019, for the first time in several decades, the United States became a net exporter of oil (see Chart 1).

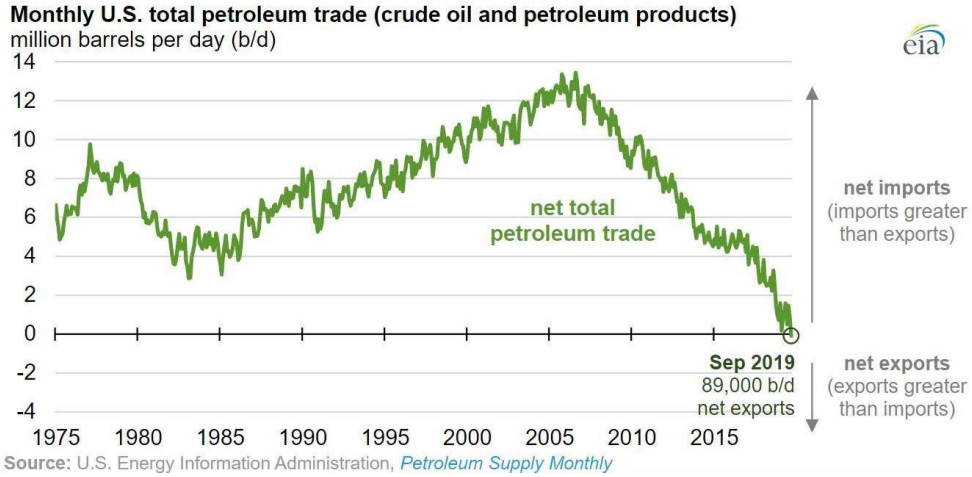


Chart 1: Petroleum trade in the US over the last 45 years.

Oil production in the US increased from 6 million barrels per day in early 2012 to almost 13 million last year. However, this was not necessarily a source of enrichment for the producers. The price of a barrel of oil dropped from $91 in 2012 to $52 recently. The energy sector had a difficult decade (see Chart 2). Few people in 2007 (when oil prices hit $140 a barrel) would have predicted such a thing. There are so many factors that interact, sometimes even in a contradictory manner to each other, that it makes the prediction of the future of this industry very complex.

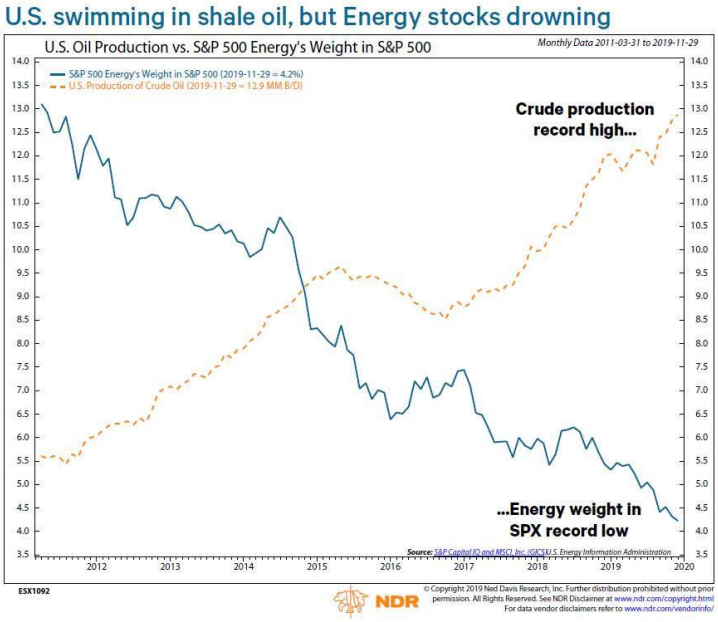


Chart 2: Oil production in the US since 2011 versus the weight of the energy sector within the S&P 500. Source: Ned Davis Research

A first for renewable energy in the United States

Another dimension of the American energy revolution also continued. In 2019, the production of electricity from renewable energy exceeded, for the first time in history, that from coal (Chart 3).

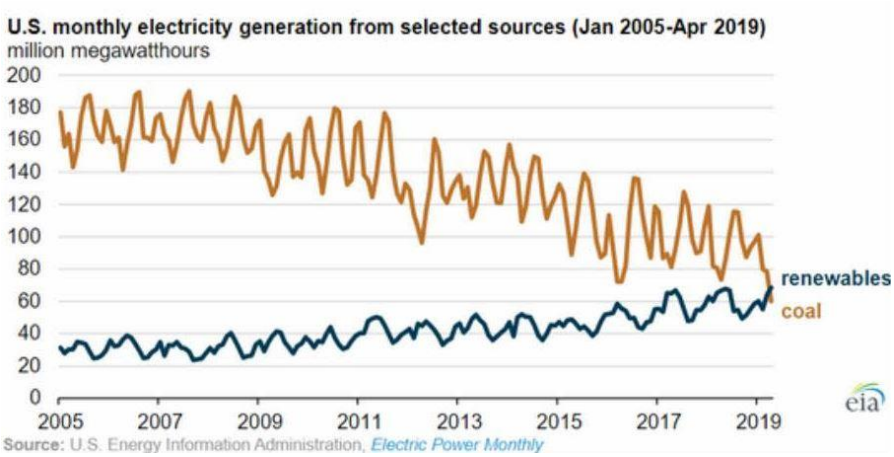


Chart 3: Monthly production of electricity generated from coal versus renewable sources.

This great news for the environment went completely unnoticed on social media. One could argue that a prolonged observation of the media in our society reveals that bad news and prophets of doom have always had excellent press agents...

Conclusion

We continue to avoid the oil sector for several reasons. First, we believe this is an area where competitive advantages are rare and seldom sustainable (excuse the pun). Over the long term, we also believe that humanity will continue to evolve towards more sustainable ways of producing the vast amount of energy we need. We own a few companies in our portfolio that should benefit from the growth of electric car in the years to come.

The flavor of the day

When you consider that a 10-year US government bond (and also that of Canada) carries an interest rate of less than 1%, the alternatives to stocks are clearly unattractive. Such rates are unlikely to be sufficient to cover inflation and it's even worse in Europe where interest rates are often negative. The only guarantee that comes with such low yielding bonds is that of getting poorer. Their popularity is difficult to understand.

The iconic example from this period is the now famous issue by the Austrian government of "century" bonds. These bonds were issued at €100 in 2017 with a 2.1% coupon and maturing on September 20, 2117. This security, in our opinion, already risky at par, rose 55% in less than two years. A second tranche of these bonds was then issued at €154 in June of 2019. At this price, the yield to maturity (in 98 years) was 1.17% annually. But a few months later, in August 2019, the price of these bonds hit a high of €210. The annual yield to maturity was then 0.61%.[1]

[1] Source: Barron's

At the current time, there is $17 trillion (or $17,000 billion) in negative interest bonds worldwide. These negative interest bonds represent, in our opinion, an aberration that is hard to comprehend.

Owner's Earnings

At Giverny Capital, we do not evaluate the quality of an investment by the short-term fluctuations in its stock price. Our wiring is such that we consider ourselves owners of the companies in which we invest. Consequently, we study the growth in earnings of our companies and their long-term outlook.

Since 1996, we have presented a chart depicting the growth in the intrinsic value of our companies using a measurement inspired by Warren Buffett: "owner's earnings". We arrive at our estimate of the increase in intrinsic value of our companies by adding the growth in earnings per share (EPS) and the average dividend yield of the portfolio. We believe that analysis is not exactly precise but approximately correct. In the non-scientific world of the stock market, we believe in the old saying: "It is better to be roughly right than precisely wrong."

	Rochon Global Portfolio			S&P 500		
Year ***	Value *	Market **	Difference	Value *	Market **	Difference
1996	14%	29%	15%	13%	23%	10%
1997	17%	35%	18%	11%	33%	22%
1998	11%	12%	1%	4%	29%	25%
1999	16%	12%	-4%	12%	21%	9%
2000	19%	10%	-9%	15%	-9%	-24%
2001	-9%	10%	19%	-21%	-12%	9%
2002	19%	-2%	-21%	13%	-22%	-35%
2003	31%	34%	3%	12%	29%	16%
2004	21%	8%	-12%	20%	11%	-10%
2005	14%	15%	0%	15%	5%	-10%
2006	14%	3%	-11%	24%	16%	-8%
2007	10%	0%	-10%	-4%	5%	9%
2008	-3%	-22%	-19%	-31%	-37%	-6%
2009	0%	28%	28%	6%	26%	20%
2010	22%	22%	0%	50%	15%	-35%
2011	17%	6%	-11%	18%	2%	-16%
2012	19%	23%	4%	9%	16%	7%
2013	16%	42%	26%	8%	32%	24%
2014	13%	19%	6%	10%	14%	4%
2015	11%	4%	-7%	1%	1%	0%
2016	9%	10%	1%	4%	12%	8%
2017	14%	20%	7%	14%	22%	11%
2018	20%	-8%	-28%	23%	-4%	-26%
2019	10%	31%	20%	3%	31%	29%
Total	1876%	1889%	13%	608%	720%	111%
Annualized	13.2%	13.3%	0.0%	8.5%	9.2%	0.7%

* Estimated growth in earnings plus dividend yield
** Market performance, inclusive of dividends (refer to Appendix B for disclosure statements on our returns)
*** Results estimated without currency effects

Note: The results of the increase in the value of the S&P 500 since 1996 were revised compared to previous letters

This year, the intrinsic value of our companies, as a whole, rose by about 10% (with dividends included). Despite some of the changes to our portfolio during the year, we consider the estimate of the EPS growth at our companies during 2019 to adequately reflect their economic reality. The market performance of our portfolio was a gain of roughly 31% (net of any currency effect). Our stocks therefore realized a price performance that was far greater than their underlying economic performance.

The companies in the S&P 500 also experience weak growth in their corporate earnings, with growth in the order of less than 1% (about 3% when we add dividends). The S&P 500 still had a total performance figure of 31% (in $USD).

Since 1996, our companies have grown their value by about 1876% and their stocks have achieved a total return of approximately 1889%. On an annualized basis, we achieved an intrinsic performance of 13.2% versus 13.3% for their stock market performance (dividend included in both cases). The correlation between the two figures over a long period is not accidental since the stock market always reflects the fair value of companies over the long term.

Our stocks have outperformed the S&P 500 by 4.1% annually over the last 24 years for the simple reason that our companies grew their intrinsic values at a rate that was 4.8% greater than that of the companies that make up the S&P 500.

A book on the life of Joseph Rosenfield

Twenty years ago, I read an article that made a significant impression on me: *The Best Investor you've never heard of* by Jason Zweig of the magazine Money. The article painted a fascinating portrait of Joseph Rosenfield. Then aged 96, Mr. Rosenfield had grown the endowment fund of Grinnell University (in Iowa) from $11 million dollars to $1 billion dollars from 1968 to 2000. Warren Buffett was among the members on his investment committee. The latter had nothing but praise for Rosenfield: "A triumph of rationality over conformism". Despite his advanced age, Mr. Rosenfield emphasized the importance of patience in the investment world throughout the interview.

I have reread this article several times since (obviously not often enough as evidenced by my occasional lack of patience). I tried in vain to find a biography of Mr. Rosenfield for years and years.

But my patience was rewarded last year when I came across a new book written by George Drake: *Mentor: Life and Legacy of Joe Rosenfield*. I've never pressed so quickly on Amazon's "Buy Now" button. I wholeheartedly recommend it to you. You will find that Mr. Rosenfield was much more than just a great investor.



Source: grinnel.edu

Five-year Post-mortem: 2014

Like we do every year, we go through a five-year post-mortem analysis. We believe that studying our decisions in a systematic manner, and with the benefit of hindsight, enables us to learn from both our achievements and our errors.

We made few changes to the portfolio in 2014, but here are a few remarks from reviewing the annual letter from that year.

- In 2014, we made our first investment in Constellation Software. When I read the company's annual report, I knew instantly that Mark Leonard was our kind of leader. The stock has climbed 500% since our first purchase.
- In 2014, we took a small stake in PRA Group. The company remained in the portfolio for just over a year. The results were disappointing and we sold it in 2015.
- On the other hand, we sold the last shares we owned of Resmed, an Australian company for which we always had great admiration. We found its shares too "expensive" at the time. We will come back to this later on in "error medals" section (and yes, it was a very bad sale).

Our Companies

"... Mr. Morrel was a prudent and rather a timid man, as are all those who have built, slowly and laboriously, a business fortune over many years...".

- Extract from *The Count of Monte Cristo*

Section for Giverny Capital's partners only

The Podium of Errors

"Misfortune is needed to bring to light the treasures of the human intellect."

- Extract from *The Count of Monte Cristo*

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2019 (or from past years). It is with a constructive attitude, in order to always improve as investors, that we

provide this detailed analysis. As is often the case with stocks, errors from omission (non-purchases) are often more costly than errors from commission (purchases)… even if we don't see those on our statements.

Bronze Medal: Microsoft

We had been shareholders of Microsoft for a few years before selling in 2011 with a very modest gain. But a new CEO, Satya Nadella, arrived in 2014 and completely transformed the culture of Microsoft. He knew how to take the company towards cloud computing and did so brilliantly. We were at the forefront of being able to see this transformation, but were skeptical of the degree level of effect on Microsoft's EPS growth rate.

The stock has multiplied by seven times in eight years.

Silver Medal: Resmed

We invested in Resmed, an Australian company specializing in medical devices to help sleep disorders, in 2003. We were shareholders for about 11 years and sold in early 2014. I then found that the growth of EPS had slowed (we were used to 20% per year) and that the stock seemed too expensive given the circumstances. I did know, however, that sleep apnea was a widespread problem that is still poorly diagnosed and even more poorly treated. Long-term growth prospects were therefore intact.

From 2014 to 2019, EPS increased by about 10% annually and the stock price climbed from $44 to $155. Today's share price reflects better growth prospects expected in the years to come.

We acquired our first shares in 2003 at around $8. We could have achieved a total return of almost 20 times our money if we had been more patient. Peter Lynch liked to say: "you should not pull out the flowers to water the weed". I clearly pulled out a full patch of roses by selling our shares in Resmed.

Gold Medal: Copart

Recently, I ran into a portfolio manager friend I have known for years. We talked about our favorite stocks and she told me she owned shares in Copart. It reopened an old wound—I had almost managed to forget this terrible mistake I made a few years ago.

Copart is a company that sells cars reported by auto insurance companies as total losses. A few years ago, the company started auctioning on the Internet and was able to reach customers worldwide. It is rare to find a company that has a simple business to understand, strong competitive advantages and high returns on equity—all with good prospects for expanding its addressable market.

The management of the company also has a very pro-shareholder approach towards the management of excess capital. In 2011, I not only noticed that the company was doing well but also that the company had gone into debt (modestly) to buy back around 10% of its shares. Copart made $0.63 in EPS in 2011 and the stock was trading at around $11 or 18 times its profits. I loved everything about this company except the valuation. So I decided to wait for a better price.

In 2014, a book was published on the story of Copart founder Willis Johnson entitled *From Junk to Gold*. Again, I found the story fascinating ... without buying the stock.

In 2019, the company made EPS of $2.47. This is the equivalent of an annual growth rate of 19% achieved over eight years. And the stock trades, as of this writing, at $80. That's 27 times the estimated profit for 2020. We could have made about eight times our money in eight and a half years, or an annual return of 26%. And even without the expansion of the P/E ratio, the stock would have done very well.

I have no excuses. The company was in my area of expertise and the value was not at all extravagant. It was a big mistake.

Ah yes, I forgot a little postscript: in early 2016, the stock corrected by 25% and traded for a few weeks at $16. At that time, the stock's P/E was 15 times. So I had the long-awaited opportunity to get a better price!

I think that I will finally give a platinum medal for this error.

Conclusion: the wisdom of Alexandre Dumas

Do you remember the episode of the TV series *Cheers* in which Sam Malone reads the Russian classic *War and Peace* to impress Diane? And at the very end of his long literary journey, he learns to his great despair, that there is a movie!

I experienced the situation in reverse last year. I watched the French mini-TV series on the classic novel by Alexandre Dumas: *The Count of Monte Cristo*. It left me hungry for more so I decided to read the 1,400-page novel. I really loved the book. First, I found in it a vast portrait of the economic world of France from 1815 to 1840. The Stock Exchange already existed at the time (the first exchange was created in Paris in 1639). But most importantly, there are deep reflections on human nature.

Obviously, to highlight just a few sentences does not do justice to this monument of literature. As you can see, I have already used some of them in other sections of this letter. My favorite sentence in the book comes from a lesson by Father Faria to Dantes (the original name of the Count of Monte Cristo):

"To learn it not to know; there are the learners and the learned. Memory makes the one, philosophy the other. But how can someone learn philosophy? Philosophy cannot be taught; it is the application of the science to truth."

Obviously, we can quickly draw a parallel with the world of stock market investment. The knowledgeable are those who assimilate a large amount of information on the economy and companies. But it must be admitted that knowledge and wisdom are two very different things.

Those who are wise (those using philosophy) try to understand the world authentically, beyond the simple accumulation of information. The word philosophy, from the ancient Greek φιλοσοφία (composed of φιλεῖν, philein: "to love"; and of σοφία, sophia: "wisdom" or "to know"), literally means "love of wisdom". It is a process of critical reflection and questioning about the world, knowledge and human existence.

A portfolio manager wanting to achieve long-term success must constantly develop such a critical thinking process.

But any investment philosophy, however thoughtful, is futile without the presence of a human quality which must be paramount: patience.

I leave the final words of this letter to Alexandre Dumas with an extract from his novel *Queen Margot*:

"To wait. All human wisdom is in this single word. The greatest, the strongest, the most skilful is he who knows how to wait."

To Our Partners

We believe that the companies we own are exceptional, led by top-notch people, and destined for a great future. They should continue to prudently navigate the often troubled waters of the global economy. Furthermore, the valuation assigned by the market to these outstanding companies is very similar to the valuation of an average company in the S&P 500, despite the fact that our companies have better growth prospects than average.

We also want you to know that we are fully aware of and grateful for your votes of confidence. It is imperative for us to not only select outstanding companies for our portfolios, but to also remain outstanding stewards of your capital. We certainly like to achieve good returns and have developed a taste for it, but it must not come at the cost of taking undue risk. Our philosophy to favor businesses with solid balance sheets and dominant business models, along with purchasing their shares at reasonable valuations, is central to the risk management of our portfolios.

Thank you from the entire Giverny Capital team and we wish a great 2020 to all our partners.



François Rochon and the Giverny Capital team

APPENDIX A

Investment philosophy

Note: This section is repeated from prior annual letters and is aimed at new partners.

In 2019, we saw a large increase in the number of Giverny Capital partners (the term we use for our clients). With all these newcomers, it is imperative that we write again (and again) about our investment philosophy.

Here are the key points:

- We believe that over the long run, stocks are the best class of investments.
- It is futile to predict when it will be the best time to begin buying (or selling) stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity).
- We choose companies that have high (and sustainable) margins and high returns on equity, good long term prospects and are managed by brilliant, honest, dedicated and altruistic people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be approximately assessed.
- The stock market is dominated by participants that perceive stocks as casino chips. With that knowledge, we can then sometimes buy great businesses well below their intrinsic values.
- There can be quite some time before the market recognizes the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

Experience and common sense teach us that an investment philosophy based on buying shares in companies that are undervalued, and holding these companies for several years, will not generate linear returns. Some years, our portfolio will have a return that is below average. This is a certainty that we must accept.

Another important point: the significant volatility of the market is often perceived negatively by many investors. It's actually the contrary. When we see stock prices as *"what other people believe the company is worth"* rather than the real value (at least in the short term), these fluctuations become our allies in our noble quest for creating wealth. Instead of fearing them, we can profit from them by acquiring superb businesses at attractive prices. The more that markets (the "other" participants) are irrational, the more likely we are to reach our ambitious performance objectives.

Benjamin Graham liked to say that the irrationality of the market provides an extraordinary advantage to the intelligent investor. The person, however, who becomes affected by short-term market fluctuations (less than 5 years) and who makes decisions based on them transforms this advantage into a disadvantage. His or her own perception of stock quotes becomes their own worst enemy. Our approach at Giverny Capital is to judge the quality of an investment over a long period of time.

So patience – ours AND that of our partners – becomes the keystone for success.

APPENDIX B

Notes on the returns of the Rochon portfolios

- The Rochon portfolio is a private family group of accounts managed by François Rochon since 1993. The returns of the period from 1993 to 1999 were realized before registration of Giverny Capital Inc. at the AMF in June of 2000.
- The Rochon Global portfolio serves as a model for Giverny Capital's clients, but returns from one client to the other can vary depending on a multitude of factors. The returns indicated include trading commissions, dividends (including foreign withholding income taxes) and other income but do not include management fees. Portfolio returns of the Rochon Global portfolio have been generated in a different environment than Giverny Capital's clients and this environment is considered controlled. For example, cash deposits and withdrawals can increase the returns of the Rochon Global portfolio. Thus, the portfolio returns of the Rochon Global portfolio are often higher than the returns realized by clients of Giverny Capital.
- Past results do not guarantee future results.
- The Rochon Canada and Rochon US portfolios are parts of the Rochon Global portfolio.
- The index benchmark group is selected at the beginning of the year and tends to be a good reflection of the asset composition of the portfolio. Weighted indices presented may not be representative of the Rochon Global portfolio. In 2019 :

  - Giverny Global Portfolio: TSX 16% Russell 2000 41% S&P 500 41% MSCI EAFE 2%
  - Giverny US Portfolio : S&P 500 100%
  - Giverny Canada Portfolio : S&P/TSX 100%

- The returns for the S&P 500 (in $USD) are provided by Standard & Poors.
- The returns for the various indices used for comparable purposes are deemed reliable by Giverny Capital.
- It should be noted that currency effects on the returns of the Rochon portfolio and indices are estimated to our best effort.
- The custodian of our client portfolios is National Bank Correspondent Network (NBCN) in Canada and TD Ameritrade Institutional and Charles Schwab in the US.
- The financial statements of the three portfolios are audited at the end of each year. The auditor's data are those provided by our custodian (NBCN). The auditor's annual reports are available upon request.
- For more information, please see the "returns" section of our website.

GIVERNY CAPITAL

Annual letter to partners 2020



Geneviève Cadieux
Elle et Lui (avec main de femme), 1997, diptych
Chromogenic print, mounted on plexiglass, aluminum frame
Each panel 195,5 x 159 cm, photo credit : Geneviève Cadieux
Giverny Capital Collection

Historical Summary

It has been more than 28 years since I discovered the writings of Warren Buffett, Benjamin Graham, John Templeton, Philip Fisher and Peter Lynch. I then decided to begin managing a family portfolio based on an investment approach synthesized from these great money managers. By the end of 1998, after five years of satisfactory results, I decided to launch an investment management firm offering asset management services aligned with my own investment philosophy. Giverny Capital Inc. came into existence.

In 2002, Giverny hired its first employee: Jean-Philippe Bouchard (JP for those who know him well). A few years later, JP became a partner; he participates actively in the investment selection process for the Rochon portfolio. In 2005, two new persons joined the firm who eventually became partners: Nicolas L'Écuyer and Karine Primeau. In 2009, we launched a US office in Princeton, New Jersey. Moreover, in early 2020, we established a partnership with a portfolio manager based in New York City who will head the office of the firm Giverny Capital Asset Management LLC in Manhattan. The directors of the US offices, Patrick Léger and David Poppe, share in the culture and long-term time horizon inherent to Giverny.

We are Partners!

From the very first days of Giverny, the cornerstone of our portfolio management philosophy was to manage client portfolios in the same way that I was managing my own money. Thus, the family portfolio I've managed since 1993 (the "Rochon Global Portfolio") serves as a model for our client accounts. It is crucial to me that clients of Giverny and its portfolio managers are in the same boat! That is why we call our clients "partners".

The Purpose of our Annual Letter

The primary objective of this annual letter is to discuss the results of our portfolio companies over the course of the prior year. But even more importantly, our goal is to explain in detail the long-term investment philosophy behind the selection process of the companies in our portfolio. Our wish is for our partners to fully understand the nature of our investment process since long-term portfolio returns are the fruits of this philosophy. Over the short term, the stock market is irrational and unpredictable (though some may think otherwise). Over the long term, however, the market adequately reflects the intrinsic value of companies. If the stock selection process is sound and rational, investment returns will eventually follow. Through this letter, we provide you with the information required to understand this process. You will hopefully notice that we are transparent and comprehensive in our discussion. The reason for this is very simple: we treat you the way we would want to be treated if our roles were reversed.

The Artwork on Our 2020 Letter

Since 2004, we have illustrated the cover of our letters with a copy of artwork from our corporate collection. This year we selected a photographic diptych by the Quebec artist Geneviève Cadieux entitled "Elle et Lui (avec main de femme)". It seemed to me like a fitting work in this year marked, among other things, by social distancing.

For the year ending December 31st 2020, the return for the Rochon Global Portfolio was 12.9% versus 15.1% for our benchmark, which represents a relative underperformance of 2.2%. The return of the Rochon Global Portfolio and the one of our benchmark include a loss of approximately 2% due to fluctuations in the Canadian currency.

Since its inception on July 1st 1993, our compounded annual growth rate has been 15.3% versus 9.5% for our weighted benchmark, representing an annualized outperformance of 5.9% over this period. It's worth noting that the effect of the fluctuations in the value of the US Dollar has been nearly nonexistent on our returns. Since 1993, the US currency has depreciated by 0.6% relative to the Canadian Dollar, which corresponds to an effect of 0.0% on our annualized returns. Our long-term and ambitious objective is to maintain an annual return 5% higher than our benchmark.

The Rochon Global Portfolio: Returns since July 1st 1993

Year *	Rochon	Index **	+ / -	$ US/Can ***
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	3.3%
1994	**16.5%**	3.7%	**12.7%**	6.0%
1995	**41.2%**	24.0%	**17.2%**	-2.7%
1996	**28.0%**	22.8%	**5.2%**	0.3%
1997	**37.8%**	28.6%	**9.2%**	4.3%
1998	**20.6%**	18.8%	**1.8%**	7.1%
1999	**15.1%**	16.3%	**-1.2%**	-5.7%
2000	**13.4%**	3.2%	**10.2%**	3.9%
2001	**15.1%**	-0.4%	**15.5%**	6.2%
2002	**-2.8%**	-18.3%	**15.6%**	-0.8%
2003	**13.6%**	14.0%	**-0.4%**	-17.7%
2004	**1.6%**	6.2%	**-4.5%**	-7.3%
2005	**11.5%**	3.6%	**7.9%**	-3.3%
2006	**3.5%**	17.0%	**-13.5%**	0.2%
2007	**-14.4%**	-11.6%	**-2.8%**	-14.9%
2008	**-5.5%**	-22.0%	**16.5%**	22.9%
2009	**11.8%**	12.2%	**-0.4%**	-13.7%
2010	**16.1%**	13.8%	**2.3%**	-5.3%
2011	**7.6%**	-1.1%	**8.7%**	2.2%
2012	**21.2%**	12.5%	**8.7%**	-2.2%
2013	**50.2%**	38.9%	**11.3%**	6.9%
2014	**28.1%**	17.8%	**10.2%**	9.1%
2015	**20.2%**	13.4%	**6.8%**	19.3%
2016	**7.3%**	14.3%	**-7.0%**	-3.0%
2017	**13.1%**	10.3%	**2.9%**	-6.6%
2018	**-0.6%**	-1.4%	**0.8%**	8.7%
2019	**25.6%**	22.3%	**3.3%**	-4.8%
2020	**12.9%**	15.1%	**-2.2%**	-2.0%
Total	**4969.2%**	**1103.5%**	**3865.6%**	**-0.6%**
Annualized	**15.3%**	**9.5%**	**5.9%**	**0.0%**

* All returns are adjusted to Canadian dollars
** Index is a hybrid index (S&P/TSX, S&P 500, Russell 2000, MSCI EAFE) which reflects weights of the assets at the beginning of the year.
*** Variation of the US dollar compared to the Canadian dollar

Refer to Appendix B for disclosure statements on the Rochon portfolios.

The Rochon US Portfolio

We have been publishing the returns of the Rochon US Portfolio, which is entirely denominated in US dollars, since 2003. The Rochon US Portfolio corresponds to the American portion of the Rochon Global Portfolio. In 2020, it realized a return of 16.0% compared to 18.4% for the S&P 500. The Rochon US Portfolio therefore underperformed by 2.4%.

Since its inception in 1993, the Rochon US Portfolio has returned 4230%, or 14.7% on an annualized basis. During this same period, the S&P 500 has returned 1334%, or 10.2% on an annualized basis. Our added value has therefore been 4.5% annually.

Year	Rochon US	S&P 500	+/-
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	37.6%	17.2%
1996	27.0%	23.0%	4.1%
1997	32.9%	33.4%	-0.4%
1998	11.0%	28.6%	-17.6%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-9.1%	20.4%
2001	8.1%	-11.9%	20.0%
2002	-4.4%	-22.1%	17.7%
2003	31.6%	28.7%	2.9%
2004	9.3%	10.9%	-1.6%
2005	12.5%	4.9%	7.5%
2006	3.3%	15.8%	-12.4%
2007	-1.7%	5.5%	-7.2%
2008	-24.3%	-37.0%	12.7%
2009	28.7%	26.5%	2.3%
2010	21.9%	15.1%	6.9%
2011	4.7%	2.1%	2.6%
2012	22.3%	16.0%	6.3%
2013	40.6%	32.4%	8.2%
2014	18.0%	13.7%	4.3%
2015	1.7%	1.4%	0.4%
2016	7.5%	12.0%	-4.5%
2017	19.7%	21.8%	-2.1%
2018	-8.3%	-4.4%	-3.9%
2019	32.1%	31.5%	0.6%
2020	16.0%	18.4%	-2.4%
Total	**4229.7%**	**1333.9%**	**2895.8%**
Annualized	**14.7%**	**10.2%**	**4.5%**

Refer to Appendix B for disclosure statements on the Rochon portfolios.

In 2020, the Rochon US portfolio slightly underperformed the S&P 500. While we owned several high-tech holdings, our weight to this sector was less than that of the index which also led to slightly weaker relative performance.

Rochon Canada Portfolio

We introduced a portfolio that is 100% focused on Canadian equities in 2007. This corresponds approximately to the Canadian portion of the Rochon Global Portfolio. In 2020, the Rochon Canada Portfolio returned 12.1% versus 5.6% for the S&P/TSX, therefore outperforming by 6.5%.

Over 14 years, the Rochon Canada Portfolio has returned 713%, or 16.1% on an annualized basis. During this same period, the S&P/TSX had a gain of 105%, or 5.2% on an annualized basis. Our annual added value was therefore 10.9%.

Year	Rochon Canada	S&P/TSX	+/-
2007	19.7%	9.8%	9.9%
2008	-24.6%	-32.9%	8.3%
2009	28.2%	33.1%	-4.9%
2010	26.7%	17.6%	9.1%
2011	13.5%	-8.7%	22.2%
2012	24.0%	7.2%	16.8%
2013	49.4%	13.0%	36.4%
2014	20.3%	10.6%	9.7%
2015	16.0%	-8.3%	24.3%
2016	11.0%	21.1%	-10.1%
2017	27.4%	9.1%	18.3%
2018	-7.6	-8.9%	1.3%
2019	29.0%	22.9%	6.1%
2020	12.1%	5.6%	6.5%
Total	712.9%	104.7%	608.2%
Annualized	16.1%	5.2%	10.9%

Refer to Appendix B for disclosure statements on the Rochon portfolios.

Our largest Canadian holding is which rose 31% in 2020—the primary source of the higher returns for our Canadian portfolio.

Since 2007, the performance of our Canadian securities has been significantly higher than that of the S&P/TSX. We would like to repeat, once again this year, that a concentrated portfolio can drastically exceed the performance of the indices.

2020

Last year I wrote that "years follow each other but are never alike." We could certainly repeat this phrase to characterize 2020. The COVID-19 virus has hit us hard—our society, our loved ones, our freedom of movement and our economy.

The stock market fell dramatically in mid-March 2020 when the World Health Organization (WHO) announced that we were officially in a pandemic. In just a few weeks, the S&P 500 had fallen 35% from its high and the Russell 2000 had tumbled 40%. The rapidity of the decline was probably only matched by the crash of 1987. Several stocks dropped to very attractive valuations and we took the

opportunity to make a new acquisition: (we will discuss individual holdings further in the "Our Companies" section)

Then on March 23rd, the US government stepped in to support the economy in such a massive manner it made the bailout of the 2008 financial crisis seem like a dress rehearsal. The stock market subsequently rebounded in a dramatic fashion. Ultimately, US markets reached record highs at the end of the year. I have not found another instance in the history of the stock market where the market has corrected at least 33% and recovered everything in the same year. Who could have predicted this at the end of March? Investors who missed the best five trading days of March and April missed much of the recovery for the year.

We unfortunately lack the necessary perspective at this time to come to any valid conclusions regarding the long-term effects of this pandemic It certainly appears that the pandemic accelerated already strong trends toward online commerce. And telecommuting may remain part of our lives and impact various segments of the economy.

As always, our philosophy remains very simple: we own approximately twenty companies with solid balance sheets, conservative accounting, a durable competitive advantage and a management team dedicated to shareholders. And, of course, we are always cautious about the price that we are willing to pay for such companies.

Our companies performed extremely well given the very significant challenges of 2020. First, about half of our companies had record earnings per share (EPS). Our holdings in aggregate will have seen their profitability decline by roughly 3%. This is significantly better than the drop in expected profits for the companies making up the S&P 500 (which is a decline of around 11%).

None of our companies had to issue shares or go into significant debt to meet their obligations. They have therefore managed to do well in a very difficult year.

A Strange Thing

Warren Buffett has often said that "strange things can happen in financial markets". On April 20, 2020, a very strange thing did indeed happen: the price of a futures contract for a barrel of West Texas Intermediate crude oil deliverable for May fell from $18 to -$37 during the day. It was certainly strange to see the price of oil trading at a negative level. Sellers were presumably willing to pay buyers to get rid of their oil contracts (so they wouldn't have to receive barrels at home!)

Such a thing has never happened before to my knowledge and it completely defies common sense. This anomaly was certainly very short lived but it was certainly long enough to ruin speculators using margin to buy these contracts. This shows us all that almost anything is possible in the world of financial markets in the short term and that using margin always carries a small probability of disaster. Even if the odds are 0.01% of losing all your capital, why take such a chance? And it seems even more baffling to me for someone who is already rich.

The fact that nonsense sometimes happens in financial markets obviously does not change our philosophy of behaving as owners of businesses. It is those who focus exclusively on short-term market quotes who put their financial future in the hands *of others*. We must never forget that while in the long term, the stock market adequately reflects the intrinsic value of companies, the stock market only reflects the opinion of what *others* think a company is worth in the short term. This opinion is

generally pretty fair and reasonable but, for strange reasons, can sometimes turn out to be downright ludicrous. This brings me to the next section of the letter.

The flavor of the day

What seems peculiar to us in recent months is that in this world where the comfort of our certainties has been turned upside down, we are witnessing a level of stock market speculation that is not unlike that of the end of 1999 and early 2000. This speculation seems localized mostly in certain sectors of the economy which have experienced strong growth during the pandemic: software, cloud computing, electronic commerce, etc.

As in the past, these euphoric segments have realistic strong anticipated growth rates. It is the almost infinite extrapolation by many investors that is unrealistic and in turn can create danger. It is not uncommon to see companies trading at 60, 80, or even 100 times their profits (and these profits are often not even adjusted to exclude actual expenses such as stock options). And this is when there actually is a profit! Otherwise, analysts can come up with an alternative: the price-to-sales ratio.

In the 1999 annual letter, I had raised the issue of high valuations of many tech companies. I then told a little fable to illustrate the low regard for stock valuations by many analysts back then: *a farmer bragged about owning a pig worth a million dollars. A friend of his asked him how he could be so sure of his pig's worth. He replied: "Nothing could be easier: I got it in exchange for two chickens worth $500,000 each."*

Two decades later, a whole new generation of speculators is invading the markets these days. For many, the intrinsic value of a business is irrelevant. A stock that goes up and an exciting story are often the only fundamental parameters guiding their choices.

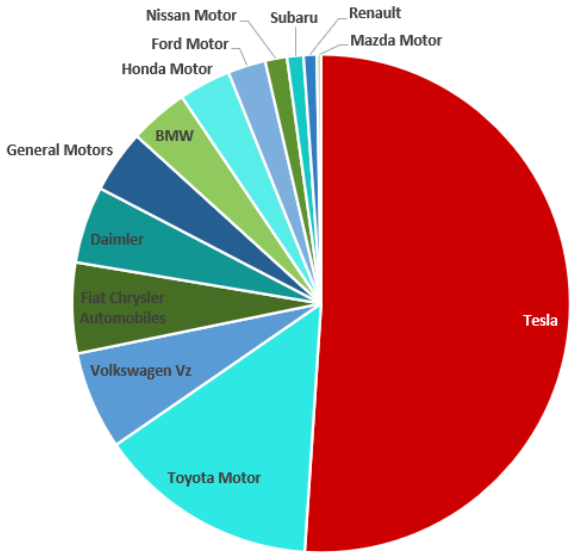
There is of course nothing immoral about speculating. But a dose of realism is appropriate: the consequences of speculation are similar to those who spend their evenings at the casino. A few lucky people come home in a limousine while the majority return barefoot. As Mark Twain would probably say: "History doesn't repeat itself but it often rhymes."

A few segments of the stock market would qualify this year for this section of the annual letter. It can be delicate to point to a particularly trendy segment. The goal is not to denigrate a company or to be condescending to certain fellow investors. Our goal is simply to share with our partners our vision of what seems risky in terms of stock market valuations.

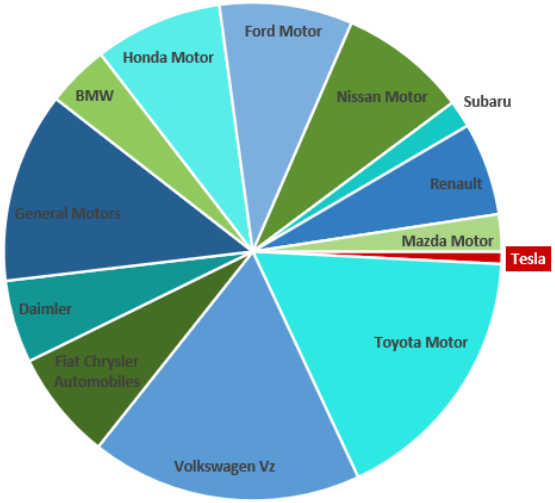
I dare to take the example of Tesla, a phenomenal company if there ever is one. It is interesting to raise the point that Tesla stock, at its current level, has a market capitalization of approximately $800 billion which is higher than all other car manufacturing companies in the world combined. Yet all the other companies in the sector sell 120 times more cars annually than Tesla.

This graph sums it all up:

Market Capitalization



Unit sales



Sources: Factset, wheelsjoint.com

Five-year Post-mortem: 2015

Like we do every year, we go through a five-year post-mortem analysis. We believe that studying our decisions in a systematic manner, and with the benefit of hindsight, enables us to learn from both our achievements and our errors. We made few changes to the portfolio in 2015, but here are a few remarks from reviewing the annual letter from that year.

In 2015, we acquired our first shares in AMETEK. EPS grew by 50% between 2015 and 2019—the stock has more than doubled. The share's P/E ratio on the stock market is therefore higher than when we first bought it. It reflects, in our opinion, the fact that AMETEK is a high quality business.

We also invested in Stericycle back in 2015 which was not a good investment for us. The company faced great pressure on its operating margins and we had to resign ourselves to selling, unfortunately at a loss. It was still a good decision to cut this investment short as the stock is lower today than when we sold it four years ago.

Keeping AMETEK and quickly selling Stericycle is in line with the rule stated by the legendary investor Philip Carret in his book published in 1930: "Be quick to take your losses, reluctant to take your profits".

Owner's Earnings

At Giverny Capital, we do not evaluate the quality of an investment by the short-term fluctuations in its stock price. Our wiring is such that we consider ourselves owners of the companies in which we invest. Consequently, we study the growth in earnings of our companies and their long-term outlook.

Since 1996, we have presented a chart depicting the growth in the intrinsic value of our companies using a measurement developed by Warren Buffett: "owner's earnings". We arrive at our estimate of the increase in intrinsic value of our companies by adding the growth in earnings per share (EPS) and the average dividend yield of the portfolio. We believe that analysis is not exactly precise but approximately correct. In the non-scientific world of the stock market, we believe in the old saying: "It is better to be roughly right than precisely wrong."

	Rochon Global Portfolio			S&P 500		
Year ***	Value *	Market **	Difference	Value *	Market **	Difference
1996	14%	29%	15%	13%	23%	10%
1997	17%	35%	18%	11%	33%	22%
1998	11%	12%	1%	4%	29%	25%
1999	16%	12%	-4%	12%	21%	9%
2000	19%	10%	-9%	15%	-9%	-24%
2001	-9%	10%	19%	-21%	-12%	9%
2002	19%	-2%	-21%	13%	-22%	-35%
2003	31%	34%	3%	12%	29%	16%
2004	21%	8%	-12%	20%	11%	-10%
2005	14%	15%	0%	15%	5%	-10%
2006	14%	3%	-11%	24%	16%	-8%
2007	10%	0%	-10%	-4%	5%	9%
2008	-3%	-22%	-19%	-31%	-37%	-6%
2009	0%	28%	28%	6%	26%	20%
2010	22%	22%	0%	50%	15%	-35%
2011	17%	6%	-11%	18%	2%	-16%
2012	19%	23%	4%	9%	16%	7%
2013	16%	42%	26%	8%	32%	24%
2014	13%	19%	6%	10%	14%	4%
2015	11%	4%	-7%	1%	1%	0%
2016	9%	10%	1%	4%	12%	8%
2017	14%	20%	7%	14%	22%	11%
2018	20%	-8%	-28%	23%	-4%	-26%
2019	10%	31%	20%	3%	31%	29%
2020	-2%	15%	17%	-9%	18%	27%
Total	1850%	2179%	329%	436%	871%	435%
Annualized	12.6%	13.3%	0.7%	6.9%	9.5%	2.6%

* Estimated growth in earnings plus dividend yield
** Market performance, inclusive of dividends (refer to Appendix B for disclosure statements on our returns)
*** Results estimated without currency effects

This year, the intrinsic value of our companies, as a whole, declined by about 2% (with dividends included). Despite some of the changes to our portfolio during the year, we consider our estimate of the EPS growth at our companies during 2020 to adequately reflect their economic realities. The performance of our portfolio on the market was a gain of roughly 15% (excluding currency effects). Our stocks therefore realized a price performance that was far greater than their underlying economic performance.

The companies in the S&P 500 experienced weaker growth in their corporate earnings, with profits dropping by approximately 11% (about a drop of 9% when we add dividends). The S&P 500 still had

a total performance figure of 18% (in $USD). The difference between the intrinsic performance of the companies in the S&P 500 and the performance of the index is hence greater than ours.

Profits of companies in aggregate decline during a recession. But this drop is always temporary in nature and corporate profits should hit new records during the next economic cycle (possibly as early as 2021).

Since 1996, by our calculations, our companies have grown their intrinsic value by about 1850% and their stocks have achieved a total return of approximately 2179%. On an annualized basis, the estimated intrinsic performance was 12.6% versus 13.3% for their stock market performance (dividend included in both cases).

The correlation between the two figures over a long period is not accidental since the stock market always reflects the fair value of companies over the long term.

Stock market equations

Last year was overwhelming on so many levels that it would be good to review our basic principles regarding stock market investing with our partners. Since we have described our investment philosophy on various occasions in the past, I thought of going there this time with a different approach inspired by my scientific upbringing (and with a bit of humor added).

During my university studies at the École Polytechnique of Montreal, I was a big fan of electromagnetic physics. And I was fascinated by Maxwell's equations. These are a set of coupled partial differential equations that, together with the Lorentz force law, form the foundation of classical electromagnetism, classical optics, and electric circuits. They describe how electric and magnetic fields are generated by charges, currents, and changes of the fields. The equations are named after the Scottish physicist and mathematician James Clerk Maxwell,

In the same vein, wouldn't it be interesting to try to simplify and unify the complex world of the stock market into four equations?

Here is therefore a proposal of four formulas which could, in my opinion, summarize the main lines which govern rational investment in the stock market.

1. Equation of convergence between Intrinsic Value and Market Value

$$\lim_{n\to\infty} (Vm)_n = Vi$$

This equation states that in the long run (*n* being the unknown number of years), a company's stock market value (*Vm*) eventually converges to its intrinsic value (*Vi*).

2. Equation of wealth increase

$$\triangle \text{ W} = \sum \text{P (y)}$$

This equation states that the level of increase in stock market wealth (W) is the sum of the aggregate patience (P) over a time variable (y).

3. Risk decrement measurement equation

$$D = \ln\left(\frac{\theta}{\delta}\right) x^2$$

This equation states that D represents the logarithmic decrement of the risk of an investment which is proportional to the level of profit margins (θ) of a company which is reduced by its level of debt (δ) multiplied by the level of the competitive advantages squared (x^2).

4. Equation for the normalization of parameters influencing returns

$$R_S = \frac{1}{\sqrt{2\pi\sigma}} \; e^{\left(\frac{\mu}{\sigma}\right)^2}$$

This equation simply states that stock market returns (R_S) eventually follow a normalized curve proportional to the rationality (μ) of an investor and inversely proportional to the parameter of his (or her) *crowd following instinct* (σ).

Our Companies

Note: This section of the annual letter is always long. We want to provide you with an accurate update of the companies in our portfolio companies. In fact, we are trying to present you with the information we would like to know if our roles were reversed. Stock prices are as of December 31st, 2020.

Section of the letter reserved for Giverny Capital's partners

The Podium of Errors

"It is not sufficient to say that we were wrong; we must say how we were wrong."

- Claude Bernard

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2020 (or from past years). It is with a constructive attitude, in order to always improve as investors, that we provide this detailed analysis. As is often the case with stocks, errors from omission (non-purchases) are often much more costly than errors from commission (purchases)… even if we don't see those on our statements.

Bronze Medal: Floor & Decor

As you know, we purchased shares in Five Below in March 2020. At the same time, we also considered another chain of retail stores: the Floor & Decor flooring company. We knew the company well because it has benefited from the popularity of new LVT (Luxury Vinyl Tile) flooring. This new coating method is experiencing strong growth and we were very aware of it because it had negatively affected the competitive advantage of a company that we held in the portfolio for several years, Mohawk Industries. We knew the strength of the Floor & Decor business model as well as the senior management. Unfortunately, since we had started to follow the company, the stock was regularly trading at high multiples.

That changed last March. The stock fell from a high of $60 to $25 in a matter of weeks. In early April, after speaking with senior management, we made the decision to buy shares at around $30. We were anticipating EPS of $1.50 for 2021 and therefore the valuation seemed reasonable to us considering the excellent long-term growth prospects.

The stock then climbed more than 10% on the very day we wanted to buy it and we hence decided to wait for a return to "our" price. Results improved quickly and the stock never returned to "our" price. The stock is currently trading for $102 and we now expect EPS of around $2 for 2021.

Silver Medal: Taiwan Semiconductor

When François Campeau joined the Giverny team, a stock he loved was Taiwan Semiconductor (TSM)—the world's leading semiconductor foundry. I looked at the company in detail and liked its balance sheet, strong competitive advantages and the culture established by senior management. Historically, its annual growth rate had been around 10-12% but its stock valuation was rarely high (around 15 times earnings on average). The reason is that its profits are cyclical (because they are linked to the capital expenditure of the sector) and its business model requires regular and significant capital expenditures (several billion dollars per year).

TSM's outlook in late 2019 and early 2020 looked better than ever. For new foundry technologies of 5nm (I won't go into detail because it is complex) and possibly 3nm, the company seemed to have little competition. It even seemed plausible that Intel could eventually subcontract TSM for its production of microprocessors which would be phenomenal for the latter. At the end of 2019, the stock was

trading in the $50 range which was a record high and also at a slightly higher P/E than normal. I still decided that the company should be part of the portfolio because its competitive advantage moat seemed to widen drastically. We just had to wait for a "better" price....

...2020 was an extraordinary year for TSM with EPS growing by over 50% and the stock has more than doubled (TSM is currently trading at $127).

Gold Medal: Pool Corp.

I met a prospective client about 14 years ago who had just sold his swimming pool service business. We had discussed the industry in detail and one company stood out as dominant: Pool Corp. It is a highly competitive industry with few competitive advantages. But consolidation and economies of scale can help reduce a company's cost structure (and therefore develop an advantage). Also, reputation for quality can also create an advantage. I had studied Pool Corp in detail but found its business to be too sensitive to the economy as well to the residential construction market (and in 2006 that was a real cause for concern).

The company had EPS of $1.74 in 2006 and the stock was trading around $36. My fears were valid because EPS fell to $0.95 in 2008-2009 but the good news was that company nevertheless remained profitable despite the cyclical volatility. The stock fell to a low of $11 in 2009. So I had the opportunity to buy the stock at a very good price (6 times the profit earned in 2006).

I never bought a share. Among other things, I had misjudged the recurring nature of the services linked to the maintenance of a swimming pool. The company went quickly back on the path of growth and achieved EPS of $8.42 by 2020, an annualized growth rate of 12% compared to 2006. Part of the 2020 results are probably magnified by the fact that most people spent the summer at home. Still, the fact remains that Pool Corp has done an exceptional job.

The stock is now trading at $325. It is true that the stock market valuation is quite high (35x the expected profits for 2021). But this does not change the fact that the company has quintupled its intrinsic value in 14 years. And that we missed the opportunity to achieve a stock return of more than 800% over this period.

And of course, we also missed a potential gain of almost 3000% if we had bought it in 2009.

Conclusion: The Big Picture

After almost three decades of investing in the stock market, I am convinced that the biggest mistake investors make is the propensity to want to predict financial markets. Whether it is waiting for a "better" time to buy or selling in anticipation of buying "lower". Or simply selling while waiting for the situation to be "clearer".

Still, investing in stocks is a winning strategy in the long run. Historically, US companies increase their profits by about 6-7% per year and pay a dividend of around 2%. This generates an annual return of 8-9% from simply owning a solid group of companies. And if we decide to be selective about the companies we choose and pay attention to stock market valuations, it is possible to do even better (which has been our experience for almost 28 years now).

Of course, over the decades, our civilization has encountered its share of challenges—the list is too long to go through. The 2020 pandemic is just one calamity that humans have had to overcome. When a new crisis arrives, the stock market can drop quickly and drastically. Many investors then lose any long-term perspective and focus only on the crisis and the short-term uncertainty it engenders.

Peter Lynch wrote an excellent paragraph on this subject in "Beating the Street", an exceptional book that I read when I started out in 1992. He talks about always keeping "The Big Picture" in mind. And when that's not enough to hone in his thinking, he then focusses on an even broader perspective on things ("The Even Bigger Picture"). He explains that during crises, we must refocus our attention on the great progress of our civilization, on the resilience of our capitalist system and on the capacity of humans to find solutions to their problems. And don't lose sight of the extraordinary rewards generated by stocks over many years—and this, against all odds.

It is not easy in our world of immediacy to keep an eye on the long term and not be affected by the sometime huge short term fluctuations of the stock markets. In the age of smartphones and ubiquitous social media, it is almost inhuman to remain indifferent to the countless opinions of others. But impassive to outside opinions and the resulting stock market fluctuations, one must remain. The easiest way to do this is to give yourself a golden rule that I have followed since the very start: do not try to predict the stock market, stay invested in solid companies and only focus on their intrinsic value.

When you rule out the possibility of trying to forecast the markets, when you constantly keep a positive long-term outlook in mind, you remove a major potential drag on your own returns. Wittingly, you make a conscious decision to let time do its work.

To Our Partners

We believe that the companies we own are exceptional, led by top-notch people, and destined for a great future. They should continue to prudently navigate the often troubled waters of the global economy. Furthermore, the valuation assigned by the market to these outstanding companies is very similar to the valuation of an average company in the S&P 500, despite the fact that our companies have better growth prospects than average.

We also want you to know that we are fully aware of and grateful for your votes of confidence. It is imperative for us to not only select outstanding companies for our portfolios, but to also remain outstanding stewards of your capital. We certainly like to achieve good returns (and have developed a taste for it), but it must not come at the cost of taking undue risk. Our philosophy to favor companies with solid balance sheets and dominant business models, along with purchasing these companies at reasonable valuations, is central to the risk management of our portfolios.

Thank you from the entire Giverny Capital team and we wish a great 2021 to all our partners.



François Rochon and the Giverny Capital team

APPENDIX A

Investment philosophy

Note: This section is repeated from prior annual letters and is aimed at new partners.

In 2020, we saw a large increase in the number of Giverny Capital partners (the term we use for our clients). With all these newcomers, it is imperative that we write again (and again) about our investment philosophy.

Here are the key points:

- We believe that over the long run, stocks are the best class of investments.
- It is futile to predict when it will be the best time to begin buying (or selling) stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity).
- We choose companies that have high (and sustainable) margins and high returns on equity, good long term prospects and are managed by brilliant, honest, dedicated and altruistic people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be approximately assessed.
- The stock market is dominated by participants that perceive stocks as casino chips. With that knowledge, we can then sometimes buy great businesses well below their intrinsic values.
- There can be quite some time before the market recognizes the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

Experience and common sense teach us that an investment philosophy based on buying shares in companies that are undervalued, and holding these companies for several years, will not generate linear returns. Some years, our portfolio will have a return that is below average. This is a certainty that we must accept.

Another important point: the significant volatility of the market is often perceived negatively by many investors. It's actually the contrary. When we see stock prices as *"what other people believe the company is worth"* rather than the real value (at least in the short term), these fluctuations become our allies in our noble quest for creating wealth. Instead of fearing them, we can profit from them by acquiring superb businesses at attractive prices. The more that markets (the "other" participants) are irrational, the more likely we are to reach our ambitious performance objectives.

Benjamin Graham liked to say that the irrationality of the market provides an extraordinary advantage to the intelligent investor. The person, however, who becomes affected by short-term market fluctuations (less than 5 years) and who makes decisions based on them transforms this advantage into a disadvantage. His or her own perception of stock quotes becomes their own worst enemy. Our approach at Giverny Capital is to judge the quality of an investment over a long period of time.

So patience – ours AND that of our partners – becomes the keystone for success.

APPENDIX B

Notes on the returns of the Rochon portfolios

- The Rochon portfolio is a private family group of accounts managed by François Rochon since 1993. The returns of the period from 1993 to 1999 were realized before registration of Giverny Capital Inc. at the AMF in June of 2000.
- The Rochon Global portfolio serves as a model for Giverny Capital's clients, but returns from one client to the other can vary depending on a multitude of factors. The returns indicated include trading commissions, dividends (including foreign withholding income taxes) and other income but do not include management fees. Portfolio returns of the Rochon Global portfolio have been generated in a different environment than Giverny Capital's clients and this environment is considered controlled. For example, cash deposits and withdrawals can increase the returns of the Rochon Global portfolio. Thus, the portfolio returns of the Rochon Global portfolio are often higher than the returns realized by clients of Giverny Capital.
- Past results do not guarantee future results.
- The Rochon Canada and Rochon US portfolios are parts of the Rochon Global portfolio.
- The index benchmark group is selected at the beginning of the year and tends to be a good reflection of the asset composition of the portfolio. Weighted indices presented may not be representative of the Rochon Global portfolio. In 2020 :
  - Rochon Global Portfolio : S&P/TSX 13% S&P 500 42% Russell 2000 42% MSCI EAFE 3%
  - Rochon US Portfolio : S&P 500 100%
  - Rochon Canada Portfolio : S&P/TSX 100%

- The returns for the S&P 500 (in $USD) are provided by Standard & Poors.
- The returns for the various indices used for comparable purposes are deemed reliable by Giverny Capital.
- It should be noted that currency effects on the returns of the Rochon portfolio and indices are estimated to our best effort.
- The custodian of our client portfolios is National Bank Correspondent Network (NBCN) in Canada and TD Ameritrade Institutional and Charles Schwab in the US.
- The financial statements of the three portfolios are audited at the end of each year. The auditor's data are those provided by our custodian (NBCN). The auditor's annual reports are available upon request.
- For more information, please see the "returns" section of our website.

Forward-looking information

Some information set forth in this letter constitutes forward-looking information which involves uncertainties and other known and unknown factors that may cause actual results or events to differ materially from those anticipated in such forward-looking information. When used in this letter, words such as "expects", "anticipates", "intends", "may", "believes" and similar expressions generally identify forward-looking information. In developing the forward-looking information contained in this letter, the manager has made assumptions (for ex.: with respect to the outlook for the global economy and publicly traded companies).These assumptions are based on the manager's perception of factors believed to be relevant (for ex.: historical trends, current conditions, expected future developments). Although the manager believes that the assumptions made and the expectations represented by such information are reasonable, there can be no assurance that the forward-looking information will prove to be accurate. Actual results or events may differ materially from those expressed or implied in the forward-looking information. Giverny Capital Inc. undertakes no obligation to publicly update or revise these forward-looking statements.

GIVERNY CAPITAL

Annual Letter to our Partners 2021



Manuel Mathieu
To begin where I end, 2021
Acrylic, chalk, charcoal, and tape on canvas
Giverny Capital Collection
Photo : Guy L'Heureux

Historical Summary

It has been nearly 30 years since I discovered the writings of Warren Buffett, Benjamin Graham, John Templeton, Philip Fisher and Peter Lynch. I then decided to begin managing a family portfolio based on an investment approach synthesized from these great money managers. By the end of 1998, after five years of satisfactory results, I decided to launch an investment management firm offering asset management services aligned with my own investment philosophy. Giverny Capital Inc. came into existence.

In 2002, Giverny hired its first employee: Jean-Philippe Bouchard (JP). A few years later, JP became a partner and participates actively in the investment selection process for the Giverny portfolio. In 2005, two new persons joined the firm who eventually became partners: Nicolas L'Écuyer and Karine Primeau. François Campeau, who joined the Giverny team in 2018, also participates in the investment selection process. In 2009, we launched a US office in Princeton, New Jersey. We also partnered with a manager from New York, David Poppe, in early 2020. He manages Giverny Capital Asset Management, based in Manhattan. Our two directors of our US offices, Patrick Léger and David Poppe, share in the culture and long-term time horizon inherent to Giverny.

We are Partners!

From the very first days of Giverny, the cornerstone of our portfolio management philosophy was to manage client portfolios in the same way that I was managing my own money. Thus, the family portfolio I've managed since 1993 (the "Rochon Global Portfolio") serves as a model for our client accounts. It is crucial to me that clients of Giverny and its portfolio managers are in the same boat! That is why we call our clients "partners".

The Purpose of our Annual Letter

The primary objective of this annual letter is to discuss the results of our portfolio companies over the course of the prior year. But even more importantly, our goal is to explain in detail the long-term investment philosophy behind the selection process for the companies in our portfolio. Our wish is for our partners to fully understand the nature of our investment process since long-term portfolio returns are the fruits of this philosophy. Over the short term, the stock market is irrational and unpredictable (though some may think otherwise). Over the long term, however, the market adequately reflects the intrinsic value of companies. If the stock selection process is sound and rational, investment returns will eventually follow. Through this letter, we provide you with the information required to understand this process. You will hopefully notice that we are transparent and comprehensive in our discussion. The reason for this is very simple: we treat you the way we would want to be treated if our roles were reversed.

The Artwork on the cover of the 2021 Letter

We illustrate the cover page of our annual letters with a reproduction of a work from the Giverny Capital Collection. This year, we have selected a painting by Quebec artist Manuel Mathieu entitled "To begin where I end".

For the year ending December 31st 2021, the return for the Rochon Global Portfolio was 27.0% versus 21.0% for our benchmark, which represents a relative outperformance of 5.9%. The returns of the Rochon Global Portfolio and our benchmark include a loss of approximately 0.4% due to fluctuations in the Canadian currency.

Since its inception on July 1st 1993, the compounded annual return of the Rochon Global Portfolio has been 15.7% versus 9.9% for our weighted benchmark, representing an annualized outperformance of 5.9% over this period of 28 years. Our long-term and ambitious objective is to maintain an annual return 5% higher than our benchmark.

The Rochon Global Portfolio: Returns since July 1st 1993

Year *	Rochon	Index **	+ / -	$ US/Can ***
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	3.3%
1994	**16.5%**	3.7%	**12.7%**	6.0%
1995	**41.2%**	24.0%	**17.2%**	-2.7%
1996	**28.0%**	22.8%	**5.2%**	0.3%
1997	**37.8%**	28.6%	**9.2%**	4.3%
1998	**20.6%**	18.8%	**1.8%**	7.1%
1999	**15.1%**	16.3%	**-1.2%**	-5.7%
2000	**13.4%**	3.2%	**10.2%**	3.9%
2001	**15.1%**	-0.4%	**15.5%**	6.2%
2002	**-2.8%**	-18.3%	**15.6%**	-0.8%
2003	**13.6%**	14.0%	**-0.4%**	-17.7%
2004	**1.6%**	6.2%	**-4.5%**	-7.3%
2005	**11.5%**	3.6%	**7.9%**	-3.3%
2006	**3.5%**	17.0%	**-13.5%**	0.2%
2007	**-14.4%**	-11.6%	**-2.8%**	-14.9%
2008	**-5.5%**	-22.0%	**16.5%**	22.9%
2009	**11.8%**	12.2%	**-0.4%**	-13.7%
2010	**16.1%**	13.8%	**2.3%**	-5.3%
2011	**7.6%**	-1.1%	**8.7%**	2.2%
2012	**21.2%**	12.5%	**8.7%**	-2.2%
2013	**50.2%**	38.9%	**11.3%**	6.9%
2014	**28.1%**	17.8%	**10.2%**	9.1%
2015	**20.2%**	13.4%	**6.8%**	19.3%
2016	**7.3%**	14.3%	**-7.0%**	-3.0%
2017	**13.1%**	10.3%	**2.9%**	-6.6%
2018	**-0.6%**	-1.4%	**0.8%**	8.7%
2019	**25.6%**	22.3%	**3.3%**	-4.8%
2020	**12.9%**	15.1%	**-2.2%**	-2.0%
2021	**27.0%**	21.0%	**5.9%**	-0.4%
Total	**6335.8%**	**1356.4%**	**4979.4%**	**-1.1%**
Annualized	**15.7%**	**9.9%**	**5.9%**	**0.0%**

* All returns are adjusted to Canadian dollars
** Index is a hybrid index (S&P/TSX, S&P 500, Russell 2000, MSCI EAFE) which reflects weights of the assets at the beginning of the year.
*** Variation of the US dollar compared to the Canadian dollar

Refer to Appendix B for disclosure statements on the Rochon portfolios.

Effect of the Canadian dollar versus the US dollar on our returns

The second question I've heard most often since my start as a portfolio manager concerns the potential effect of fluctuations in the Canadian currency compared to its American counterpart (the first question is, of course, *is it a good time to invest in the stock market*?) It is informative to observe in the table above that the currency fluctuation effect ultimately had virtually no impact on our returns: since 1993, the Canadian dollar has appreciated a total of 1.1% against the US dollar—corresponding to an annualized effect of -0.04% on our returns.

The Rochon US Portfolio

We have been publishing the returns of the Rochon US Portfolio, which is entirely denominated in US dollars, since 2003. The Rochon US Portfolio corresponds approximately to the US portion of the Rochon Global Portfolio. In 2021, it realized a return of 27.9% compared to 28.7% for the S&P 500. The Rochon US Portfolio therefore underperformed its benchmark by 0.8%.

Since its inception in 1993, the Rochon US Portfolio has returned 5438%, or 15.1% on an annualized basis. During this same period, the S&P 500 has returned 1746%, or 10.8% on an annualized basis. Our added value has therefore been 4.3% annually.

Year	Rochon US	S&P 500	+/-
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	37.6%	17.2%
1996	27.0%	23.0%	4.1%
1997	32.9%	33.4%	-0.4%
1998	11.0%	28.6%	-17.6%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-9.1%	20.4%
2001	8.1%	-11.9%	20.0%
2002	-4.4%	-22.1%	17.7%
2003	31.6%	28.7%	2.9%
2004	9.3%	10.9%	-1.6%
2005	12.5%	4.9%	7.5%
2006	3.3%	15.8%	-12.4%
2007	-1.7%	5.5%	-7.2%
2008	-24.3%	-37.0%	12.7%
2009	28.7%	26.5%	2.3%
2010	21.9%	15.1%	6.9%
2011	4.7%	2.1%	2.6%
2012	22.3%	16.0%	6.3%
2013	40.6%	32.4%	8.2%
2014	18.0%	13.7%	4.3%
2015	1.7%	1.4%	0.4%
2016	7.5%	12.0%	-4.5%
2017	19.7%	21.8%	-2.1%
2018	-8.3%	-4.4%	-3.9%
2019	32.1%	31.5%	0.6%
2020	16.0%	18.4%	-2.4%
2021	27.9%	28.7%	-0.8%
Total	5438.1%	1745.6%	3692.5%
Annualized	15.1%	10.8%	4.3%

Refer to Appendix B for disclosure statements on the Rochon portfolios.

Rochon Canada Portfolio

We introduced a portfolio that is 100% focused on Canadian equities in 2007. This corresponds approximately to the Canadian portion of the Rochon Global Portfolio. In 2021, the Rochon Canada Portfolio returned 30.9% versus 25.1% for the S&P/TSX, therefore outperforming its index by 5.8%.

Over 15 years, the Rochon Canada Portfolio has returned 964%, or 17.1% on an annualized basis. During this same period, our benchmark had a gain of 156%, or 6.5% on an annualized basis. Our annual added value was therefore 10.6%.

Year	Rochon Canada	S&P/TSX	+/-
2007	**19.7%**	9.8%	**9.9%**
2008	**-24.6%**	-32.9%	**8.3%**
2009	**28.2%**	33.1%	**-4.9%**
2010	**26.7%**	17.6%	**9.1%**
2011	**13.5%**	-8.7%	**22.2%**
2012	**24.0%**	7.2%	**16.8%**
2013	**49.4%**	13.0%	**36.4%**
2014	**20.3%**	10.6%	**9.7%**
2015	**16.0%**	-8.3%	**24.3%**
2016	**11.0%**	21.1%	**-10.1%**
2017	**27.4%**	9.1%	**18.3%**
2018	**-7.6**	-8.9%	**1.3%**
2019	**29.0%**	22.9%	**6.1%**
2020	**12.1%**	5.6%	**6.5%**
2021	**30.9%**	25.1%	**5.8%**
Total	**964.3%**	**156.0%**	**808.3%**
Annualized	**17.1%**	**6.5%**	**10.6%**

Refer to Appendix B for disclosure statements on the Rochon portfolios.

Our largest Canadian holding is which rose 42% in 2021—the primary source of the higher returns for our Canadian portfolio (we'll return to this corporation in the "Our Companies" section).

Since 2007, the performance of our Canadian securities has been significantly higher than that of the S&P/TSX. We would like to repeat, once again this year, that a concentrated portfolio can drastically exceed the performance of the indices.

2021

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way--in short, the period was so far like the present period that some of its noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only."

You probably recognize the famous first paragraph of *A Tale of Two Cities* by Charles Dickens. Written in 1859, these words still ring true in our world turned upside down by COVID-19 (Dickens' story is set at the time of the French Revolution).

It's hard not to be pleased with a 27% return this year as an investor. It was the 6th best year out of 28 for our portfolio (excluding the half year for 1993).

The companies that make up the S&P 500, as a whole, reached a record level of profitability (as measured by their profit margins). Dominant companies—like Amazon, Apple, Facebook, Google, Microsoft and Netflix—created revolutionary products and services that transformed our lives. They have economic models with almost unparalleled competitive advantages in the history of our civilization. Other companies—like Pfizer/BioNtech, Moderna and Astra Zeneca—created coronavirus vaccines at lightning speed and helped save millions of lives. The benefits of American-style capitalism are more evident than ever.

On the other hand, however, COVID-19 has greatly affected our lives for two years—first and foremost in terms of the many fatalities it caused.

The pandemic also profoundly affected the nature of what freedom and the entrepreneurial spirit mean to us. While some sectors experienced good growth in spite of the lockdown of citizens, other sectors — such as restaurants, hotels, commercial real estate, the arts, air transportation, everything related to tourism, etc. — suffered greatly. The level of dichotomy between diverse "economic cities" has been unprecedented.

And the magnitude of the challenges that await us does not stop with a pandemic. Global warming continues to be a major issue that we are slow to tackle ardently. In addition, the invasion of Ukraine in early 2022 further increases our concern about the legitimacy of democracies around the world.

Humanity's search for plenitude has faced challenges for as long humanity has existed. Just over the course of the last century—think of the Spanish flu, Nazi Germany, Soviet totalitarianism, and the proliferation of nuclear weapons—some of these challenges seemed insurmountable at the time.

It is obviously not the role of Giverny Capital to venture into the fragile and slippery terrain of political and social debates. Our mission is to be good stewards of our partners' capital. We have always been capitalists who value integrity, transparency, meritocracy, and entrepreneurial freedom. And it is these values that continue to be our beacons during these cloudy times.

No crises, whether economic, geopolitical, or social, have managed to undermine Benjamin Graham's fundamental investment approach by one iota. Almost a century ago, in 1934, Ben Graham and David Dodd published a book called *Security Analysis*. The authors stipulated that investing in the stock market is first and foremost about acquiring fractional ownership in businesses and that a business' intrinsic value will eventually be reflected in a company's stock price over the long term.

I would add that I have always been keen to emphasize the importance of another vital ingredient in the business world: optimism. Over the centuries, nothing has ever been built with pessimism. It is essential to constantly put forward a positive attitude even if, at times, it can become difficult not to succumb to feelings of fatalism.

Large numbers of citizens of London lived in abject poverty at the time of Charles Dickens. The infant mortality rate was 20% and life expectancy was 37 years in impoverished neighborhoods. Tuberculosis, cholera, rickets, scarlet fever, typhoid fever, and smallpox wreaked havoc on an annual basis.

Our capitalist civilization, despite its flaws, has enabled its citizens over the course of two centuries to double their standard of living every 36 years (an annual increase of approximately 2%). Believe it or not, this means that the average standard of living likely increased by a factor of more than 25 times since the publication of *A Tale of Two Cities*.

The percentage of people living in extreme poverty in the world has fallen from 87% in 1850 to less than 10% today. I do not believe that Charles Dickens could have envisioned such a world as we have today back in 1859.

The market in 2021

Financial markets did very well in 2021. Once again, the S&P 500, powered by a few dominant companies, outperformed the majority of indices around the world. The companies in our portfolio have also been able to hold their own.

Companies, both those in the S&P 500 and in our portfolio, saw their profits increase substantially. Part of this increase is linked to a rebound in the economy relative to 2020, a year of declining profits, and another part is related to a sharp increase in profit margins.

Inflation has certainly played a role in the rise of corporate profits. It should be noted, however, that the usual side effect of inflation, namely a probable increase in interest rates, has not yet had an effect on the economy and on interest expenses borne by companies.

Inflation is an integral part of our capitalist system. Although the rate varies from one period to another, it has continually been a factor within our system. This is why we have always favored companies that, in our opinion, have significant competitive advantages that allow them to increase the price of their products and/or services.

The Rochon Global portfolio slightly underperformed the S&P 500 in 2021. One of the reasons is that we had a lower weight than the index in technology stocks and this was the source of weaker relative returns. We of course still have investments in technology companies like

But we didn't own some of the big market stars of recent years.

In 2021, of the 27% rise in the S&P 500 (excluding dividends), Microsoft, Nvidia, Apple, Alphabet and Tesla contributed one third of the return. The other two thirds of the increase came from the other 495 companies. Of these five giga-cap stocks, which disproportionately influence the S&P 500, two seem to us to be valued extremely optimistically by the market: Nvidia and Tesla.

Nvidia had a market value of $735 billion dollars at the end of the year. Analysts predict revenues of $35 billion in 2022 and about $14 billion in profits. The estimated price-earnings is therefore more than 50x. As for Tesla, the company's market value was over $1 trillion dollars (1000 billion) at the end of the year. Its estimated revenues in 2022 are $84 billion and its profits estimated at around $11 billion for a price-earnings of around 90x.

For more than 28 years, we have always advocated an approach favoring a selection of exceptional companies with a level of intrinsic risk, both in terms of the business model and the stock market valuation, that we've appraised to be lower than average.

And there are always opportunities to do better than average for investors who have taken a "value" approach. We thus continue to unearth securities for our portfolio which—we believe—should be able to continue generating higher returns than the indices.

The flavor of the day

Each year, this section addresses securities or segments of the investment world that seem dangerously popular to us. The purpose, of course, is not to criticize fellow investors. We are aware that investing wisely is not easy. Our objective is to simply point out valuations levels to our partners that appear to us as reflecting overly optimistic scenarios and therefore present a higher level of risk to investors given an eventual normalization of valuations.

A strange trend over the last few years is that of stocks that have been called "meme stocks" (the best known being GameStop). Groups of investors believe that they can control the price of a stock without any correlation to its intrinsic value[1]. This strategy is doomed to failure in our opinion because our fundamental principle is that the price of a stock invariably ends up trading at a level close to its intrinsic value over the long term. But this craze is only limited to a few stocks.

Everything related to cryptocurrencies still seems to be the flavor of the day and on a much larger scale. The total value of all these virtual currencies reached $2 trillion (2000 billion) dollars by the end of the year. In our humble opinion, an entire financial sector seems to have been created on an asset whose intrinsic value seems completely arbitrary. Wall Street is obviously on board, sniffing out a whole new source of commissions, and several financial institutions followed for fear of missing the gravy train.

Even a few entities from the art world have joined this universe with the creation of NFTs (non-fungible tokens) which is—to put it simply—a form of digital securitization for works of art. It seems to me that some dangers also exist for this new product which has similarities to cryptocurrencies.

There is a nebulous line between what could be considered an investment and what could be considered speculation. One way to discern them is to ask yourself the following: if the stock market were closed for 10 years, would I be happy owning this security?

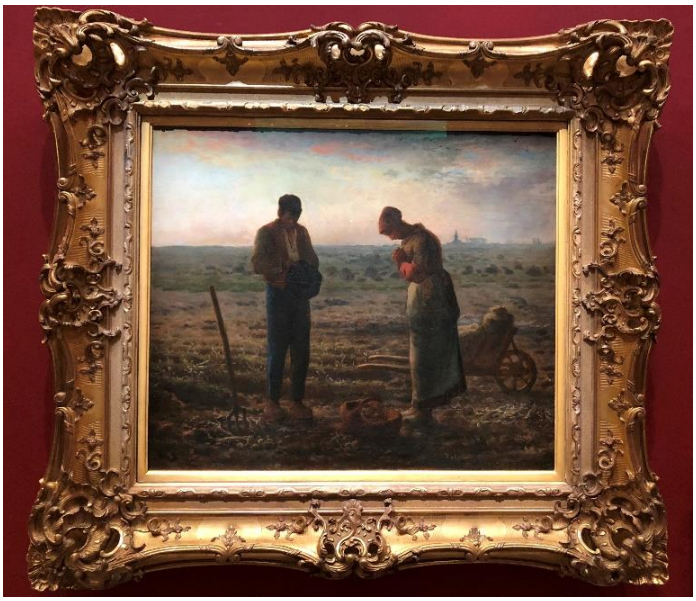
An investor believes that if the company in which he is a shareholder increases its intrinsic value by increasing its profits at a rate of (say) 10% per year, in 10 years, his or her investment will have increased its intrinsic value by 160%. Owning a productive asset (and being able to value it) does not require a short-term stock price; in the same way that the value of a dairy farm is measured by the amount of milk it produces. If the only objective, however, is the hope to sell the security to someone else for more in a fairly short period of time, this requires a short-term price and this resembles more a form of speculation.

[1] A practice similar to the activity known as "cornering the market".

Speculation is, of course, neither illegal nor immoral. But speculating can be a perilous activity—at any time during human history. This is obviously not the first time that an asset has become dangerously popular. One of the most famous speculative bubbles was that of tulip bulbs in Holland during the 17th century. At its height, in early 1637, the price of a single tulip bulb corresponded to the price of 12 acres of land[2]. The value of the most beautiful tulip bulb at the time has been estimated at more than 5,500 guilders—or the equivalent of approximately $750,000 in today's US dollars.

The (financial) history of The Angelus by Jean-François Millet

The Angelus is a painting by the great French painter Jean-François Millet, produced between 1857 and 1859. It is a masterpiece which is exhibited at the Musée d'Orsay in Paris and is also one of my favorite paintings in the history of art.



Jean-François Millet, *L'Angélus,* 1857-1859; Oil on canvas; 56x66 cm
Bequest of Alfred Chauchard, 1909; Paris, Musée d'Orsay; Photo: F.R.

You are probably wondering where I'm going with this at this point—isn't this a letter intended for financial investors? Leaving aside the incredible artistic contribution of this painting, I would like to tell you about the misadventures of one of its owners.

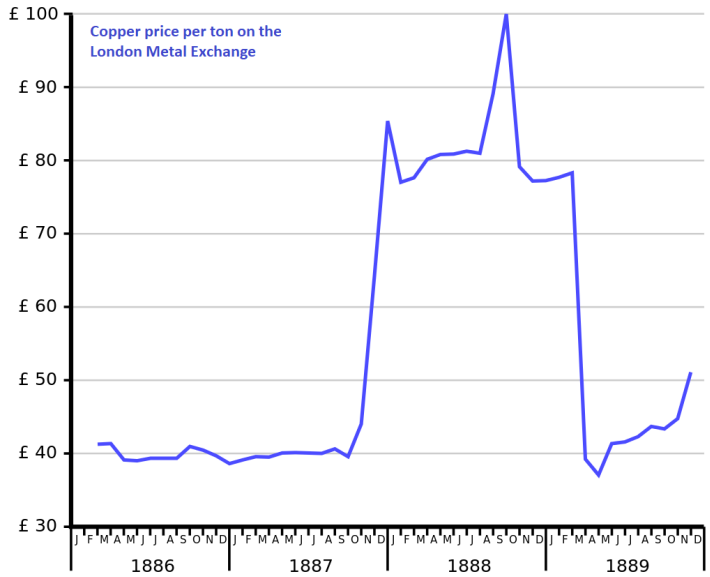
Before ending up at the Louvre (and then eventually at the Musée d'Orsay), the painting had several owners. Although he never took delivery, Thomas Gold Appleton commissioned the work around 1857. The piece was initially acquired in 1860 for 1,800 francs by Alfred Feydeau. The painting then changed hands a few times, eventually to be acquired for 160,000 francs in 1881 by a copper industrialist, Eugène Secrétan.

Of humble origins, Mr. Secrétan was self-taught. Through hard work, he became one of the French specialists in the processing of non-ferrous metals and became head of the *Société industrielle et commerciale des métaux*, a holding company comprised of six companies and more than 3,000 employees. These companies were specialized in the mining of copper, lead and tin. In 1878, he was one of the donors of the copper used to create the Statue of Liberty (300 tons donated) and was named Knight of the Legion of Honor.

[2] According to the book *Extraordinary Popular Delusions and the Madness of Crowds* by Charles Mackay

He then created an exceptional collection of works of art (including The Angelus) with his fortune.

Mr. Secrétan, attracted to speculation, began to acquire tin and lead in the fourth quarter of 1886. He then discovered that the world supply of copper had been reduced to 40,000 tons and that prices fell below 36 pounds sterling per ton. He gathered up around sixty million francs to control the supply of copper with the help of a group of financiers. In three months, prices rose to 84 pounds per ton. In 1888, his company had to raise 37.5 million francs in capital to cope with higher prices and to fund additional mining activities.



Copper prices at the London Metal Exchange, during the cornering of the copper market[3].

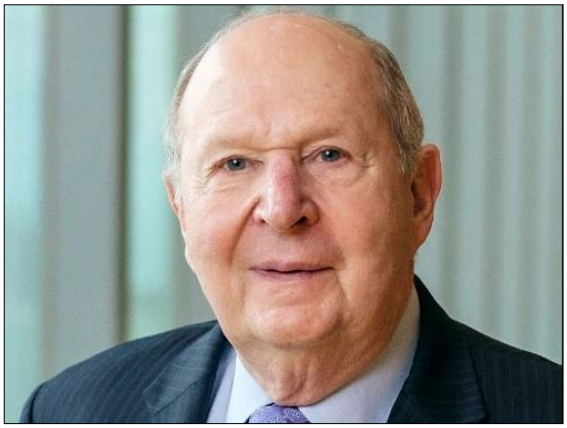
In early March 1889, following the greatest financial speculation in the history of copper production, the price of copper collapsed, and with it the shares of *Société industrielle et commerciale des métaux*. In financial difficulties, Mr. Secrétan had to part ways with his extensive art collection, including The Angelus. The businessman and collector Alfred Chauchard acquired it for the incredible sum of 750,000 francs—a price that held the record for the most expensive modern painting ever purchase for quite some time. Mr. Chauchard bequeathed The Angelus to the Louvre upon his death in 1909.

Mr. Secrétant, however, managed to recover from his losses and began rebuilding his business using a new technology for manufacturing copper tubes by electrolysis. But despite his end-of-life success, copper speculation caused him tremendous troubles, as well as the loss of The Angelus.

It is such a shame to see people who are already rich speculate to the point of endangering their fortunes. As Warren Buffett says, “You just need to be rich once.” Speculation today (with bitcoin or otherwise) is certainly more sophisticated than before, but the very nature of speculation remains just as dangerous.

[3] Source: Wikipedia

Lou Simpson (1936-2022)



Source: Crain's Chicago Business

It is with great sadness that we learned of the passing of Louis Simpson in January 2022. Lou had a fantastic career in the investment world. He worked as a portfolio manager at GEICO (a subsidiary of Berkshire Hathaway since 1996) for more than 30 years, from 1979 to 2010. He obtained exceptional returns during these four decades.

For several years, Warren Buffett pointed to Lou as his potential successor as fund manager under Berkshire. I invite you to read (or re-read) the excellent book "The Warren Buffett CEO" by Robert Miles in which a chapter is devoted to Lou. Our colleague Allen Benello also devoted a chapter to Lou in the book "Concentrated Investing".

Lou decided to leave Berkshire Hathaway in the early 2010s and founded his own firm with his wife Kimberly: SQ Advisors. Jean-Philippe and I had the good fortune to meet him at his home in 2014. We've had long conversations with Lou and Kimberly about equity investments a few times since then. We also shared other passions with them, such as the arts and wine. In their constant great generosity, Lou and Kimberly shared their best bottles when JP and I went to visit them in Chicago. It's not every day that you get to share a Château Margaux with one of our heroes!

Lou has created a lot of wealth for GEICO shareholders, for Berkshire and for its clients. Lou and Kimberly have also been very generous with their fortune through numerous philanthropic activities. I will miss him very much.

Owner's Earnings

At Giverny Capital, we do not evaluate the quality of an investment by the short-term fluctuations in its stock price. Our wiring is such that we consider ourselves owners of the companies in which we invest. Consequently, we study the growth in earnings of our companies and their long-term outlook.

Since 1996, we have presented a chart depicting the growth in the intrinsic value of our companies using a measurement developed by Warren Buffett: "owner's earnings". We arrive at our estimate of the increase in intrinsic value of our companies by adding the growth in earnings per share (EPS) and the average dividend yield of the portfolio. We believe that analysis is not exactly precise but approximately correct. In the non-scientific world of the stock market, we believe in the old saying: "It is better to be roughly right than precisely wrong."

	Rochon Global Portfolio			S&P 500		
Year ***	Value *	Market **	Difference	Value *	Market **	Difference
1996	14%	29%	15%	13%	23%	10%
1997	17%	35%	18%	11%	33%	22%
1998	11%	12%	1%	4%	29%	25%
1999	16%	12%	-4%	12%	21%	9%
2000	19%	10%	-9%	15%	-9%	-24%
2001	-9%	10%	19%	-21%	-12%	9%
2002	19%	-2%	-21%	13%	-22%	-35%
2003	31%	34%	3%	12%	29%	16%
2004	21%	8%	-12%	20%	11%	-10%
2005	14%	15%	0%	15%	5%	-10%
2006	14%	3%	-11%	24%	16%	-8%
2007	10%	0%	-10%	-4%	5%	9%
2008	-3%	-22%	-19%	-31%	-37%	-6%
2009	0%	28%	28%	6%	26%	20%
2010	22%	22%	0%	50%	15%	-35%
2011	17%	6%	-11%	18%	2%	-16%
2012	19%	23%	4%	9%	16%	7%
2013	16%	42%	26%	8%	32%	24%
2014	13%	19%	6%	10%	14%	4%
2015	11%	4%	-7%	1%	1%	0%
2016	9%	10%	1%	4%	12%	8%
2017	14%	20%	7%	14%	22%	11%
2018	20%	-8%	-28%	23%	-4%	-26%
2019	10%	31%	20%	3%	31%	29%
2020	-2%	15%	17%	-9%	18%	27%
2021	32%	28%	-4%	48%	29%	-19%
Total	2474%	2817%	343%	676%	1152%	476%
Annualized	13.3%	13.9%	0.5%	8.2%	10.2%	2.0%

* Estimated growth in earnings plus dividend yield
** Market performance, inclusive of dividends (refer to Appendix B for disclosure statements on our returns)
*** Results estimated without currency effects

This year, the intrinsic value of our companies, as a whole, increased by about 32% (with dividends included). Despite some of the changes to our portfolio during the year, we consider our estimate of EPS growth at our companies during 2021 to adequately reflect their economic realities. The performance of our portfolio on the stock market was a gain of roughly 28% (net of any currency effect). Our stocks therefore realized a price performance that was less than their underlying economic performance. This corrects, in part, the inverse situation which occurred in 2020.

The companies that make up the S&P 500 index also experienced a sharp increase in their profits this year, rising by around 48%. The index achieved a total performance of 29% (in US dollars).

Since 1996, our companies have grown their value by about 2474% and their stocks have achieved a total return of approximately 2817%. On an annualized basis, we achieved an intrinsic performance of 13.3% versus 13.9% for their stock market performance (dividend included in both cases).

Here are the figures over the course of the last decade, from the end of 2011 to the end of 2021:

	Rochon Global Portfolio			S&P 500		
Annualized	Value *	Market **	Difference	Value *	Market **	Difference
2011-2021 ***	14.0%	17.6%	3.6%	9.8%	16.5%	6.7%

* Estimated growth in earnings plus dividend yield
** Market performance, inclusive of dividends (refer to Appendix B for disclosure statements on our returns)
*** Results estimated without currency effects

It is interesting to note that over the last decade our companies have increased their intrinsic value by 14% annually compared to almost 10% annually for the companies in the S&P 500 (roughly in line with our long-term historical figures). Our stocks have done well, increasing by approximately 17.6% per year (net of any currency effect). Thus, our companies on the stock market have done about 3.6% per year better than the intrinsic performance of the underlying companies. This reflects an increase in the price-earnings ratio of our companies during this decade. Indeed, in 2011, equities in general were greatly undervalued and the subsequent revaluation seems justified to us.

However, for the S&P 500, the increase in valuation was much greater (around 6.7% annually). So the stock market revaluation for the index was much more pronounced than for our companies and probably also vis-à-vis most of the other indices in the world. In our opinion, it is very unlikely that this will continue in the future.

We are confident that if our companies continue to grow their intrinsic value at higher-than-average rates, the market performance of their shares will follow suit—in absolute terms and also relative to indices, as it has since 1996.

Five-year Post-mortem: 2016

Like we do every year, we go through a five-year post-mortem analysis. We believe that studying our decisions in a systematic manner, and with the benefit of hindsight, enables us to learn from both our achievements and our errors. We made few changes to the portfolio in 2016, but here are a few remarks from reviewing the annual letter from that year.

In 2016, we acquired shares in Heico company. This company has two divisions: the manufacturing of parts for the aviation industry and an electronic products division. The first is the one that caught our attention. Heico sells alternative (non-original) aeronautical parts to aviation companies. It is very difficult to obtain Federal Aviation Administration (FAA) approvals to supply aircraft parts. With its vast number of approved products, developed and commercialized over several years, Heico has a very significant competitive advantage.

Of course, Heico has been greatly affected by the major recent issues affecting the airline industry around the world. Despite this, from 2016 to 2021, Heico's EPS grew from $1.39 to $2.51, the equivalent of an annual growth rate of 13%. The stock has done even better in the stock market, climbing more than 200% since our first purchase. One of the reasons for our purchase in 2016 was our admiration for the members of the Mendelson family who run the company—this admiration has only increased since.

Our Companies

Note: This section of the annual letter is always long. We want to provide you with an accurate update of the companies in our portfolio companies. In fact, we are trying to present you with the information we would like to know if our roles were reversed. Prices are as of December 31, 2021.

Section of the letter reserved for Giverny Capital's partners

The Podium of Errors

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2021 (or from past years). It is with a constructive attitude, in order to always improve as investors, that we provide this detailed analysis. As is often the case with stocks, errors from omission (non-purchases) are often more costly than errors from commission (purchases)… even if we don't see those on our statements.

Bronze Medal: A2 Milk

We acquired A2 Milk during the summer of 2020. Based in New Zealand, the company manufactures milk and milk products (primarily infant formula) based on a variant of milk that many consumers find easier to digest than conventional milk. The A2 beta casein protein is present in breast milk and some breeds of dairy cows, although most dairy cows produce both A1 and A2 beta casein protein. It is the A1 protein that may cause discomfort in some consumers. The company has become a leader in this niche and had experienced strong growth in recent years. One of the key markets for the company is China.

Some of its sales in China were through independent distributors who traveled to Australia to buy the company's infant formulas and bring them back to China (a distribution method called *daigou*). During the first part of 2020, this mode of distribution continued despite the pandemic and reassured us of the solidity of this business model. But then, the daigou slowed considerably later in 2020. The company had to reduce its sales and profitability forecasts and the stock fell.

We thought at the time that it was a temporary problem that should resolve itself within a few quarters. We realized in 2021 that A2 Milk's challenges were more persistent than anticipated and we decided to sell our shares.

We had invested about 2% of the portfolio in this company and sold at a loss—it was a very disappointing investment.

Silver Medal: Old Dominion Freight Line

I have always followed the trucking industry since the beginning of my investment career. We once held shares in the Quebec company Groupe Goyette. Subsequently, we had shares in Heartland Express and then Knight Transportation in the early 2000s. It's an industry that, when well managed can have good fundamentals despite its cyclical tendencies and its dependence on various factors such as finding qualified drivers and dealing with the price of fuel.

The stock market experienced (another) correction in 2018 and I had studied Old Dominion Freight Line, based in North Carolina. The company's track record was phenomenal. From 2006 to 2018, EPS had grown from $0.58 to $4.97, or an annual growth rate of nearly 20%. Its net profit margins reached 15% which is a rare level in the industry. The management team seemed to me competent and motivated (management owns 12% of the shares). The stock was trading at around $90, or 18 times the company's profits. This valuation seemed high to me for a trucking company, even for the best, so I decided to wait.

In 2021, the company achieved EPS of $8.86 and the outlook is for over $10 in 2022. EPS will likely have doubled in four years and the stock is currently trading at $288. We could therefore have tripled our money in a little over three years if I had agreed to pay a slightly high evaluation (justified *a posteriori*) for this exceptional company.

Gold Medal: Fox Factory Holding

Jean-Philippe and I frequently attended the ICR investment conference in Orlando before the pandemic. Several dozen companies present their outlooks and no one needs to twist our arms to warm up for a few days in early February.

At the 2016 conference, I listened to a presentation from a company I had never heard of: Fox Factory Holding. The company was a leader in a niche product: shock absorbers for mountain bikes. It had also started selling products for utility trucks and the company was very profitable and had good growth prospects. The stock was trading at around $16, which was a reasonable valuation for the expected EPS of $0.96 in 2016. The stock then quickly climbed to $20 and I chose to wait for a *better price*.

I have continued to follow the company closely and its performance has been nothing short of phenomenal. It has developed many new products and new markets and, in only five years, its revenues have more than tripled and its EPS reached $4.50 in 2021—or more than four times the level of 2016. Analysts forecast EPS greater than $5 for 2022.

The stock has soared 500% in six years and reached $100.

Conclusion: The greatest mistakes by investors (take 4).

As I stated at the beginning of this letter, the question that comes up most often is always the same: "Is this the right time to invest in the stock market?" It is good to come back to this important question in these (once again) uncertain and worrying times.

Let's first go back to our 2003 letter to partners to answer this question, when I presented an article by André Gosselin on investor results versus the performance of the S&P 500. He explained that there was a huge difference between the results of mutual fund holders in the United States and the leading stock market index.

André was inspired by the results of the research firm Dalbar on the behavior of stock market investors. This firm publishes a fascinating research report annually on the results of all US investors invested in mutual funds compared to indices. We also referred to this data in the 2006 and 2014 annual letters.

The underperformance of investors vis-à-vis the indices over a long period is such that André published a book in 2004 on this subject entitled "An open letter to irresponsible investors". The title is a little harsh, but André

nevertheless presents several important points for investors. I am talking again about this book because a second edition has just been published[4]. André hence provides an update on Dalbar's figures.

"According to the financial information firm Dalbar, the holder of equity funds in the United States achieved an average annual return of 6.24% between 1990 and 2020, while the return of the S&P 500 index has been 10.7%; a shortfall of 4.46% per year in terms of annualized return. .... For the holder of fixed-income mutual funds, the situation is worse. Also between 1990 and 2020, investors who invested in fixed-income funds settled for an annual return of 0.45%, while the benchmark Bloomberg-Barclays Aggregate Bond Index provided an average annual return of 5.86%".

This 4.5% annual underperformance over three decades for holders of equity mutual funds (and even more so for bond funds) cannot be explained by management fees. The only plausible explanation is that investors, as a whole, consistently buy and sell their funds at inopportune times. In other words, they veer from stocks to bonds and back inappropriately. This underperformance is therefore mainly behavioral in origin.

The only solution for the investor who wants to avoid falling into the trap of this behavioral penalty is not to try to predict the stock market. It is vital to always keep this in mind, especially in periods of declines and/or crises.

From the start, I made the decision to always be 100% invested in the stock market. Rather than futilely attempting to predict the market, I focused my efforts on finding high quality companies for our portfolios. It is the opinion of all of us at Giverny Capital that this remains the strategy with the best probability of success.

To Our Partners

We believe that the companies we own are exceptional, led by top-notch people, and destined for a great future. They should continue to prudently navigate the often-troubled waters of the global economy. Furthermore, the valuation assigned by the market to these outstanding companies is very similar to the valuation of an average company in the S&P 500, despite the fact that our companies have better growth prospects than average.

We realize that we live in uncertain times, although a wise observer of human history might ask the question: "Were they ever certain?". We want you to know that we are fully aware of and grateful for your vote of confidence. It is imperative for us to not only select outstanding companies for our portfolios, but to also remain outstanding stewards of your capital. We certainly like to achieve good returns (and have taken a liking to it), but it must not come at the cost of taking undue risk. Our philosophy is to favor companies with solid balance sheets and dominant business models, along with purchasing these companies at reasonable valuations.

Thank you from the entire Giverny Capital team and we wish a great 2022 to all our partners.



François Rochon and the Giverny Capital team

[4] André Gosselin – *Lettre ouverte aux investisseurs irresponsables* – 2022 edition – Éditions Guy Saint-Jean.

APPENDIX A

Investment philosophy

Note: This section is repeated from prior annual letters and is aimed at new partners.

In 2021, we saw a large increase in the number of Giverny Capital partners (the term we use for our clients). With all these newcomers, it is imperative that we write again (and again) about our investment philosophy.

Here are the key points:

- We believe that over the long run, stocks are the best class of investments.
- It is futile to predict when it will be the best time to begin buying (or selling) stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity).
- We choose companies that have high (and sustainable) margins and high returns on equity, good long term prospects and are managed by brilliant, honest, dedicated and altruistic people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be approximately assessed.
- The stock market is dominated by participants that perceive stocks as casino chips. With that knowledge, we can then sometimes buy great businesses well below their intrinsic values.
- There can be quite some time before the market recognizes the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

Experience and common sense teach us that an investment philosophy based on buying shares in companies that are undervalued, and holding these companies for several years, will not generate linear returns. Some years, our portfolio will have a return that is below average. This is a certainty that we must accept.

Another important point: the significant volatility of the market is often perceived negatively by many investors. It's actually the contrary. When we see stock prices as *"what other people believe the company is worth"* rather than the real value (at least in the short term), these fluctuations become our allies in our noble quest for creating wealth. Instead of fearing them, we can profit from them by acquiring superb businesses at attractive prices. The more that markets (the "other" participants) are irrational, the more likely we are to reach our ambitious performance objectives.

Benjamin Graham liked to say that the irrationality of the market provides an extraordinary advantage to the intelligent investor. The person, however, who becomes affected by short-term market fluctuations (less than 5 years) and who makes decisions based on them transforms this advantage into a disadvantage. His or her own perception of stock quotes becomes their own worst enemy. Our approach at Giverny Capital is to judge the quality of an investment over a long period of time.

So patience – ours AND that of our partners – becomes the keystone for success.

APPENDIX B

Notes on the returns of the Rochon portfolios

- The Rochon portfolio is a private family group of accounts managed by François Rochon since 1993. The returns of the period from 1993 to 1999 were realized before registration of Giverny Capital Inc. at the AMF in June of 2000.
- The Rochon Global portfolio serves as a model for Giverny Capital's clients, but returns from one client to the other can vary depending on a multitude of factors. The returns indicated include trading commissions, dividends (including foreign withholding income taxes) and other income but do not include management fees. Portfolio returns of the Rochon Global portfolio have been generated in a different environment than Giverny Capital's clients and this environment is considered controlled. For example, cash deposits and withdrawals can increase the returns of the Rochon Global portfolio. Thus, the portfolio returns of the Rochon Global portfolio are often higher than the returns realized by clients of Giverny Capital.
- Past results do not guarantee future results.
- The Rochon Canada and Rochon US portfolios are parts of the Rochon Global portfolio.
- The index benchmark group is selected at the beginning of the year and tends to be a good reflection of the asset composition of the portfolio. Weighted indices presented may not be representative of the Rochon Global portfolio. In 2021:
  - Rochon Global Portfolio : S&P/TSX 13% S&P 500 40% Russell 2000 40% MSCI EAFE 7%
  - Rochon US Portfolio : S&P 500 100%
  - Rochon Canada Portfolio : S&P/TSX 100%

- The returns for the S&P 500 (in $USD) are provided by Standard & Poors.
- The returns for the various indices used for comparable purposes are deemed reliable by Giverny Capital.
- It should be noted that currency effects on the returns of the Rochon portfolio and indices are estimated to our best effort.
- The custodian of our client portfolios is National Bank Correspondent Network (NBCN) in Canada and TD Ameritrade Institutional and Charles Schwab in the US.
- The financial statements of the three portfolios are audited at the end of each year. The auditor's data are those provided by our custodian (NBCN). The auditor's annual reports are available upon request.
- For more information, please see the "returns" section of our website.

Forward-looking information

Some information set forth in this letter constitutes forward-looking information which involves uncertainties and other known and unknown factors that may cause actual results or events to differ materially from those anticipated in such forward-looking information. When used in this letter, words such as "expects", "anticipates", "intends", "may", "believes" and similar expressions generally identify forward-looking information. In developing the forward-looking information contained in this letter, the manager has made assumptions (for ex.: with respect to the outlook for the global economy and publicly traded companies). These assumptions are based on the manager's perception of factors believed to be relevant (for ex.: historical trends, current conditions, expected future developments). Although the manager believes that the assumptions made and the expectations represented by such information are reasonable, there can be no assurance that the forward-looking information will prove to be accurate. Actual results or events may differ materially from those expressed or implied in the forward-looking information. Giverny Capital Inc. undertakes no obligation to publicly update or revise these forward-looking statements.