Giverny Capital Inc.

Letter to our partners –2nd quarter 2010

Comments

The market experienced a correction at the end of the quarter. The economic situation in Europe has been worrisome for investors (personal note: with a short-term perspective becoming more and more widespread, we should think about finding a more appropriate term to designate the majority of participants in financial markets).

So far, our companies have weathered the brunt of the correction, resulting in our portfolio significantly outperforming the index as of the end of the second quarter. The performance of our companies continues to be excellent — in many cases exceeding our expectations — and the outlook for the remainder of the year remains strong. We are finding many interesting buying opportunities and have completed a few portfolio transactions to profit from them.

As is the tradition at Giverny Capital, we use our mid-year letter to answer questions from our partners.

Your Questions

We received many questions from you—we have partners who follow their finances closely! It would be unthinkable to answer all of these questions and you will also notice that many of them pertain to subjects we have already addressed in our past annual or quarterly letters and/or at our annual meeting. Nonetheless, we take your questions seriously and will repeat certain comments from earlier discussions.

Question: There has been lots of discussion recently about worldwide government debt. Many countries are experiencing significant difficulties, such as Greece, Spain, Ireland, the UK, …, etc. Many economists are worried about the enormous deficit in the US as well as its ever-increasing debt. My question is the following: Has there ever been a period like the one we are currently living through? Can this period of high indebtedness continue for a long time and what will be its impact on equities in general?

Answer: There are many questions within the first question (and this is only the first of four).

The indebtedness of Western countries is certainly the topic of the hour (with our brains bombarded on a daily basis). Have we ever lived through such indebtedness in the West? Unfortunately, the answer is yes—and more than once. The problems of debt and defaults are nothing new. I recommend reading an extraordinary book that was recently published entitled “This Time is Different: Eight Centuries of Financial Folly”. The books reveals that, if we take an average over 200 years, approximately one out of five countries is in default or debt restructuring. During major recessions, about a third of countries have had to restructure their debt.

Several countries are experiencing financial hardship these days such as Greece, Ireland, and Spain (with 20% unemployment). Brazil, despite its high current growth rate, had its share of difficulties in the past. Brazil had to devalue its currency on five different occasions just over the course of the last century. Germany, one of today’s economic powerhouses, had its economy completely destroyed twice over the last century. In 1923, the Mark experienced one of the worst periods of inflation in history (at the end of 1923, postage for a letter cost something like 20 billion Marks).

At the end of the Second World War, the majority of countries were vastly indebted (45% of all countries were restructuring their debt). Allied governments had borrowed as much as they could from their citizens with War bonds. Germany and Japan were completely destroyed. Today, there is no doubt we have our share of problems, but we still have our cities, infrastructure, hospitals, and our workforce. Imagine for two seconds being surrounded by ruins, with a population of young workers that had been decimated. Everything had to be rebuilt.

On top of having borrowed heavily for its war effort, the U.S. decided to pay for the reconstruction of Germany and Japan. Yet, the 1950s proved to be one of the most glorious economic decades. The U.S. stock market compounded at 18% annually during this decade and Japan went on to experience an era of unprecedented economic growth between 1950 and 1990.

Today, it is China that is experiencing rapid growth after decades of economic difficulties.

What are the consequences of indebtedness in many countries? Some governments will certainly deal with this problem by devaluing their nation's currency. Since currencies always have a value relative to other currencies, and that most Western countries have similar debt problems, the brunt of the impact will come from inflation.

What is the best hedge against inflation? Owning companies with unique products that have high pricing power. If I were a German investor in 1945, I would have wanted to own Porsche, Beck's, Hugo Boss, Bayer, Braun, and Nivea. The value of the German currency could have gone to zero, but if the brands were solid, you still could have realized a profit in any currency. Our job is to select solid companies that can withstand inflation and other economic risks.

What is the worst investment against inflation? Bonds. The objective of governments who are overly indebted will be to devalue bonds so that their burden can be reduced. Yet, what are investors doing these days? They are aggressively buying bonds and moving away from equities. They rant against debt but continue to buy government notes or leave cash in the bank at 1% interest.

And as for our brave economists, they often seem nervous don't you think? It seems curious that they most often don't seem nervous right before an economic crisis. Ultimately, we observe with the years that they seem most nervous when the best bargains are available to investors!

If you allow me to be a bit philosophical for a moment, I would add that the great thinker Victor Frankl liked to say that the greatest liberty of human beings is its ability to choose its attitude towards adversity. It is not a constructive attitude to quit, hide, or complain without acting. Fear and pessimism have never built anything aside from nuclear bomb shelters.

The problems of nations are part of the human condition. If we wait for a moment without problems to build something out of our lives (investing is building!), this life won't suffice. And yet when we look objectively at the accomplishments of our civilization, there has been constant progress despite all the difficulties encountered. And throughout this time, equities earned about 10% annually for shareholders.

At Giverny Capital, we have chosen optimism and the belief that our civilization is fundamentally progressing. While prudence frames our approach towards stock selection, we have so far been rewarded for maintaining a constructive attitude.

Q: I would like to know how the Giverny team finds its investment ideas. When we look at financial publications, it seems that it's always talking about the same companies followed by a group of analysts. I read Peter Lynch's book and he mentions that his best investment ideas had often been with companies with boring names that had evolved in boring industries and which weren't followed by Wall Street.

A: I'm a big fan of Peter Lynch and I share his enthusiasm for companies which aren't terribly exciting but, if well-managed, are highly profitable. We like simple businesses that don't attract too much competition and too many Wall Street analysts. Fastenal is a good example: it's a company that sells nuts and bolts that we've owned since 1998. We made a lot of money on Bed Bath & Beyond between 1998 and 2005. When I met the management team at Bank of the Ozarks in Little Rock, Arkansas, there were about 15 members of the executive team along with the CEO. It was obvious that Wall Street analysts didn't come knocking on their door very often!

How do we find investment ideas? We look at nearly all public companies. We use filters that eliminate about 95% of those companies (the company must be profitable, have a strong balance sheet, not be too cyclical, etc). Despite this, we still follow several hundred companies from around the globe. We do not want to constrain ourselves to a straightjacket, as is most often the case with institutional money management (large cap vs. small cap, value vs. growth, emerging countries, etc). We look for superb businesses regardless of their size or nationality. Our capitalist antennas are always on. When we travel, we always take the opportunity to visit stores, restaurants, look at advertising in airports, etc. We are always in a mode of discovery.

It's a bit like being a hockey fan. Imagine that there are 10 games per day on television (NHL as well as Russian and Swedish leagues) and that you watch three games per day for 20 years. After a while, you become familiar with all the players and get to know the ones who stand out. And this is not work. You watch hockey because you enjoy it. Everything is best learned when it is not a chore!

Q: In comparison to the S&P 500 which has a dividend yield of around 2%, where does the Giverny portfolio stand given that large positions (such as Berkshire or MTY Food) do not pay a dividend?

A: It is true that many of our companies do not pay a dividend but others do pay one (M&T Bank, Medtronic, or Omnicom for example), which results in our portfolio's dividend yield being fairly close to that of the S&P 500. Since we generally favor companies that can maintain a growth rate that is higher than average, we sometimes need to compromise on a smaller dividend.

Q: We often hear that 2010 will not be a very good year for the stock market. Over the course of the last several weeks, market indices have dropped significantly. Can you tell us more about your market forecast for 2010, knowing that the first six months are already behind us?

A: In 1949, Ben Graham wrote in "The Intelligent Investor" that, in the short term, the stock market was unpredictable and irrational—that it was essentially a manic-depressive entity. But in the long term, the market always ultimately reflected the intrinsic value of companies. Nothing has changed since. Human nature—and by extension the stock market—is always the same. If the market is irrational in the short term, it cannot by definition be rationalized (or predicted). This does not prevent experts—and lesser experts—from providing shorter-term market predictions. The large number of divergent and cacophonous market opinions, amplified by the ever-increasing number of media outlets in the last years, do not change the basic principles here.

At Giverny Capital, we do not make short-term market predictions. We estimate returns for a five-year period for the companies we follow as well as the S&P 500. In order to outperform the index, we select businesses that we believe have above-average prospects and buy them at attractive prices.

When markets are falling, the potential for future appreciation in stocks generally increases. At the moment, and since we believe that stocks are very inexpensive, we believe that the potential appreciation of equities is very high. No one knows whether this will be realized in 2010 or 2011. Can I dare add: is it really important that this occur in 2010? What truly matters is what happens to the companies in our portfolio, since this is what will ultimately be reflected in their market values.

Q: What does it take for an excellent investor to become a phenomenal investor?

A: This question is so interesting although it doesn't come up very often. It's a little bit like asking what it takes for a good hockey player to become the next Bobby Orr or Wayne Gretzky. By definition, genius is rare. Pablo Picassos, Mozarts, Victor Hugos, or Warren Buffetts, don't come around very often.

But the good news is that you don't need to be a genius to do well in the stock market. It is true that those who outperform the market, especially for long periods of time, are rare. It is well known that about 85% of money managers and most individual investors do not beat the market. I've thought quite a bit about this subject since my beginnings in this business almost twenty years ago. I know that it's not a question of intelligence, good intentions, or hard work. The majority of investors have such qualities.

I made the following inverse reasoning when I was young: What do those who beat the market do differently than others? I went ahead and read everything I could get my hands on about Peter Lynch, John Neff, Ben Graham, Phil Carret, John Templeton, Philip Fisher, and of course, Warren Buffett. Although Peter Lynch could have 500 stocks in his portfolio while Phil Fisher only had six, both shared the following fundamental approach: they viewed shares as fractional ownership in real businesses and they were never afraid to go against the crowd of the market.

Ben Graham explained in his writings that succeeding in the market was primarily a question of attitude—to be able to see stocks as parts of businesses and to not let yourself be affected by stock quotations. He added: "You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right." Therefore, you must be impervious to the judgment of others (the others *are* the market). Warren Buffett has repeatedly used the adjective RATIONAL to qualify good investors. A rational investor does not let himself be influenced by fads or affected by crises. He does not let emotions trump reason. Mr. Buffett recently added that he believed that this ability to not let one be affected by market quotations was acquired at birth (genetically coded in a minority of individuals).

In addition to a rational attitude, I believe that there is another important quality (and evident in Warren Buffett): the capacity to always want to learn and progress. The world is constantly evolving and it is not easy for someone to also be constantly evolving. In order to be in a state of constant learning, one must not only have passion for his art but also remain humble. Without humility, there is no openness for something new.

So, paradoxically, in order to become a good investor, one must know how to combine a high level of conviction in his judgment while maintaining a high level of humility. A difficult and fragile equilibrium.

Q: Does a company's social responsibility "balance sheet" factor in your stock selection process?

A: I will answer yes to your question but some nuances should be acknowledged. First, the concept of "social responsibility" is necessarily subjective. The perspective of a socialist who believes that all businesses exploit honest workers is almost definitely different from that of the president of a company (or the director of human resources in a large enterprise). The social responsibility perspective of a militant Greenpeace activist would also likely be very different.

A few years ago, I met Barnett Helzberg—the entrepreneur who had sold his jewelry chain (Helzberg Diamonds) to Berkshire Hathaway. He told me that, according to him, the key was treating your employees well and that everything else flowed from there. But after our experience with Cognex (see our 2006 annual letter), we became skeptical that this was the only factor that mattered. An interesting example of social responsibility is Disney which, in 2008, published a comprehensive report on corporate responsibility. You can read it at: http://disney.go.com/crreport/home.html.

I have my own views regarding social responsibility. I believe that businesses should aim to reach a balance in its management style in which all stakeholders are treated with respect and fairness: employees, clients, the environment, executives, and shareholders. It is with this in mind that we look for businesses that try to maintain this balance. Ultimately, I believe that these businesses will experience the most success.

It is not easy to use wisdom to address a problem of a subjective nature. But still, we dare believe that our experience of the business world, along with our long-term vision, are adequate tools of judgment.

Q: Do you believe that the price of our stocks are still undervalued now? What are your growth projections for the next 3-5 years?

A: We believe that our stocks are still greatly undervalued. Our view is that our stocks, when looked in aggregate, trade at around a 40% discount to their true value. We use a 6% discount rate for this analysis. This undervaluation would be even greater if we based ourselves on current long-term rates of around 4%.

Our objective is to achieve a portfolio return that outperforms the index by 5% in the long term. We own the securities in our portfolio because we believe that they have the characteristics that allow for such wealth creation potential. Since we are of the opinion that the major indices (for example the S&P 500) will return 10% annually for the next five years, we believe that we can achieve an annual return of 15% between now and 2015.

Q: Will Berkshire Hathaway's stock ever be overvalued?

A: This question comes from a partner who is likely a little tired of hearing us say (or read in our writings) that Berkshire Hathaway is undervalued. I know that the market will eventually accurately reflect the fair—and quite high—value of Berkshire. Will there be a point when investor enthusiasm could lift Berkshire shares at a level higher than its true value? Nobody knows. It is certainly possible given the nature of the stock market. If this were to happen, we would sell our shares.

Incidentally, the stock has been overvalued in the past. In 1998, Berkshire was trading well above its intrinsic value. Not only that, but the holdings in Mr. Buffett's portfolio (such as Coca-Cola or Gilette) were also greatly overvalued by the markets. So, there was a period of "double overvaluation", where stocks were individually assigned a price premium by the market while a group of those stocks was also assigned a price premium. Today, it's likely the inverse situation: a "double undervaluation".

In 1998, American blue-chip companies were the favorite of investors from around the world (the S&P 500 was perceived as a risk-free index). I remember being invited to a ScotiaBank conference that summer (ScotiaBank had a significant ownership in the firm where I worked at the time) about investing in the American markets. It's amusing to think that 12 years later, the S&P 500 is trading below the level from that summer and that no one seems to want to invest in the U.S now that it is way cheaper !

It's important to not forget that things can often change rapidly: only two years after the 1998 enthusiasm towards Berkshire, in the midst of the tech madness, Mr. Buffett's approach was no longer in fashion and Berkshire stock dropped nearly 50%. Good for us and bad for the sellers: we were able to make our first purchase of Berkshire, at almots a third of today's price!

I would add that Warren Buffett knew that Berkshire shares were overvalued in 1998 and benefited from the market's enthusiasm by using shares (roughly equal to 20% of the company) as his currency to purchase General Re. Further, the addition of GenRe's own large portfolio (its "float") diluted the impact of overvalued shares in Berkshire's portfolio at the time, such as Coca-Cola.

Q: In the long term, what analysis can be done regarding the upcoming health care reforms in the U.S. and its impact on the growth in earnings at Medtronic? Why does this company seem undervalued? In my view, you did the right things in buying shares in Medtronic, but given the skepticism of others, why not take the opportunity to profit by buying more shares at a bargain price?

A: The vast majority of health care stocks, in both the U.S. and Europe, seem undervalued. Health care reform in the U.S., along with the loss of many pharmaceutical patents, appear to be the primary causes (not to mention widespread pessimism). Regarding Medtronic, the issue of patents does not apply. Health care reform, however, will add a special tax for companies producing medical devices (and Medtronic is one of the more significant players in this space). On the other hand, the revenues of these companies will increase from the greater health coverage of the American population.

We are confident, when looking at both the pros and the cons, that Medtronic will continue to grow its earnings at 10-12% annually like it has in recent years. Since the stock is trading at 10 times earnings (half of its historical level), we believe that the stock is greatly undervalued. And we are considering increasing our holding.

Q: We hear and read that that the "new economy" (i.e. globalization and the rapid reaction of markets) is not suitable for a "buy and hold" investment approach. Does the market truly behave differently these days?

A: We "hear" many things all the time. We would quickly become impoverished if we used what we hear to invest our capital. In fact, if we were to summarize what we most often "hear" in one phrase, it would be: "the trends of the last years will continue in the future". I've said in the past that the greatest quality of financial analysts is their ability to extrapolate.

There are cycles in all economies, all sectors, and all asset classes. Who would have thought, after 10 years of stagnation during the 1990s, that Canadian real estate would do so well in the last years? Yet, in 1999, we "heard" that we had to invest in the "new economy" such as fiber optic (Nortel) and the Internet (Yahoo!). We didn't hear in 1999 that real estate would make a good investment.

Paradoxically, it was the best time to buy a house in Canada and we all know what happened to the "new economy" between 2000 and 2002.

In 2005, we "heard" that we couldn't lose by buying a house or a condo in the U.S—that real estate values always went up. There were waiting lists for condo projects in Miami. Two years ago, we "heard" that China (and also Dubai) was the growth territory of the future. The Chinese index is 60% lower today than its 2008 high and investing in Dubai real estate didn't turn out to be the Eldorado that was expected.

Having a "buy and hold" approach is not a fad but rather a principle. North American equities, on average and over the long term, have returned 10% annually because companies have increased their annual profits by 7% and paid out an average dividend of 3%. This would be the return of a portfolio consisting of a group of companies representative of the market over a number of years. Unfortunately, the majority of investors do not experience this 10% return. Too often, they buy when everything is going well (and/or whenever something is "popular") and pay too much for the asset acquired. Then they usually sell during a crisis or they throw in the towel when the stock/sector/country is unpopular for a couple of years. They therefore eliminate any benefit of stock ownership in the long term. It is not "buy and hold" that does not work, it is the behavior of the majority of market participants.

The key to succeed in such an environment is to view shares as fractional ownership in businesses rather than tokens in a planetary casino. One must have their own judgment as to the value of a stock and behave and think from the perspective of a business owner. This is the guiding principle of an intelligent investor[1]. This principle has not changed and will not change.

From this perspective, we aim to find companies that will grow their intrinsic value at an annual rate of 12-15% (including dividends), which should correlate into the market performance of the portfolio if we hold the rights securities over the long term. A good example is Fastenal. Since we bought it for $6 in 1998, profits have increased eightfold or 19% annually—and the stock price has risen by a factor of eight. We bought O'Reilly in 2004 and EPS has risen 150% in six years—the company's stock price has risen 150%.

Q: If Warren Buffett was 41 years old today and managing a $20M portfolio, would he own the same stocks that we have?

A: We have $100 million under management but this does not change the essence of your question. This is a fascinating question, though completely hypothetical. I'm convinced that there would be a lot of similarities. A company such as Fastenal would almost certainly be in Mr. Buffett's stable of companies. I believe that the primary difference would be in the level of blue-chip holdings such as Procter & Gamble, Omnicom, or Wal-Mart. I doubt Mr. Buffett would be as interested in buying those if he had considerably less capital under management—unless their price was very compelling.

We do it at Giverny since, for the majority of our partners, we manage nearly all of their retirement savings. So we like to have part of our equities in extremely solid companies—without being Treasuries—whose intrinsic value is quasi risk-free if a reasonable price is paid for them. We don't aim to get 20% annual returns out of those companies. If this were our objective, we would have more companies such as Resmed, Lumber Liquidator, and Carmax. But we would also be taking on slightly more risk than we are willing to pass on to our partners.

[1] My favorite Ben Graham saying is: "Investment is most intelligent when it is most businesslike."

I would add that it is normal for two different people to have their own way of carrying out the art of investing, even when they share a common fundamental philosophy.

Q : Do you believe, like Warren Buffett, that the South Korea market is the most attractive for investment these days?

R : Warren Buffett believed that South Korean stocks were very attractive in 2002. He bought of group of them in 2002 at around 3 or 4 times earnings. But since then, the Seoul market has rebounded and the stocks are not as cheap as they were. But we do follow some Korean companies and their valuations are interesting, although not that different from those in the US. The low level of their currency (in terms of PPP) is a big plus for their exporters.

We follow many more asian companies that 10 years ago and could continue to purchase some of them depending on the opportunity available to us.

Q : Are there some of our companies that benefits from a strong Canadian dollar?

R : Dollarama is probably the one that benefits the most. A lot of their products are purchased in China so a strong Canadian dollar increases their gross margin.

Q : Do some of our companies have a high exposure to the Europe economy? Is the changes announced for the level of Chinese yuan a problem for some of our companies dealing in China?

R : We have only modest exposure to Europe, mostly through ownership of multinationals. The one that has the highest exposure is probably Omnicom which has 30% of their revenues coming from Europe. The stock is so cheap that it already discounts many problems. And their results so far in 2010 are very good despite Europe and the slow recovery in the US. But on the other hand, we do find lots of interesting and cheap stocks in Europe these days.

Our main investment in China is the company China Fire & Security. Since it sells fire safety products for Chinese clients from Chinese based plants, they are not affected by the yuan. Moreover, there clients are mostly selling their products in China (steel) so they are not as sensitive to the currency than for example manufacturing companies selling their products to the West.

Q : Can you go further into the question of the real estate market in Canada? Could it go down a lot? Will their be consequences similar to the ones that happened in the US?

R : This question is in reference to our latest's annual letter section "Flavor of the day" (it is available upon resquest). I would add first that you should read the very interesting article in *Bloomberg Business week* on the sky high prices in Vancouver. A small bungalow can sell for a million dollars!

Eventually, this irrational level of prices will wear off. All assets trade at their intrinsic value at some point. We could have either a long (very long) period of stagnation of prices or an abrupt drop in prices (particularly in region of irrational levels like Vancouver or Calgary). What would the consequences on the economy be? The main problem is that banks have "transferred" the problem to the federal government (in other words, *us*). The CMHC has transformed itself in a Canadian version of Fannie Mae. It has sold billions of secondary mortgage paper with the federal garanty seal. If these were to fall in value, the federal government could have to rescue tens of billions of dollars in losses. This could harldy be good news for the economy, our deficit and our currency.

Moreover, the Canadian consumer that has not zipped-up his pocket as its American counterpart, could feel much less rich if real estate went down in price. He could reduce his retail spending dramaticaly. This is even more scary considering that the level of consumer debt is at an all time high.

We do not like to be pessimist. But we are very prudent towards any business that would be affected by a real estate crisis in Canada. We do own Canadian securities we regard as shielded from those possible problems like Astral Media (Teletoon should be ok), Dollarama or MTY Food.

Q : Is the company "Got-Junk?" a good investment idea?

R : It's quite funny since I asked myself the same question a few weeks ago. I went to their website and found out that the company was private. Perhaps some day….

Q: Is MTY Food a future "tenbagger" ?

R : For those not aware of this term, it was popularized by Peter Lynch. It is a stock that increasese by a factor of 10 times in the stock market (usually over a few years span). MTY Food is a young Montreal based company that we admire a lot. We like their business (simple and dull). We like the CEO. And we were able to purchase shares at an attractive level. So far, it's been a satisfactory investment but it is a little soon to know if it will increase by 900% in the future. We do hope so!

Q: Since I am younger than François Rochon, I'm curious to know if there's a continuity plan at Giverny Capital following his retirement?

A: Here's a question I like receiving from my partners. For the simple reason that this assumes that this partner wants to stay with us for a long time (given that my life expectancy is for another 40 years). I don't think about retiring unless I had health issues. I'm doing today what I love to do and my greatest wish is to continue doing what I love—with people I love—for the rest of my life.

Despite this, we already have a continuity plan. Jean-Philippe Bouchard, who is 11 years younger than me, is already a portfolio manager and has all the qualities (if not more) to manage the business. Patrick Léger, our US division director, also adds some depth in the management team.

Further, we are even thinking about continuity beyond J-P's life span. We often meet young and bright businessmen that we keep track of. Exceptional investors are rare and we have to keep our eyes open at all times.

So, more than just investing over the long term in exceptional companies, we also have a long-term vision as to the management of our own business with the aim that Giverny Capital will carry on beyond its founder.

Best wishes to all our partners for a great quarter.

François Rochon

François Rochon and the entire Giverny Capital team