Giverny Capital Inc.

Our companies: an excellent second quarter

Sommaire :

Our companies, as a whole, had a terrific second quarter. Most of them surpassed our expectations for the first six months of the year.

Many questions we received pertained to macroeconomics (or politics). We've never believed, like Warren Buffett, that we can predict the future of the economy. It's not that the future of our economy isn't important, but rather, that it is unknowable (though that this doesn't keep people from speculating about it).

The good news is that investing in outstanding businesses that are trading at compelling valuations is a rational approach amidst all the fortune telling that is going on about our macroeconomic future.

Although many investors allow themselves to be distracted by financial newspapers (almost tabloids in some cases), we continue to focus on the most important issue: **the intrinsic performance of the businesses in which we are shareholders.**

Our estimates are that earnings per share, in aggregate, should increase by 17% for our portfolio in 2011.

Furthermore, the valuations of our companies are, as measured by their stock price relative to their earning power, is very low, currently at about 13 times their profits.

Our companies have historically grown their earnings at an above average rate (the average over the last 15 years is 12% annually). From this perspective, we believe that a conservative valuation would justify stock prices that are 35-40% higher than their current prices.

So, without making any short-term market predictions, we are very optimistic about the years to come.

WE REITERATE TO OUR PARTNERS THAT WE CONTINUE TO SEE A STRONG OUTLOOK FOR INVESTING. WE BELIEVE THAT THE COMPANIES IN OUR PORTFOLIO ARE TRADING AT COMPELLING VALUATIONS AND OFFER OPPORTUNITY TO ADD CAPITAL FOR LONG TERM INVESTING.

Your questions

Like every year, our second quarter letter serves as a forum for answering questions from our partners.

Q: Do you think that the recent optimism of Warren Buffett about the economic recovery in the US is justified?

A: Absolutely. First, Warren Buffett's conglomerate, Berkshire Hathaway, owns several dozen businesses in a number of different industries. He could not be better positioned to have a grounds-up opinion on the American economy.

We have, in our own portfolio, over twenty companies that continue to post very impressive results in 2011, following an already excellent year in 2010.

I have never met anyone who is more intelligent and has more integrity than Mr. Buffett in my whole life. Without being infallible, I believed that you can have confidence in his judgment.

And unlike many commentators (economists, politicians, bloggers, etc.), he's doesn't say anything just to be heard.

Above all, he is able to remain rational while the crowd lets emotion be its guide.

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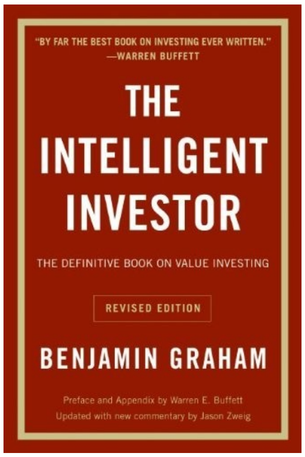
Your questions (continued)



Q: At a meeting around 2007, you said that shareholders before the year 2000, on average, held their shares for several years. After 2000, shareholders are holding their shares less than two months. Is it possible that electronic and new technological products have completely changed the process for compounding money and that the notion of long-term ownership (as espoused by Giverny Capital) should be revised?

A: Good question. Actually, I would like to correct your numbers. Since 1960, the average holding period for shares on the NYSE has gone from 7 years to 6 months. But the essence of your question remains the same.

The fundamental principle that supports our investment philosophy is the following: « In the short term, the market is irrational and manic depressive. In the long term, however, the market always ultimately reflects the value of the underlying businesses. »

This principle was pronounced in 1949 by Ben Graham in « The Intelligent Investor ». This book had such an impact on Warren Buffett that he called it the best book ever written about the market.

By definition, principles do not change or they wouldn't be principles. The S&P 500 has returned 9% annually since 1991 (when I started) and companies have grown their profits by 6-7% annually and have paid out about 2-3% in dividends. During these 20 years, the S&P 500 has fluctuated wildly (losing 10% probably about 12 times and 50% twice). Yet the market's performance reflected, approximately, the performance of the underlying companies in the S&P 500.

The Dow was at 750 forty years ago, and now it's at 12,000. It has risen sixteeen-fold for the simple reason that the profits of the companies in the Dow have risen sixteen-fold.

We bought O'Reilly Automotive in 2004. The company's stock has fluctuated wildly (it dropped by 20% on four different occasions), but today, the stock price is triple what we paid for the simple reason that the company's earnings have tripled since 2004.

And it's a good thing when the market is irrational, volatile and when impatient shareholders have the itch to sell: this is our ally in finding bargains. This allowed us to buy Bombardier at 10 times earnings in 1993, Fastenal at 1/12 of its current price in 1998, and….

….Wells Fargo at very good prices these days.

What happened to Lumber Liquidators?

Q: One of our businesses, Lumber Liquidators, seems to have been affected by lower spending in residential renovations. Has the company taken steps to strengthen itself during this crisis?

A: We bought an initial position (less than 2%) in Lumber Liquidators last year. We admire their low-cost business model and highly dynamic management team. The company has 220 stores and is growing quickly. In fact, the company anticipates opening another forty or so stores in 2011. The company has a great balance sheet and is highly profitable.

A danger that threatens all retail stores is the possibility of cannibalization between existing and new stores. Up to now, LL juggled through this challenge very well and was able to continue increasing same-store sales even during the crisis in residential construction (2006-2010).

Last quarter, however, same store sales tumbled by 8% which was quite a surprise. We are now questioning our growth forecasts for the moment and decided to sell our shares in order to invest capital into stocks with brighter prospects.

And Apple?

The first corporate logo of Apple, depicting Isaac Newton under the apple tree.

Q: What is your view on the intrinsic value of Apple ?

A: When we met Peter Lynch last February, he was biting his fingers as he was using his iPad: « How did I miss this? »

I, of course, also have regrets to have missed Apple. But from another angle, it was a difficult investment to foresee and one that I had put into the « too hard » pile.

I bought my first computer in 1982 (a Commodore Vic-20) and have diligently followed the adventures of tech companies since. Companies such as IBM, Commodore, Digital, Wang Computers, Compaq, Sun Microsystems and Dell all had their glory days (and I'm skipping many others).

Apple had some good days with the Apple II in 1977 and with the revolutionary Macintosh in 1984. The company (without elegance) asked Steve Jobs to leave the company in 1985. Twelve years of stagnation followed until the return of Mr. Jobs, and it wasn't until the introduction of the iPod that Apple began its phenomenal renaissance (and I wish there was a stronger word to describe it).

The biggest success at Apple now is the iPhone. It would have been very difficult to predict such domination in such little time. I knew a time when Motorola dominated the mobile phone industry. Then Nokia was the king of the universe, and then Blackberry (Research in Motion) revolutionized mobile phones. This universe evolves so quickly that it becomes very hazardous for an investor to attempt to predict who will dominate the market in a couple of years.

Since evaluating <u>future</u> earnings is so central to the work of evaluating the intrinsic value of a company, taking on companies that are ever so changing becomes a very difficult task.

So, we continue to follow Apple very closely (and with admiration) but for the moment, this remains a very difficult company to evaluate.

Why the sale of Microsoft?

Q: You recently sold Microsoft and bought Google. Why do you prefer Google over Microsoft?

A: These were actually two separate decisions. We already had in mind to buy Google at the right price (see our last annual letter). And the price was right a few months ago. So we looked through our portfolio for something that seemed less compelling to us and would be replaced by Google.

Microsoft is undervalued. We were, however, very disappointed with their capital allocation decisions. We were already on guard when the company was tempted to buy Yahoo! Thankfully Yahoo! rejected the $30 offer from Microsoft (the stock is now trading at $13). We were outright horrified when Microsoft bought Skype for $8.5 billion. Less than two years prior, as shareholders in eBay (the then owner of Skype) we were happy to see Skype sold to a consortium of private investors for $2.5 billion.

Imagine our reaction when Microsoft paid a $6 billion premium for this asset that we found fairly valued at the prior price just a few quarters prior.

Microsoft can buy back its own shares at 10 times earnings these days. Instead, the company spends (a diplomatic word) its money on pricey acquisitions. We sold.

And Europe?

Q: With the crisis in Europe, it seems that there would be many high quality European businesses trading at terrific prices (like in the US in 2008 -2009). Is this not a good time to go bargain hunting for the best companies that will rebound once the crisis has passed?

A: We follow several European companies very closely. There are 3 or 4 that fall within our strict selection criteria that we would buy at the right price (including one Scottish company that seems truly exceptional).

Strangely, the companies that interest us have not dropped that much in recent months and still trade at relatively high P/E multiples (not true bargains).

We also should remember that the Euro remains relatively high (about 12% overvalued relative to the US Dollar according to the OECD). We need to account for this in our securities analysis.

There is also a Swiss company that is very interesting to us. Its stock price has dropped considerably in recent time and we might eventually be able to buy some.

Still, it's in the US where we are seeing the most compelling valuations. This is no coincidence, since this is where there is the greatest pessimism.

The US debt

Q: There's lots of talk these days about the American debt. Since this debt is primarily taken on by American citizens through its treasury obligations, isn't this debt quite stressful? How does this debt is owed to Americans entities compare to other countries? Are American assets worth more than its debt?

A: The total government debt of $14 trillion is primarily separated into two parts: the portion owned by its own citizens and the portion owned by foreigners.

American individuals and institutions own 42% of the debt. Other US governmental groups own another 26%. So, more than 68% of the American debt is owed to Americans.

About 7.5% of the debt is owned by China and 6.4% by Japan, with the rest owned by other countries.

Now, about the balance sheet of the US. Total assets of US households is $70 trillion, with $18 trillion in real estate and $46 trillion in financial assets. So, the total debt is $14 trillion, so therefore the net assets of households is $56 trillion.

It's critically important to understand that a substantial part of this federal debt is a result of the cause of the American recession: the drop in real estate. The fall of more than 30% in US housing prices was the cause of a $10 trillion decrease in the value of US households. About half of this drop was absorbed by the American government in 2008 (through the nationalization of Fannie Mae and Freddie Mac, among other things). It was though the government decided that it was better that they take a lot of the impact from lower housing prices instead of households.

An interesting fact to note is that the median price of a home in the US is about $180,000, a lever quite a bit lower than current levels in Canada (even with the Canadian GDP per capita being 17% lower).

The Canadian government, through the CMHC, guarantees a significant portion of mortgages. So, since Canadian housing prices have not (yet) decreased, the federal government has not yet had to absorb any losses.

Let's go through a theoretical exercise: if US real estate prices rose by 60% (approaching the Canadian level), this would result in an $11 trillion increase in the value of American households—roughly 80% of the total federal debt. From this perspective, Americans own undervalued assets which will reduce the relative size of their debt once housing prices rise.

Some books...

Q: What are some good books you have read recently on the market or other areas of interest?

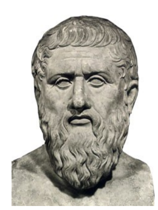
A: My book for the summer isn't directly related to the market. In fact, it's a novel published in 1957 by the American philosopher Ayn Rand: « Atlas Shrugged ».

Throughout its thousand pages, we discover an authentic anthem to capitalism and entrepreneurship. The heroine, Dagny Taggart, manages a railroad company and is forced to deal with a society that crushes businesses with regulation and government intervention. But the enigmatic man of science, John Galt, finds a way to save the spirit of innovation so essential for human progress...

I also enjoyed « Value Investing » by James Montier. This book is full of revealing graphs and interesting statistics pertinent to the « value investing » approach.

Finally, I read the book "Get Smarter" by Seymour Schulich, a Canadian businessman and philanthropist (co-founder of de Franco Nevada). Although his investment style is significantly different from mine, I found his sense of humor and frank manner of speech to be refreshing.

Philosopher's corner



To choose life is always to choose the future. Without that momentum that carries us forward we would be nothing more than a mold on the surface of the earth.

- Simone de Beauvoir