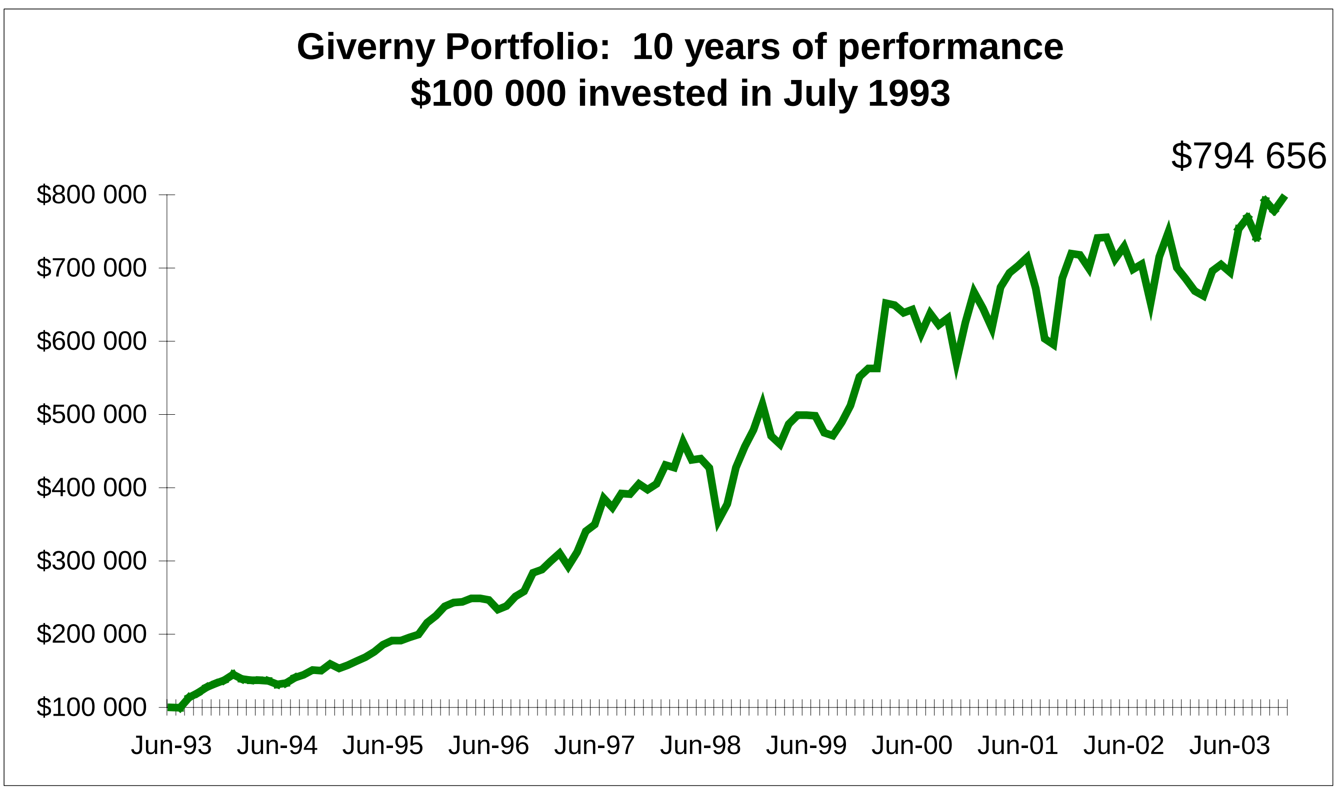
Giverny Capital Inc.

Annual report 2003

10th anniversary



Giverny Capital Inc.
Annual report 2003 ©

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

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

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

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

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

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

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

An educational mistake

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

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

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

Our return over the last 10 years

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

Giverny portfolio (all returns in Canadian dollars) :

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

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

Giverny International (in US dollars) :

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

Giverny RRSP (in Canadian dollars):

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

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

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

The year in review

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

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

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

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

The biggest mistake stock investors regularly make

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

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

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

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

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

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

Trying to predict market quotations – for a stock, a sector or the whole market – is futile. It is astounding to see how many investment “professionals” continue to waste their time and talent on an activity that has so many times proved its uselessness. And what is most surprising is that many investors still continue to read almost religiously market forecasts. In Greek mythology, Cassandra was condemned by Apollo to know the future but to be disbelieved when she foretold it. Hence the agony of foreknowledge combined with the impotence to do anything about it. Wall Street gurus are in the reverse situation: They don't know the future but they are often blindly believed when they foretell it.

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

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

How to react to market volatility

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

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

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

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

Macro-economic comments

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

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

Investment philosophy

It's "Dejà vu" all over gain
- Yogi Berra

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

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

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

Here are the key points:

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

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

So, your role as a partner is far from being negligible. The time I spend on reassuring clients and commenting on stock fluctuations is not devoted to analysis. So we have adopted a clear and specific mode of communication. I write a detailed annual report (and considered my many quite long) and three quarterly reports. If there is truly a bad news on one of our companies, we will inform you (good news takes care of itself). If you genuinely adhere to our philosophy, you can do your share by trying not be affected by the market and by keeping your eyes on the long term.

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

The example of BMTC Group

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

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

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

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

BMTC was such an opportunity.

Five years postmortem: 1998 in review

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

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

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

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

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

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

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

Our purchase of Fastenal was more rewarding. I knew Fastenal for a while when finally the stock traded in October 1998 at very attractive levels. I bought shares. And I became much more acquainted with its CEO Robert Kierlin. In the past, I've said nice words about Mr. Kierlin. They are totally deserved: he is one of the best CEO in the World. In fact, he's a great human being. In the last few years, the recession in the manufacturing sector has slowed Fastenal growth but the company did very well in these tough circumstances. And the stock has increased by 300% in five years.

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

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

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

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

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

Index funds : The flavor of the day in 1998

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

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

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

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

<u>Our companies</u>

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

- Dr. Robert Shillman, CEO of Cognex

Cognex (CGNX.Q)

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

M&T Bank (MTB.N)

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

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

BMTC Group (GBTa.T)

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

Progressive Corp (PGR.N)

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

Fairfax Financials (FFH.N)

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

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

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

Expeditors International of Washington (EXPD.Q)

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

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

<u>Owner's earnings</u>

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

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

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

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

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

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

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

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

Mistake *du jour*

Managers who avoid risk and fear failure spend their entire careers cheating themselves, their people, and their companies.

- Ken Iverson, CEO of Nucor (1965-1995)

This section of the report is a yearly tradition and a favorite of our clients (I wonder why). What is a tradition also – unfortunately – is the huge amount of mistakes I come up with each and every year. Some times, the mistake is recognized rapidly (read: we lose money). In many cases, it takes years to realize how a buying (or a non buying) decision was costly. Time brings something that nothing else in this world can bring: perspective.

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

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

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

Bronze Medal : Stryker (SYK.N)

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

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

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

Silver Medal: Vitesse Semiconductor (VTSS.Q)

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

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

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

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

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

Gold Medal: eBay (EBAY.Q)

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

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

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

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

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

Even more than a Galapagos Islands' giant turtle.

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

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

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I wish you all a great year in 2004.

François Rochon
President and portfolio manager
Giverny Capital Inc.