

Affordable Quality

It sounds almost old-fashioned in today's day and age, but François Rochon's investing strategy since founding Montreal-based Giverny Capital hasn't wavered: "We're looking for 20 to 25 companies we can own for the long run that we believe can increase their intrinsic values by about twice the rate of the S&P 500," he says, "and we want to be prudent about what we pay for them."

Now managing \$1.6 billion, he's executed on that deceptively simple premise quite well. His Global portfolio, typically 85% invested in the U.S., has earned a net annualized 14.2% since 1993, vs. 10.2% for the S&P 500. Today he's finding what he considers affordable quality in such areas as Internet services, insurance and used cars.

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INVESTOR INSIGHT



François Rochon
Giverny Capital

Investment Focus: Seeks companies with simple businesses and sustainable growth prospects that the market doesn't yet – but ultimately will – fully value.

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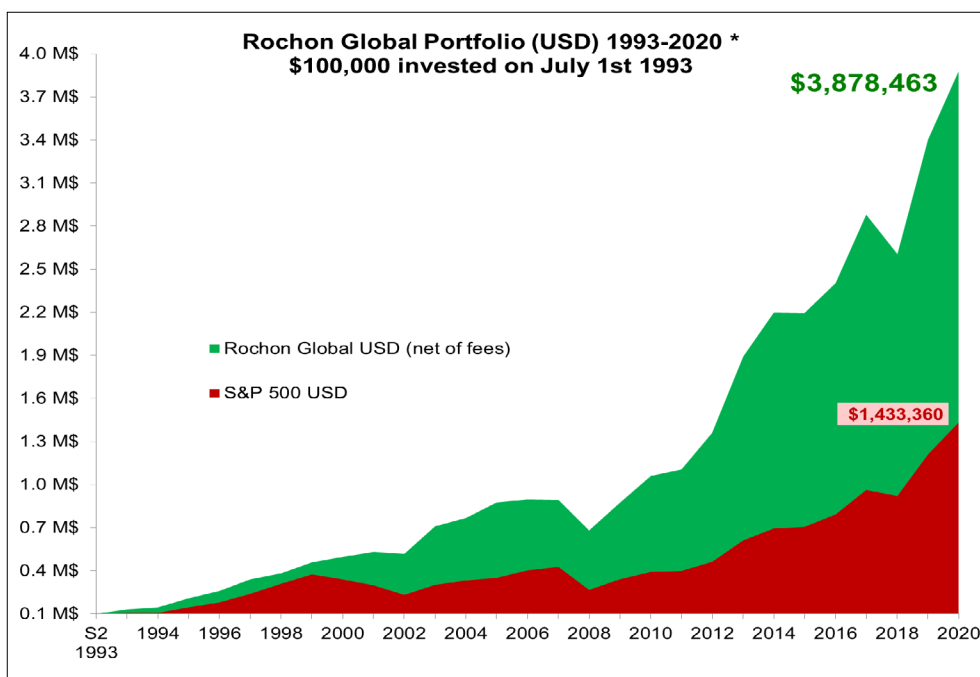
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Investor Insight: François Rochon

François Rochon of Giverny Capital describes what about his strategy makes it both timeless and timely, the mistake he wishes he could take back from last March, his latest views on top holding Berkshire Hathaway, the macroeconomic concern he considers most prominent, and why he's seeing mispriced value in Facebook, Progressive, Market and CarMax.

Your strategy has proven nicely built for the long term. How has it been faring though the unusual series of short terms we've had over the past year?

François Rochon: Since I started managing my portfolio in 1993, I have never tried to predict where the market, the economy, politics or even our civilization was going to go in the short term. Our philosophy is to own 20 to 25 high-quality companies that we believe can increase their intrinsic value at twice the rate of the S&P 500 average. Knowing that there will be recessions along the way, we filter out companies that are unprofitable, heavily indebted, sensitive to commodity prices, highly cyclical and/or have high market valuations. In difficult times, the stock prices of such companies tend to suffer more.

Over the past 25 years we have tracked the growth of our portfolio companies' "owner earnings" – which consists basically of earnings per share adjusted for things like stock-option expenses and the amortization of intangibles – plus the dividend yield. It's not a precise measure, but we believe it is approximately correct. Through 2020, the market value of our companies has grown by almost exactly the same amount as their intrinsic value. We've outperformed the S&P 500 over the long run for the simple reason that our companies have grown their intrinsic values on average faster than the companies that make up the S&P 500.

To your specific question, our companies have fared well over the past year. Their earnings have come down at a lower rate than average – we estimate a decline of around 7%, compared to a 15% decline for the S&P 500. Close to half of our companies should report record earnings for 2020. If we're right about our holdings' ability to increase intrinsic value at a rate higher than the market, since the stock market ultimately reflects the fair value of

companies over the long term, over time we should be rewarded as shareholders.

Are you finding your opportunity set expensive today?

FR: Our portfolio at the end of 2020 was trading at about 20x estimated earnings for 2021, which is at the high end of our historical range. But that's still lower than the S&P 500, at 22x, for companies we believe can grow at higher-than-average rates. In our opinion, they should trade at a premium and they don't.

I should also explain how important it is for us to be prudent about the price we pay for what we consider to be superior companies. If you pay too high a price, you can be right about the intrinsic value increase but not benefit from that because the valuation at some point contracts. Our discipline to address that is at purchase to look out five years and estimate a target price based on what we believe the company can earn and the P/E ratio we believe would be warranted for such a company at that time. We'll consider a stock as a new purchase candidate if the price today is no more than half our five-year target.

We don't believe the 40-50x P/Es on many growth companies today are sustainable, so it's not easy to find companies we want to own at reasonable prices. But we've always been able to find opportunity in areas that are less exciting and not so fashionable. That's true today as well.

We'll come back to that soon, but on the subject of 2020, were you active in buying and selling through the worst of the market turmoil?

FR: At the end of March there appeared to be some exciting opportunities for long-term investors. We're always fully invested, so for us it required weighing the extent of the new opportunities we saw against

what had become increasingly attractive valuations in our current portfolio.

We did trim some existing positions we thought were a bit more negatively impacted by the pandemic to establish a position in Five Below [FIVE], the specialty retailer that has become very popular with pre-teens and teens. It's a stock I'd been following for years and I really liked the company, the concept, the management and the balance sheet. It also had significant room to grow. I almost bought it in late 2017 when the P/E was probably in the mid-20s. Then the stock went up a lot, the P/E ratio went to 40-50x, and it looked like we had missed it. In March the market gave us another chance and we took advantage of it – the window to act actually turned out to be quite narrow. [Note: Trading at around \$125 at the beginning of 2020, FIVE shares went below \$50 in March. They now trade at around \$176.]

Berkshire Hathaway [BRK.B], one of your largest holdings, was hardly a stand-out performer for much of 2020. Did that make it more or less attractive to you?

FR: We were disappointed that Warren Buffett did not invest more of the cash on hand in March when opportunities were plentiful. But we understand his reasons: Mr. Buffett has spent his entire life as a good steward of capital and he didn't want to do anything that he thought would put the company and its employees at increased risk in a very uncertain time.

While we still think the stock is undervalued at present levels, we recognize that it will be hard for Berkshire to meet our intrinsic value growth targets if close to a quarter of the investable capital stays invested in assets like cash that yield next to nothing. We were encouraged that they stepped up share repurchases considerably in the third quarter – buybacks totaled \$9 billion. If Berkshire can continue to buy

back shares at such high rates, eventually shareholders will be rewarded.

Used-car seller CarMax [KMX] has been a long-time holding of yours. Is it a good example of something you think the market is relatively neglecting today?

FR: It's a good example both of the type of company we're attracted to and of one we think is undervalued today. It is a leader in its industry, conservatively and well managed, with an extraordinary reputation among customers and a long runway for growth in an industry where scale often provides a competitive advantage.

It's also a business that has been disrupted. I can tell you when I first bought the stock I didn't imagine a time when people would be buying used cars entirely online. But the company has adapted by investing massively in its omnichannel capabilities and we think it is very well positioned to deliver whatever experience customers want, from all in-store, to all online and whatever is in between.

The comparison between it and on-line-only competitor Carvana [CVNA] is interesting. CarMax sells close to three times more cars than Carvana and should generate revenues of \$22 billion or so this year, compared to \$8 billion for Carvana, which by the way is still expected to be unprofitable. But the market cap of CarMax is around \$19 billion, compared to \$45 billion for Carvana.

Of course, a low relative valuation is not reason enough to own CarMax. We believe it's competitively advantaged, but it still has less than 3% total market share. It could double that market share over the next ten years. That doesn't mean Carvana can't prosper and challenge CarMax as the market-share leader. We think there's plenty of room for both to be successful.

To give you a sense of how we look at valuation, our scenario for CarMax is for same-store sales growth, store growth and share buybacks to pretty equally drive intrinsic-value growth of around 12% annually. That would result in earnings per share of around \$10 by 2026 and with what we'd consider a reasonable P/E of

20x, the stock would trade at around \$200. The stock has gone up strongly so far this year, but that's still nearly 70% above today's price [of just under \$118].

What do you think the market is missing in Facebook [FB]?

FR: It sounds strange given how high-profile the company is, but we think people underestimate the strength of Facebook's business. It's almost a monopoly as a social media network and I would argue that it and Google have among the strongest and most durable moats I've ever seen. It

has more than 2.7 billion monthly users – a third of the humans on the planet have an active Facebook account – and once you're signed on where all your family and friends are, there's no practical incentive to use another network. The service is free, so there's no economic incentive to change either. The importance of its position and of the role it plays has only been reinforced during the pandemic.

Facebook, also along with Google, should remain a primary beneficiary of the ongoing transition of marketing and advertising spending moving online, where messaging can be better targeted and more

INVESTMENT SNAPSHOT

Facebook

(Nasdaq: FB)

Business: Provider of advertising-supported social-networking products and services worldwide; key brand franchises include Facebook, Instagram, WhatsApp and Oculus.

Share Information (@1/29/21):

Price	258.33
52-Week Range	137.10 – 304.67
Dividend Yield	0.0%
Market Cap	\$735.84 billion

Financials (TTM):

Revenue	\$85.96 billion
Operating Profit Margin	38.0%
Net Profit Margin	33.9%

Valuation Metrics

(@1/29/21):

	FB	S&P 500
P/E (TTM)	25.6	40.9
Forward P/E (Est.)	23.2	22.1

Largest Institutional Owners

(@9/30/20 or latest filing):

Company	% Owned
Vanguard Group	7.2%
Capital Research & Mgmt	6.0%
Fidelity Mgmt & Research	5.0%
BlackRock	4.4%
T. Rowe Price	4.2%

Short Interest (as of 1/15/21):

Shares Short/Float	0.8%
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FB PRICE HISTORY



THE BOTTOM LINE

Armed with what François Rochon considers "among the strongest and most durable moats I've ever seen," the company should be able to navigate regulatory challenges and continue to prosper from broad secular trends in its favor, he says. At what he would then consider a reasonable 25x his 2025 earnings estimate, the shares would trade at \$500.

Sources: Company reports, other publicly available information

impactful. That shift in spending may have temporarily accelerated during the pandemic, but it still has far to go before running its course. The growth potential outside the U.S. is even more pronounced. Facebook's average quarterly revenue per user is close to \$54 in North America, but only \$17 in Europe, \$4 in Asia and less than \$3 in the rest of the world. North America today makes up approximately 9% of Facebook's users, but represents 49% of revenues. That gap should narrow as the company steadily increases revenues per user outside the U.S. and Canada.

The big worry is that Facebook is a target of regulators around the world who dislike its monopoly-like characteristics, its privacy policies, and its control (or not) over controversial content. We don't profess to be experts on regulatory matters, but we do believe the company has shown the willingness and the ability to respond when challenged, and that it will continue to do so in a way that doesn't fundamentally change the execution or profitability of its business model. Even with all the public discussion around privacy and content, there's been little noticeable impact on user or advertiser engagement. There will continue to be controversy, we just believe the business is so solid that it can sustain some troubles here and there.

How are you looking at valuation with the shares now trading at around \$258.30?

FR: The stock trades at 21.5x the \$11 per share we believe the company can earn in 2021, adjusted for \$21 per share in cash on the balance sheet. We think that multiple is quite reasonable given the quality of the earnings – everything that should be expensed is expensed – and the growth potential we see in revenue and profits.

Operating income hasn't always grown as fast as revenues in recent years as the company has invested in people and processes necessary to meet the increasing demands of users, advertisers and, in some cases, regulators and politicians. We believe that this year operating margins will start to stabilize and that revenue and profit growth will be more in sync. So

as the number of users increases, as the switch from traditional media spending to online continues, and as revenues per user increase worldwide, we believe that can translate into 15-20% annual revenue and earnings growth over the next five years.

We estimate EPS could reach close to \$20 in 2025. With a 25x P/E multiple, that would result in a share price of around \$500. It's really a fairly simple premise: this is one of the strongest businesses in the world, with a clean balance sheet, con-

ON REGULATORY ISSUES:

We believe the company will respond in a way that doesn't fundamentally change its execution or profitability.

servative accounting, a large moat and an only average multiple that in our opinion undervalues its prospects.

Describe your investment case for car-insurer Progressive [PGR].

FR: I first started to research the company in 1994 when I read a recommendation for it in the newspaper by legendary investor Philip Carret, who was 97 years old at the time but still looking for interesting companies to purchase for the long haul. I followed it for five years before getting the chance to buy in after the stock fell by 60-70% when the market got concerned, in part, about its heavy investment to transition its direct-to-consumer business to what was then a nascent Internet. We did well with it over the next several years and sold at a point when we believed the growth rate was slowing enough to be a concern.

We always kept an eye on the company, and got interested enough to buy it again in 2019 as we saw earnings starting to grow more meaningfully. Tricia Griffith took over as CEO in 2016 and has done a great job of reinvigorating growth by investing in technology, which allows

Progressive to set premium rates more efficiently, and adding a home insurance line that could be effectively bundled with car policies to drive incremental sales.

Progressive's main competitive advantages are its technology leadership and its ingrained culture of keeping costs low. They've been selling online longer than anyone and were also early adopters of telematics, which involves installing a device on a customer's car – with permission, of course – to track how he or she drives so premiums can be priced more accurately. The company consistently earns better-than-average combined ratios – 92-93% over the last few years, vs. closer to 100% for the industry – and returns on equity have been running better than 20%. Berkshire Hathaway's Geico and Progressive have consistently taken market share and are now the #2 and #3 car insurers in the U.S. We think both are likely to continue to take share.

Are you expecting any longer-term impacts on the company's business from the pandemic?

FR: One positive for car insurers would be if people as things return more to normal drive their own cars more rather than take Uber or public transportation. One negative would be if more people working from home results in fewer miles driven and puts pressure on premium levels. I would say in general we don't believe the long-term pandemic impacts will be that high, either because behavior doesn't ultimately change that much or because positives more or less offset negatives.

As for other secular trends, we don't see an issue for Progressive from electric cars. People will still be driving them and still need insurance to do so. The bigger worry would be if self-driving cars were to become pervasive and that resulted in a significant decline in the number of cars bought and in the incidence of accidents. I don't know when or if that happens on a large scale, but I am pretty confident that it happening at a level that would materially impact Progressive is likely many, many years away.

How inexpensive do you consider the company's shares at the current price of around \$87.20?

FR: Earnings in 2020 were out of the ordinary due to the pandemic, but from 2019's base we think EPS can increase by roughly 12% per year over the next five years to about \$10.75 in 2025. We expect that to be driven primarily by continued share gains, premium increases and reaching new customers who want to bundle their car and home insurance. The stock has historically traded at a 12-18x P/E,

and if we assume 16x – which is slightly above the forward multiple on consensus earnings today – the shares would trade at \$172.

This is a good example of what we're finding attractive in the current market. The growth maybe isn't as exciting as you can find elsewhere, but this is a much better than average company that we think can increase its intrinsic value by 12% per year – and we're getting that at a discounted multiple relative to the market. That's a dynamic that has historically worked quite well for us.

Sticking to insurance, why are you high on the prospects for Markel [MKL]?

FR: This is another company I've followed for more than 20 years and we've owned it for nearly eight. We know [Co-CEO] Tom Gayner and his team well and consider them excellent stewards of capital.

The company operates in a number of specialty insurance lines – like insuring summer camps or dental practices – that are less commoditized. It's proven strong over time at underwriting, with combined ratios frequently at or below 100. Like Berkshire, they invest the float more heavily in equities and have also built a Markel Ventures unit with independent operating companies outside of the insurance sector. Book value over a long period of time has increased at an 11-12% annual rate.

On top of that solid foundation, we believe the insurance pricing cycle has the potential to improve over the next few years as low interest rates and the relatively soft market in recent years has put increasing pressure on insurers to put through more substantive price increases and improve profitability. We never count on getting the timing of something like that right, but the messages we're getting from a number of our industry contacts are consistently more optimistic than usual about the pricing environment. Markel can do well either way, but a harder pricing cycle would be an added bonus.

The shares, now around \$970, are still well off their 52-week highs. What upside do you see from here?

FR: We're basically assuming that all the elements are in place for the company to continue to increase its book value at 11-12% annually going forward. It will continue to generate underwriting profits, to invest the float competently, and to reinvest capital in both insurance-related and Markel Ventures acquisitions. If we're right in that basic assessment, it would mean that book value could reach \$1,400 per share in 2025. At the stock's average multiple over the past ten years of around

INVESTMENT SNAPSHOT

Progressive
(NYSE: PGR)

Business: The third-largest automobile insurer in the U.S., selling both directly and through traditional agency channels; diversified into home insurance through acquisition in 2015.

Share Information (@1/29/21):

Price	87.19
52-Week Range	62.18 – 102.05
Dividend Yield	0.5%
Market Cap	\$51.02 billion

Financials (TTM):

Revenue	\$42.64 billion
Operating Profit Margin	17.3%
Net Profit Margin	13.4%

Valuation Metrics
(@1/29/21):

	PGR	S&P 500
P/E (TTM)	9.0	40.9
Forward P/E (Est.)	15.0	22.1

Largest Institutional Owners
(@9/30/20 or latest filing):

Company	% Owned
Vanguard Group	7.8%
Wellington Mgmt	6.6%
BlackRock	5.1%
State Street	4.3%
JPMorgan Inv Mgmt	2.5%

Short Interest (as of 1/15/21):

Shares Short/Float	0.9%
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PGR PRICE HISTORY

THE BOTTOM LINE

The company's technology leadership, marketing prowess and ingrained culture of keeping costs low should allow it to continue to take car-insurance market share in the U.S., says François Rochon. He expects earnings to grow at 12% annually over the next five years, and at a 16x P/E on his 2025 estimate the shares would trade at more than \$170.

Sources: Company reports, other publicly available information

INVESTMENT SNAPSHOT

Market
(NYSE: MKL)

Business: Specialty insurer known for its Berkshire Hathaway-like reinvestment strategy focused on public equities and, increasingly, independent operating companies.

Share Information (@1/29/21):

Price	969.48
52-Week Range	710.52 – 1,347.64
Dividend Yield	0.0%
Market Cap	\$13.36 billion

Financials (TTM):

Revenue	\$8.96 billion
Operating Profit Margin	9.8%
Net Profit Margin	5.4%

Valuation Metrics

(@1/29/21):

	MKL	S&P 500
P/E (TTM)	29.9	40.9
Forward P/E (Est.)	21.6	22.1

Largest Institutional Owners

(@9/30/20 or latest filing):

Company	% Owned
Vanguard Group	8.3%
BlackRock	4.9%
Principal Global Inv	4.8%
Wellington Mgmt	3.6%
Akre Capital	3.4%

Short Interest (as of 1/15/21):

Shares Short/Float	0.6%
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MKL PRICE HISTORY



THE BOTTOM LINE

François Rochon believes there's been a significant and unwarranted divergence over the past year in what's happened to the company and what's happened to its stock price. If it continues to increase book value by 11-12% annually and if its shares trade at their 10-year-average price/book ratio, he expects the stock price to reach \$2,100 by 2025.

Sources: Company reports, other publicly available information

1.5x book, it would result in a \$2,100 share price.

Over the past year there's actually been a pretty significant divergence in what's happened to the company and what's happened to the stock. We believe book value will probably have increased 6-7% in 2020, but the stock was down 15%. That's the opposite of what you see in a great number of cases today.

In an effort to learn from mistakes, you often examine what you consider your errors of omission. Can you share a recent example?

FR: One stock we almost bought at the same time we were studying Five Below was Floor & Decor [FND], a manufacturer and retailer of mostly tile residential and commercial flooring. We'd been a long-time shareholder of Mohawk Industries and had noticed how luxury vinyl tile has changed the flooring industry and Floor & Decor has been an important player in that change. It has an excellent business model and a strong track record of growth. The P/E on its stock had generally reflected that growth, so was too expensive for us. But when the pandemic hit the shares fell below \$30, against the

\$1.50 or so in EPS we thought the company could earn in 2021.

I don't remember the exact day, but probably on a Friday in early April we decided to buy Floor & Decor shares on Monday. The stock went up \$3-4 on Monday, so we decided to hold off and wait for it to come back down. We had done the homework and thought we knew the company very well. Given the upside we saw in the stock that \$3-4 really didn't matter, but we couldn't pull the trigger. It's a natural thing for value investors to do and I've made similar mistakes many times, but we can be a bit wiser than that. It's rare to have confidence a company can grow its earnings at a 15-20% annual rate – if the price is still reasonable you shouldn't try to put too fine a point on it. [Note: Having fallen as low as \$24 in March, FND shares currently trade at \$92.]

What would you say is your biggest worry as an investor today?

FR: I mentioned that I avoid trying to predict the future when it comes to anything macroeconomic, but I do think any investor today should at least be thinking about what would happen to their portfolio holdings if interest rates went up. One of the only ways to justify some of the 40, 50 and 60x P/Es we see these days is if you assume interest rates will stay as low as they are for many, many years. In many instances, that results in what are in my opinion quite slim margins of safety.

I also ask what would happen to a lot of balance sheets and to profitability if interest rates rose even close to where they've been historically? What happens to valuations? I'm not forecasting higher interest rates, but I want to acknowledge the risks such an increase might create. We like owning companies like JPMorgan [JPM], Bank of America [BAC] and Charles Schwab [SCHW] that would likely benefit from higher rates. We like owning Berkshire Hathaway and other insurance companies that also would likely benefit from higher rates. We want to avoid companies with too much debt – that's always the case, but more so today than ever. VII

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Notes on Rochon Global portfolio's returns

The Rochon Global portfolio is a private group of personal and family accounts managed by François Rochon, the president of Giverny Capital Inc. ("GCI"). The Rochon Global portfolio has existed since 1993, that is seven years before the registration of GCI as portfolio manager with the AMF, the securities regulator in the province of Quebec. The Rochon Global portfolio returns indicated in the presentation include trading commissions and dividends (including possible foreign withholding taxes).

Net returns are estimated since no management fees are charged to the accounts forming the Rochon Global portfolio. These returns are based on an annual management fees of approximately 1% of the value of assets under management (calculations based on fees of 0.25% of market value of assets under management at the end of each quarter). Certain client accounts may have a different fees structure depending on their specific circumstances. GCI does not charge performance-based fees. All returns are calculated on a time weighted basis. Past results do not guarantee future results.

Although the Rochon Global portfolio serves as a model for GCI's clients, clients' individual portfolio returns may differ from the returns achieved by the Rochon Global portfolio due to moderate differences in weightings of individual securities, the timing of individual transactions, the influence of additions and withdrawals and restrictions that clients may have placed on individual accounts. The Rochon Global portfolio's returns are generated in a different environment than GCI's clients and this environment is considered controlled. Thus, the portfolio returns of the Rochon Global are often higher than the returns realized by clients of GCI. For the same reasons, and the fact that some clients may have different fees structure depending on their specific circumstances, clients' individual portfolio returns may vary from one to another.

GCI invests in securities denominated in US dollars and other currencies (Canadian and other). For the purpose of calculating returns for the Rochon Global portfolio, GCI uses the exchange rates from the central banks of the currencies' source country (ex.: Bank of Canada). Fluctuation in the exchange rate between the currency in which the security is held and the currency in which the returns are presented may have an impact on the portfolio performance presented. For instance, an increase in the value of the U.S. dollar will generally result in a decrease in the value of a security denominated in foreign currency (Canadian and other).

Note on the market indices used as benchmark

Information regarding market indices shown in the presentation, such as that of the S&P 500 (an index of 500 of some of the largest and most liquid publicly traded U.S. stocks) are included solely for purposes of showing the performance of the Rochon Global portfolio against well-known, broadbased equity benchmarks. The use of these indices is intended to show relative market performance for the period indicated and is not for use as a standard of comparison, since the indices are unmanaged, broadly based indices of public equity securities which differ in numerous respects from the Rochon Global portfolio's composition. The Rochon Global portfolio may hold securities not included in the indices. Reference to an index does not imply that the Rochon Global portfolio will achieve returns, volatility or any other result similar to that index. The indices do not incur expenses. The Rochon Global portfolio may present different types and levels of risks than an investment which tracks an index.