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: <u>Our goal is to win the Stanley Cup</u> 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.

<u>Consequences for our portfolios:</u>

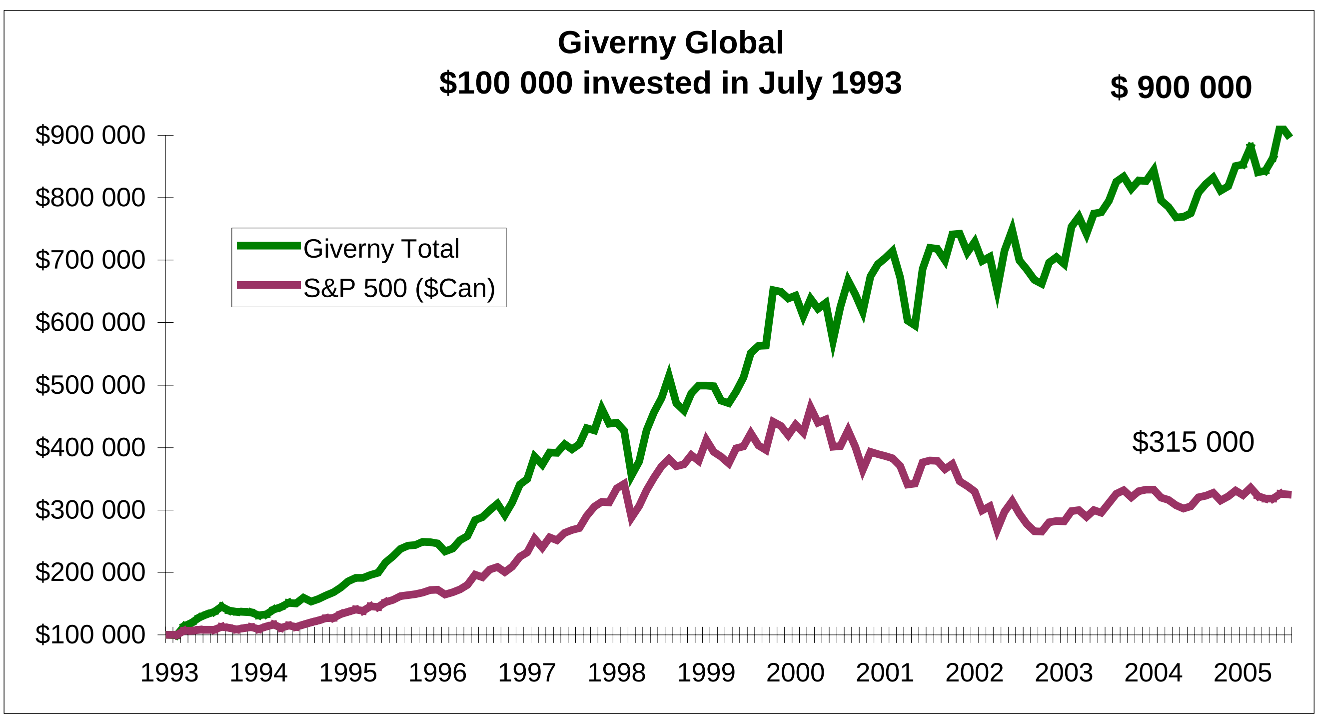
- Since our RRSP portfolio won't be materially different from the non-RRSP portfolio, we decided to stop differentiate it from the Global portfolio.
- Since we have many US mandate, we will continue to measure the Giverny US portfolio (which is mostly the US part of the Global Giverny portfolio).
- So, 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.



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[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 <u>own</u> 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."*

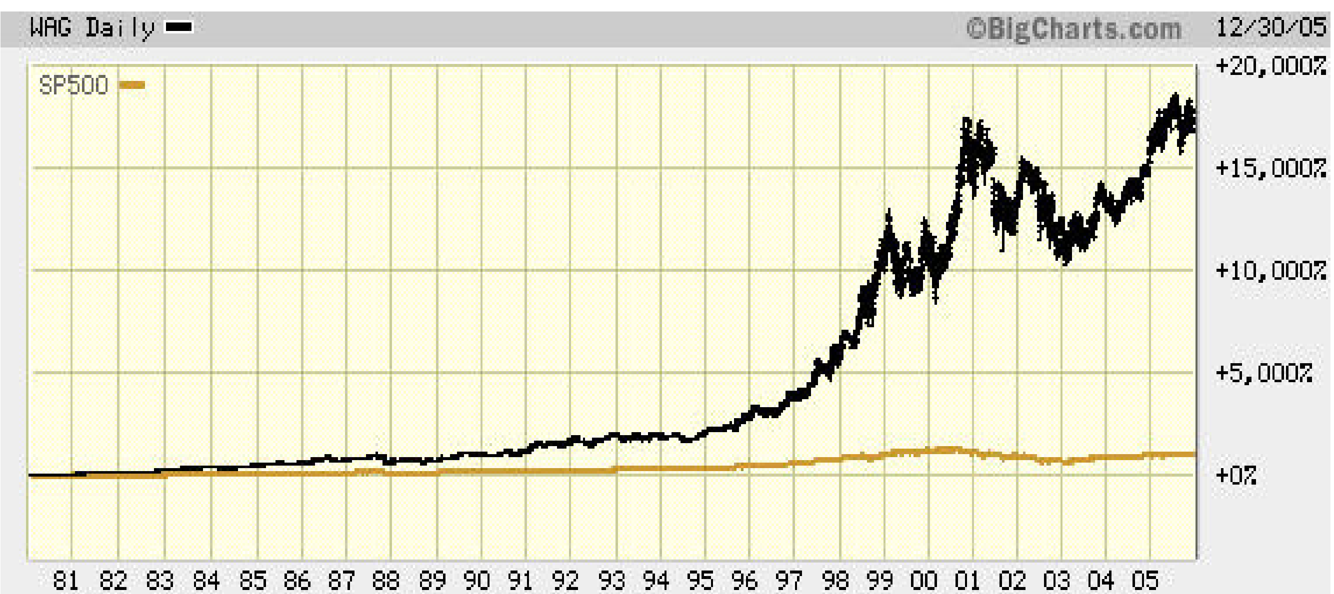
Fortunately, the consequences of the fog of the economy are less tragic than those of war. But still, too many investors bet their financial future on parameters that are both unpredictable and uncontrollable.

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...

Our businesses

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….

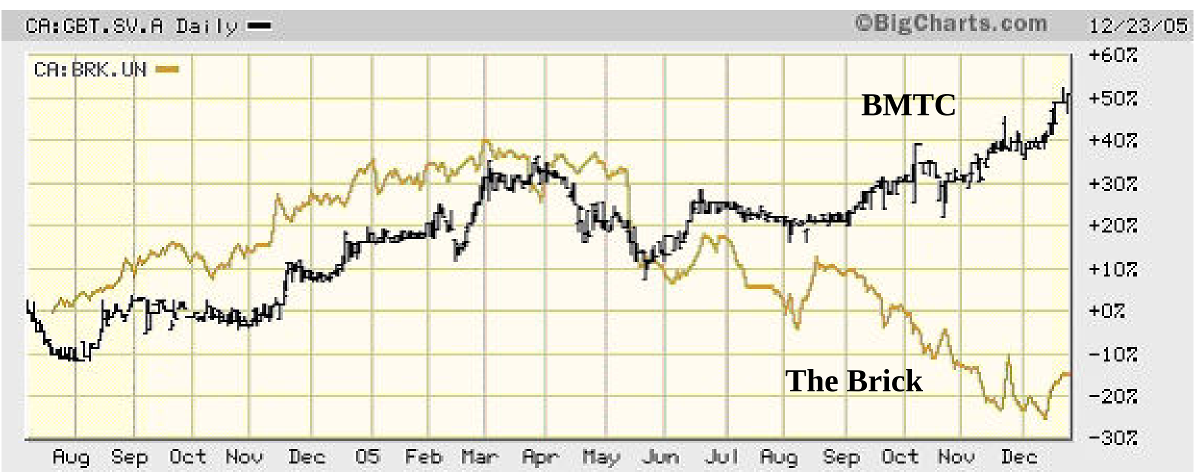


Chart of BMTC's stock performance compared to The Brick over 15 months (Source BigCharts.com)

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.

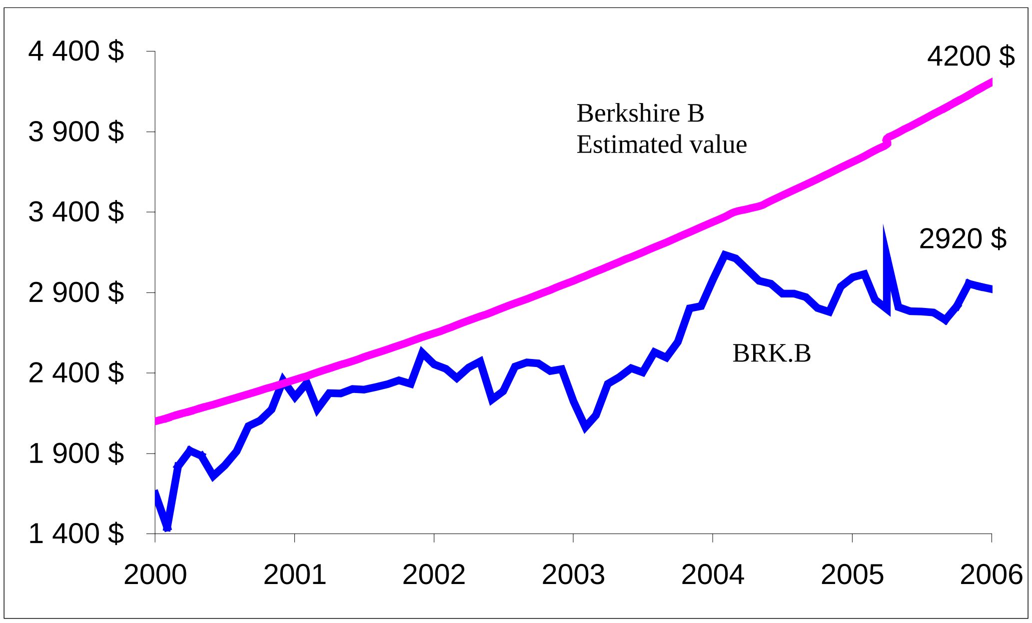
When ResMed was formed in 1989, its primary purpose was to commercialize a device for treating obstructive sleep apnea (OSA), a major subset of SDB. OSA affects millions of people worldwide (approximately 20 million in the United States alone), its prevalence being comparable to that of asthma or diabetes. 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: <u>our portfolio did better than the S&P 500 because our companies did better.</u> 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 <u>allies</u> 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.