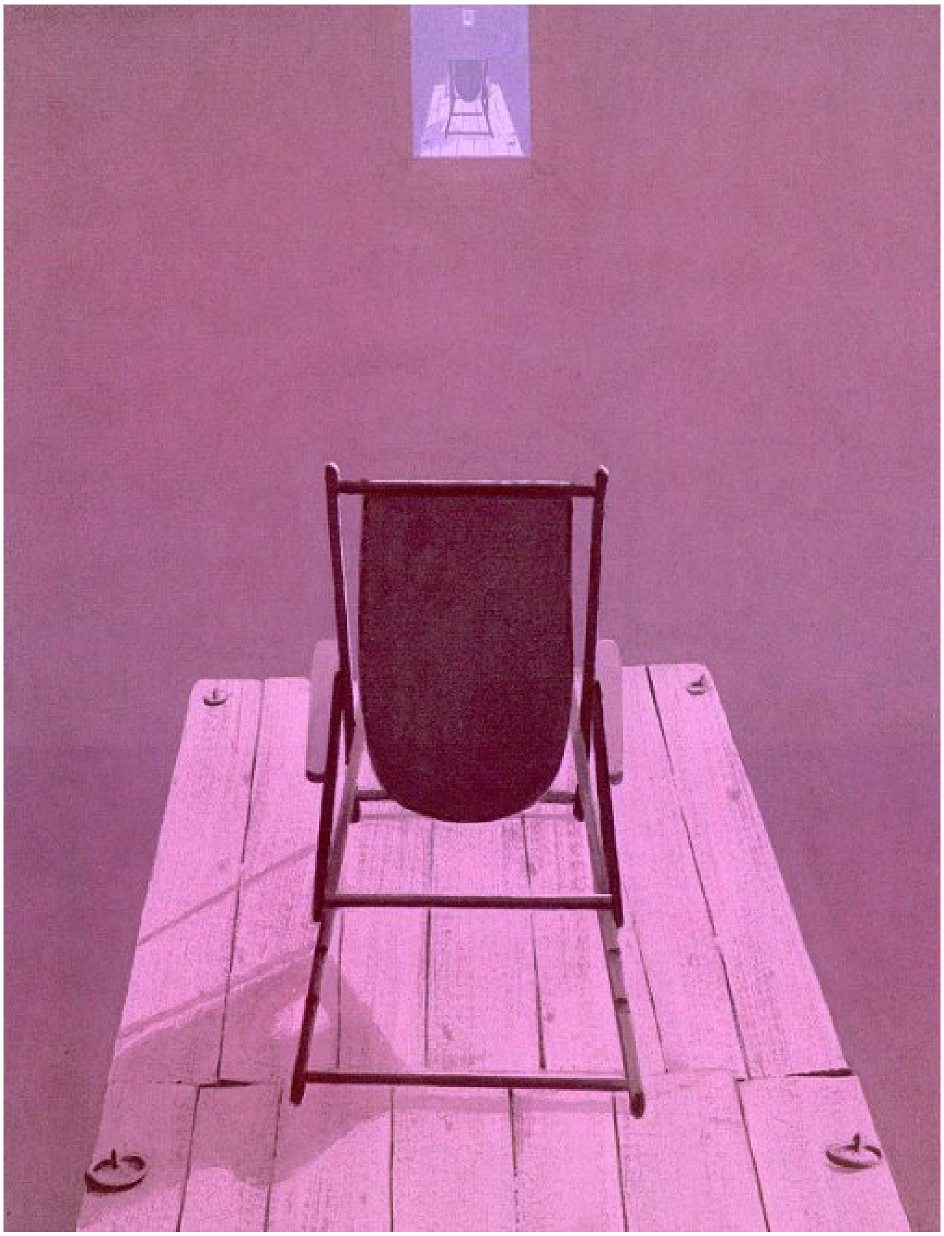
Giverny Capital Inc.

Annual Report 2004



Edmund Alleyn (1931-2004)
Transat pour Giacometti, 1989

Giverny Capital Inc. – Annual report 2004 ©

For the year ending December 31st 2004, the return on our Global Giverny portfolio was 1.6% in Canadian currency. The International portfolio (in US currency) achieved 9.3% for the year. Our weighted benchmark had a return of 6.1% in Canadian currency and the S&P 500 achieved 10.7% (in US dollars). It is important to underline that our US stocks (80% of the Global portfolio) were impacted again by the fall of the US currency, losing 7% to its Canadian counterpart.

Since starting the fund, July 1st 1993, our annual return has been 19.9% compared to 10.4% for our benchmark and 10.4% for the S&P 500 (all in Canadian currency).

It's hard to be happy about our returns in 2004. What's important, though, is that our businesses had a great year, as their combined earnings increased 20% for the year (we'll go through the details in the "owner's earnings" section). As for the Canadian dollar effect, we won't - of course - be influenced by it. Over many years, the effects are almost negligible. Since 1993, the US dollar has lost 6%, the effect being an annual loss of 0.6%.

In fact, our underperformance in 2004 was due mainly to our Canadian stocks. Not to the extent to what we owned but to what *we didn't own*. The year 2004 was very good for the resources stocks, a sector which we avoid. As you know, our philosophy is to own companies that have a competitive advantage. So we tend to avoid enterprises that sell a commodity-like product or service (as Warren Buffett said: no one ever asks, "I want a Coke only if it comes in an Alcoa aluminum can"). We believe that our philosophy is prudent and rational. We also believe that it should yield superior returns over the long run. We will not change it because of one or two years of underperformance.

"It's a special episode of 'Fear Factor'. They're daring the contestants to get back into the stock market!"

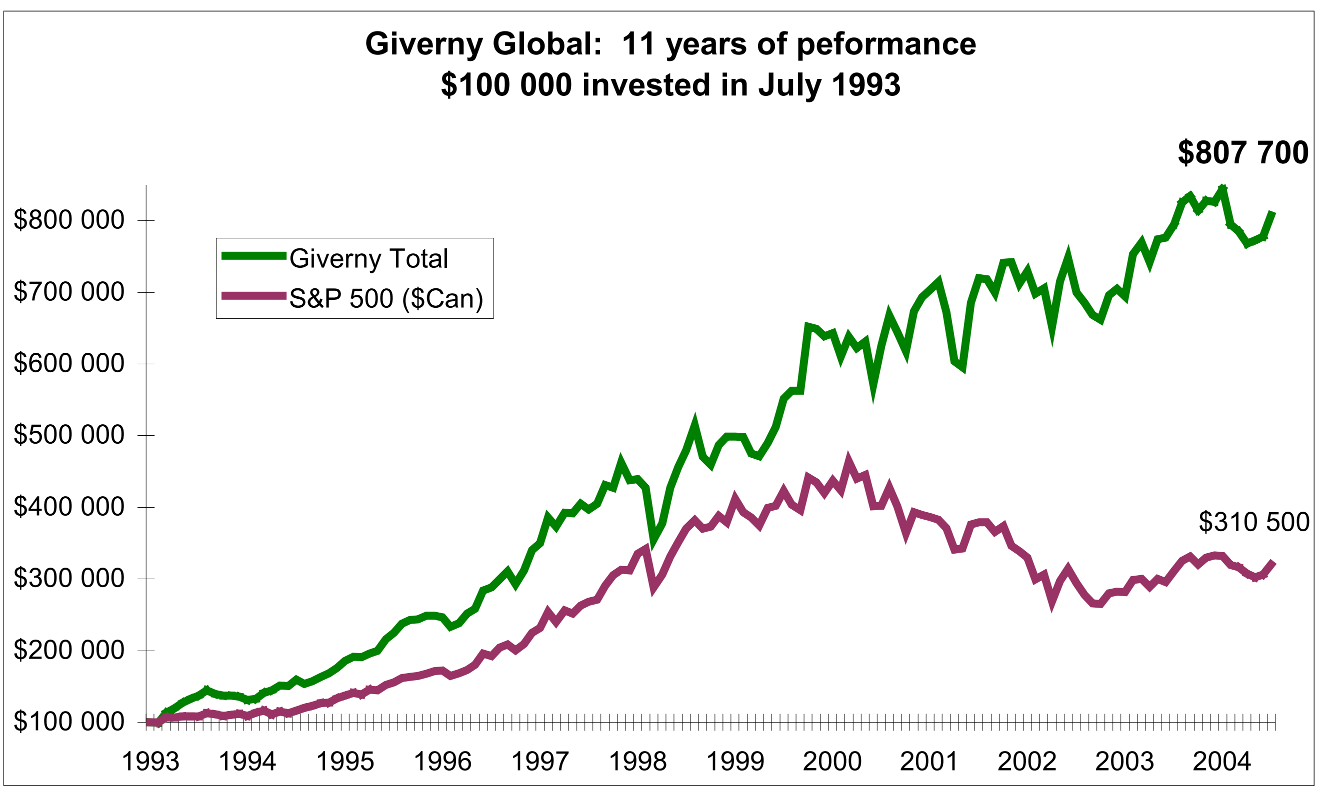
Our returns since 1993

Our portfolio is « real » money. It is a family portfolio (most of the capital being my own). The portfolio is separted in two parts : Around 20% is a RRSP based part (limited to 30% in non-Canadian content) and the other 80% is the International part (invested mostly in US stocks). Our returns have been audited by PriceWaterhouse Coopers.

Giverny portfolio (all in Canadian currency) :

Returns	Giverny	Benchmark *	+ / -	S&P 500	+ / -	$ US / Can
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	8.4%	**28.6%**	3.3%
1994	**16.5%**	3.7%	**12.7%**	7.3%	**9.1%**	6.0%
1995	**41.2%**	24.0%	**17.2%**	32.9%	**8.3%**	-2.7%
1996	**28.0%**	22.8%	**5.2%**	22.7%	**5.4%**	0.3%
1997	**37.8%**	28.5%	**9.2%**	36.7%	**1.1%**	4.3%
1998	**20.6%**	18.8%	**1.8%**	37.7%	**-17.1%**	7.1%
1999	**15.1%**	16.3%	**-1.2%**	14.1%	**1.0%**	-5.7%
2000	**13.4%**	3.2%	**10.2%**	-4.6%	**18.0%**	3.9%
2001	**15.1%**	-0.4%	**15.5%**	-5.7%	**20.8%**	6.2%
2002	**-2.8%**	-18.3%	**15.6%**	-22.0%	**19.2%**	-0.9%
2003	**13.6%**	14.0%	**-0.4%**	5.7%	**7.9%**	-17.8%
2004	**1.6%**	6.1%	**-4.5%**	2.8%	**-1.1%**	-7.3%
Total	**707.7%**	**211.9%**	**495.8%**	**210.5%**	**497.1%**	**-6.3%**
Annualized	**19.9%**	**10.4%**	**9.5%**	**10.4%**	**9.6%**	**-0.6%**

* The benchmark is made out of weighted indexes (S&P/TSX, S&P 500, Russell 2000, etc). in a way to reflect assets allocation



Giverny International portfolio (in US dollars)

Year	Giverny Intl.	S&P 500	+ / -
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	36.6%	18.2%
1996	27.0%	22.3%	4.8%
1997	32.9%	31.0%	1.9%
1998	11.0%	28.5%	-17.5%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-8.2%	19.5%
2001	8.1%	-11.2%	19.3%
2002	-4.4%	-21.4%	16.9%
2003	31.6%	28.6%	3.0%
2004	9.3%	10.7%	-1.4%
Total ($US)	711.3%	230.3%	480.9%
Annualized	20.0%	10.9%	9.0%

Period	Giverny	S&P 500
1 year	9.3%	10.7%
3 years	11.2%	3.8%
5 years	10.6%	-1.8%
10 years	18.7%	12.0%
Since start	20.0%	10.9%

Giverny RRSP porfolio (in Canadian dollars)

Our RRSP portfolio underperformed the S&P/TSX in 2004. But we have to keep in mind that 25-30% of it is invested in US stocks (which were impacted by its currency). Secondly, since we avoid resources stocks (35% of the index) and we do not own, at this time, Canadian banks (25% of the index), our correlation to the TSX is quite low. To this day, our focused approach yielded good results although some years, the discrepancy with the index can be large.

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%
2004	2.9%	14.0%	-11.1%
Total	463.1%	165.8%	297.3%
Annualized	18.9%	10.3%	8.6%

Giverny RRSP porfolio: 10 years of return

This was our 10th year for the Giverny RRSP portfolio. Over 10 years, our return as 18.9%, an annualized added value of 8.6%. Also, we had no negative year (knock on wood)

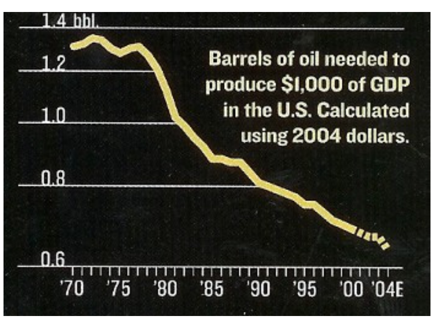
Période	Giverny RRSP	S&P / TSX	+/-
1 year	2.9%	14.0%	-11.1%
3 years	13.1%	8.5%	4.6%
5 years	12.1%	4.1%	8.0%
10 years	18.9%	10.3%	8.6%

Long term objectives

Our results since 1993 have been way better than anticipated and what can be expected in the future. Our ambitious objective is to sustain yearly returns of 5% better than the indexes. If stocks in general return something like 5 to 9% over the next decade – to me, a realistic assessment – we would be quite pleased to return 10 to 14% on our capital. We try to select companies that we believe should permit us to attain such goals, in other words that grow their intrinsic value at twice the average.

Review of the year 2004

In the US, corporate earnings were up on average an impressive 19%. Including the dividend, the S&P 500 returned around 11%. The increase in earnings was clouded by a sharp rise in basic material prices. On the other hand, we have to realize that basic material prices are not as important to the economy as it used to be. For example, recent studies have shown that over the last 34 years, oil needs in the US have gone down 50% : In 1970, the economy needed 1.31 barrel of oil to produce $1000 of GDP (in 2004 dollars). This ratio was down to 0.64 barrel in 2004[1].



Source : Forbes

Low dependency on resources is important to me. I try to choose businesses to which "knowledge" and "brand" are the most important assets (both intangible). Companies like Astral Media, Johnson & Johnson, Cognex or Resmed do not see their costs go up in a significant way when oil or steel rises.

Cyclical stocks

In the long run, investing in cyclical stocks can yield – at best – modest returns. In my early days, I invested in many cyclical companies (that looked "cheap"). I've own, for example, shares of

[1] Source : Forbes Sept 2004. Calculations by Joel Darmstadter and Ian Parry, « Ressources for the Future».

Goodfellow, Héroux, Czar Ressources, Franco-Nevada, Pan-American Silver, Chrysler, Idéal Métal, Amisk, CCL Industries and Slater Industries. I've been there and I did not like the experience.

The most important investment I made in a cyclical stock was Nucor in 1997. Nucor is a steel producer whose costs are way lower than those of its competitors. Under Ken Inverson, the company increased its value by 20% annually for almost 30 years (the stock was up 250 fold). I also admired its successor John Correnti. But when Mr. Correnti left the company in 1999, I decided to sell our shares. But I was an owner for long enough to realize how much the company was struggling with cheap steel imports (from Russia at that time). So even if the company had the lowest cost in its industry, it was not good enough. And such parameters are beyond the control of any company, even the best managed ones. I've come to appreciate businesses where profit margins are not too dependant on external factors. The intelligence without the control to apply it is futile.

Nucor's EPS went nowhere for 10 years: They were $1.57 in 1995 and $0.40 in 2003. In fact, in 2003, the stock was at the same price as in 1993. But, in 2004, EPS exploded to more than $7 a share and the stock more than doubled. But 10 years is quite a long time to reap the reward of an investment. And many industry participants did not survive long enough (at least the stockholder's equity) to get their share of the reward: Bethlehem Steel, Birmingham Steel, Slater and Ivaco had to resort to Chapter 11 at some point in the last decade.

A luxury we can afford

The beauty of the stock market is that it gives us the luxury to avoid sectors and/or businesses that are outside our circle of understanding.

Since the start, I knew there were going to be ups and downs in the economy, corporate profits, interest rates and inflation level. That is why I choose companies that I believe can sail through the occasional storms that hit our "econo-system". We don't try to predict the sequence of those storms but rather select companies that we believe are so strong that we have the luxury to focus on the long term.

And at Giverny Capital, I have given myself means to afford such a luxury. When I worked for others, I had a pressure to beat the S&P 500 every quarter (every months if marketing had its way). Moreover, many clients expect their manager to be invested in every sector (particularly those which are doing well in the market) and that the biggest weights in the index (like GE for example) be an integral part of their portfolios (particularly in times – you've guessed it! – when the stock is going up).

We have no constraints or pressure of that manner. It could not be more simple: I buy for Giverny's partners the same stocks as for my own portfolio. And for me, I have the luxury to buy what I like, when I like and with the time horizon that I believe is sensible. In the end, such a managing style is more than a luxury, it becomes a competitive advantage. It's the equivalent – in baseball terms – of being at bat in front of the stock market pitcher and have no strike being called on us: We can choose the balls we'll swing at! Managers whose returns are scrutinize by clients and their consultants (sometime the brother in law) don't have my luck!

The flavor of the day 2004

It is usually common wisdom to avoid what's popular in the market. So we try to avoid what's the flavor of the day in Wall-Street (or Bay Street in Canada). It's hard not to be skeptical of the huge popularity (particularly in Canada) of the basic materials sectors. Not being objective in this manner (since we do not own any of such securities), I will just share a little paragraph in Business Week magazine's edition of January 31st 2005:

> *In 2003, a seat on the Chicago Board of Trade sold for just $338,000 compared with 2 millions for one on the New York Stock Exchange. But in early January of 2005, a seat on the Chicago futures exchange changed hands for $1.25 million – just off a November high of $1.4 million. Meanwhile, the price of a seat at the NYSE has eroded to a nine-year low of $975,000, thanks in part to uncertainty over plans to automate more trading. It's the first time in roughly 20 years that a CBOT membership is priced higher than that of the NYSE.*

Investment philosophy

Note : this section is a repetition or old annual reports for the sake of the new clients.

The year 2004 was good for Giverny Capital. The number of partners (the term we use for a client at Giverny) has climbed to 525. With all these new comers, it is imperative that we talk again (and again) about our investment philosophy.

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 the key points:

- It is futile to predict when it will be the best time to begin buying (or selling) stocks.
- A stock return will eventually echo the increase in per share intrinsic value of the underlying company (usually linked to the return on equity).
- We choose companies that have (sustainable) high margins and high returns on equity, good long term prospects and that are managed by brilliant and devoted people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be grossly assessed.
- The stock market is dominated by participants that perceive stocks almost as casino chips. With that knowledge, we can then buy great businesses sometimes well bellow their intrinsic value.
- There can be quite some time before the market recognizes the true value of our companies. But if we're right on the business, we will eventually be right on the stock.

This discrepancy between the market quotes of a business and its underlying intrinsic value and the high volatility of the securities market are perceived by many participants as disadvantages. It's the other way around: market imbalances and fluctuations are our *allied* in our noble quest for wealth. In fact, the more irrational the stock market, the higher our chances are to attain our financial objectives.

But there is one important point: Owning a few undervalued securities (around 20) over many years doesn't yield linear returns. To stare at a freshly planted tree does not make it grow faster. Our approach is to judge the quality of an investment over a five years period. I truly believe that at least such a similar horizon is necessary to judge a money manager.

So patience – ours AND those of the partners – becomes the key ingredient for success. Real patience is neither easy nor that common. That is why many investors pray in those words: “Dear God, could you gratify me with patience? And if it is at all possible, RIGHT NOW”

The Rule of Three

In conjunction with our investment philosophy, I’ve added a market rule that I called : The Rule of Three. This rule comes from historical observations: it is not a scientific process that has come to its enunciation but an empirical one.

- One year out of three, the stock market will go down at least 10%.
- One stock out of three that we buy will be a disappointment.
- At least one year out of three, we will underperform the index.

What are the consequences of these rules? First, it is quite obvious that in the next 10 years, the market will go down 10% at least three times. It is important to be mentally ready for such corrections (those who panic can’t be helped by even the best money manager). Secondly, out of 20 stocks or so that we buy, around 7 of them will yield deceiving results. So we should not judge the result of one investment but the whole portfolio. Thirdly, over a 10 years period, it would be a normal occurrence that our performance be lower than the index around three times.

The judgment that you – as partners – pose on my work should be in line with these parameters.

Creativity according to Erich Fromm

Beyond a sound investment philosophy, there is one element necessary to any art: creativity.

It is true that principles by definition do not change…because they’re would not be principles! Paradoxically, a philosophy that seeks to echo human thinking must be in constant evolution. If not, it will rapidly not be able to depict adequately the world it wishes to reflect. In that sense, creativity, the capacity to build something “new” from the established, becomes the catalyst in any evolution process.

And some conditions are necessary for creativity to blossom. The great German philosopher Erich Fromm stated that theses conditions are at the opposite of what we instinctively cherish. By our nature, we hate insecurity and cherish what is familiar. The genuine creativity needs the courage to let go of some certainties to attain a constant state of mind opening.

Experience teaches us that investment success goes way beyond finance and numbers (otherwise all CFAs would be multimillionaires). It blossoms out of rationality and judgment but also in combination with the capacity of thinking independently, which needs more often than not creativity. And this, in light of the fundamental needs of security entrenched in those who have cumulated capital over the years. I know what I’m talking about!

Post Mortem 1999

For a third year in a row, we do a postmortem on my decisions (and writing) of five years ago. Since, five years is our general time horizon., it is fitting to do such yearly reviews.

The year 1999 is now known as the culminating moment of the high tech bubble (in fact the peak was reached in March of 2000). In my 1999 annual report, I had highlighted the fact that I believed that many investors not familiar with some notions of economic valuations were numerous in the stock market. And that I did not intended to participate in their "funfair". Unfortunately, the fair ended badly for many of them. And my decisions to sell most of our shares of Cisco Systems, JDS-Uniphase and Intel in 1999-2000 were appropriate.

Purchases : the class of 1999

In 1999, I wrote about three important purchases: Masco, Promatek and Progressive Corp. After our purchase, Masco acquired a few companies (mostly with debt) and it seemed to me that their growth plan was too aggressive. I've learned over the years that companies that seek a high growth rate – although a noble cause – are entitled to making huge mistakes. I believed that Masco was taking on too much debt and I decided to sell (at a small loss).

I sold Promatek – with a small gain – in 2000. You can read about this sale in the annual report of that year. I wrote then that I believed that the company had modest growth prospects and even though the stock was quite undervalued, our capital would be more wisely invested in other securities. In the end, shareholders were well enriched (with capital gains and huge dividends). It validated at least my belief that the stock was cheap. But, I must add that the stock is very illiquid and it would be have been impossible to buy this stock for more that 40 or 50 clients.

Progressive

My purchase of Progressive Corp of Ohio was a homerun! The story of this purchase is interesting, even instructive. We have to go back to 1993. When I read all I could find on the life and career of Warren Buffett, I've learned all about the history of GEICO, a car insurance company which was a major investment for Mr. Buffett.

In 1993, the *Wall Street Journal* published an interview with Philip Carret, a famous money manager who had a tremendous 65 years track record of returning 14% to its investors. Warren Buffett said of him that he was the "Lou Gehrig of investment"[2].

In the interview, Mr. Carret recommends a few stocks including Progressive which he labeled the "next GEICO". I immediately wrote to the company to get its annual reports. And in the six years subsequent, I followed the company closely and watch it climb in the market by 400%. I was biting my fingers so much that my friends taught that my girlfriend was cannibal.

In 1999, I finally got my chance: the stock went down 67% from a high of $58 to $25. Progressive was getting aggressively on the Internet as it decided to become the leader. At the same time, there was some underwriting margin pressure in the industry. So for a few quarters, EPS were down. I believed that these were temporary problems and decided to acquire shares. My purchase was not instantly rewarding as the stock went down to $16 just a few weeks afterward (a drop of 35%).

[2] Lou Gehrig was a baseball player who from 1925 to 1938 played in 2130 consecutive games. His record, for a long time believed to be unbreakable, was surpassed by Cal Ripken Jr. in 1995.

But five years latter, all that is forgotten. The combined ratio of Progressive has never been better and the company earned $7.40 per share in 2004, an incredible performance. It is now a clear leader in the car insurance sell through the Internet. And the stock has reached more than $85.

There are two important conclusions. First, the fact that PGR went down 35% just after I bought it ("the Rochon effect") shows us – once more – that the stock market can be irrational in the short term. And this fall was happening during a huge bull market as many young companies with no revenues were reaching many billions in market cap.

The other conclusion is equally important. We did not make money out of Masco and Promatek but the gains realized with Progressive more than compensated this. Judging a portfolio in its whole and over many years is wise. In fact, the combination of two mistakes and one success can be enough to earn decent returns (as this illustrates). In this line of thinking, selling quickly our losers and holding on to our winners is a constructive way to manage portfolios. Doing the other way around is the equivalent – to use Peter Lynch's words – of removing the flowers and watering the weeds.

Philip Fisher (1907-2004)

The legendary investor Philip Fisher passed away in 2004. I had the chance to talk to him two times on the telephone and to meet him briefly in San Francisco, many years ago. Over our conversations, I asked him many questions and at some point, he summarized his approach in these words : "*You know, Wall Street focuses on lots of unimportant things. But the quality of the management makes up 90 to 120% of the success of a business. Investors think with a such a short term horizon but in the end, management is the key factor*". I never forgot this advice.

I've read all of Mr. Fisher's books. There is a chapter in "Path to wealth through common stocks" that I want to recommend because few investors have heard about it ("How the greatest rise in stock prices comes about"). This book – I believed – has never been republished since its first edition in 1960; it is almost a historical treasure. And you would not believe how long I searched for it. Even Mr. Fisher could not help me find a copy.

Finally, I did find it at the central library in New York city. I could not take the book out but I did make photocopies (it's hard to invest $20 more wisely). The other three books of Mr. Fisher have been republished in a single book lately but "Path" is still a hidden gem.

I owe a lot to Mr. Fisher. He wrote books out of pure altruism (he was already wealthy at that time) to simply share his experience with us. I thanked him then and I thank him again. Giverny Capital owes a part of its existence to him.

A new purchase : Knight Transportation

In 1994, I bought shares of a small trucking company in St-Hyacinthe (Quebec) called Groupe Goyette (one of the first company I visited). Since then, I've been following the trucking industry closely. In the last two years, I purchase shares of Knight Transport, a Phoenix (AZ) company.

I discovered Knight in 1998 when I studied competitors of Heartland Express (which I owned at that time). Like Heartland, Knight is a small company that does well in this hyper competitive industry characterized by low margins and modest ROEs.

Let's first look at the numbers of a few players :

Companies	Margins	ROE *	EPS CAGR **
Arkansas Best	3%	11%	7%
CNF Inc.	2%	8%	8%
Heartland Express (HTLD)	13%	16%	15%
J.B. Hunt	4%	9%	9%
Knight Transportation (KNX)	11%	16%	26%
Ryder	3%	10%	3%
Swift Transport	3%	9%	16%
USF	2%	6%	1%
Werner Enterprises	5%	10%	8%
Yellow Roadway	2%	12%	12%
Average (without HTLD and KNX)	**3%**	**9%**	**8%**

* Return on equity

** Annual growth in EPS, last 10 years

Clearly, two companies stand out from the group : Heartland Express and Knight Transport. Both have cost structures well bellow the average (their cost ratio being 82% compared with 95% for the industry). But I think that Knight has a little intangible something better than Heartland.

The main difference lies in their business plan for growth. Heartland mostly grows through acquisitions. The negative side of that plan is that candidates are not always available at good prices but also – sometime – "surprises" can lie in the acquired business (and rarely are surprises positive).

Knight grows organically. It opens offices in new areas. Initially based in Phoenix , the company has opened 8 new operational centers in the last 10 years (not counting the new Knight Refrigerated division started this year). I believe this path should lead to a more stable and durable growth. Another important point for us: Knight is managed by four members of the same family (two pairs of brothers, cousins to each other). The four have a similar salary of $265 000 per year and are owners of 9% of the stock. Their interests are in line with ours.

We paid around $17 for our shares or a P/E ratio of around 20 times. It's not cheap but I believe it's warranted. Few companies – all sector included – has such a track record (10 years of 26% CAGR in EPS). And its balance sheet has stayed solid over the years.

<u>Our businesses</u>

Once again, I've made only minor changes in our portfolios this year. Our core holdings are the same as last year. We own shares of some of the best businesses in the World. Our attitude is that of a museum director: We only want to own masterpieces.

M&T Bank

Our Buffalo bank continues to reward its shareholders like a metronome. The acquisition of Allfirst Financial in 2003 has yielded good results. EPS went up 14% in 2004. We have been owners of M&T since 1998. In that timeframe, EPS have doubled from $3.08 to $6.38, a 13% annual growth rate (if we use the same accounting in 1998 than in 2004, mostly expensing stock options, EPS would have grown at around 15% a year). The stock has followed EPS growth increasing from $45 to $107.

As it is so often the case, this investment was also not rewarded instantly. In fact, 18 months after our first purchase, the stock was at $36 (a drop of 20%). At that time, March 2000, only tech stocks were viewed as good long term investments (the "new economy" was the expression used). What an opportunity for true investors that acquire shares of such a great company at a price well bellow intrinsic value. And we bought more with enthusiasm. Can you imagine the consequences if we had let the market quotations undermine our judgment?

Groupe BMTC

2004 was the 10th year we where shareholders of BMTC Group, the leading furniture retailer in Québec. After a year 2003 where margins reached unbelievable level, it was realistic to lower our expectations. Moreover a 3 weeks strike hurt the company this summer as the arrival of a new competitor – The Brick – put some additional margin pressure. But even those events did not alter BMTC's strong business model (to this day at least). ESP were up 30% (5% if we take into account special charges in 2003) and prospects for 2005 are very positive.

BMTC is a much stronger company than The Brick. Its revenues per store are three times higher, their stock rotation is 12 times compared with 7 times for Brick and – most important of all – the ROE at BMTC is way higher than 20% compared with less than 10% for The Brick.

Cognex

Cognex had a very good year 2004 although the first 3 quarters were better than the last. I've been owning Cognex since 1996. I have to admit it's been a so-so investment. Our first purchase was made at $15. Since the stock trades at $27, we earned around 8% per year on this purchase, a similar return than the S&P 500 for the period.

We have to accept that Cognex revenues can be cyclical. On the other hand, the company has virtually a monopole in its industry (and in good years, earns 30% on sales). And Cognex has an outstanding balance sheet: It has $8 in cash, the sum of all its earnings since its foundation. I believe that Cognex has transformed itself in the last years and should be less sensitive to the semi-conductor industry in the future. And – as you know by now – I truly admire Bob Shillman, its CEO. So I do think that our patience will be rewarded in the next years.

Walgreens

It was another great year for our favorite drug store chains : EPS were up 19% and same store growth was around 9%. In fact, it was the 17th consecutive year of 10% or more EPS improvement. The company is the biggest player in its industry and has the best balance sheet. With only 12% of the prescriptions market, the growth potential still remains high.

Expeditors International of Washington

Our logistic Seattle company had a very good year : EPS were up 26%. The sharp rise in energy costs had a slight negative impact but overall, it was a banner year. This investment has proved very rewarding so far: the stock has doubled in less than 3 years. The P/E ratio is not low (around 30 times

2005 estimates). Using the word "overvaluation" would be simplistic but the margin of safety is not as high as I would hope for. But CEOs like Peter Rose are scarce. We are happy to be partner with him.

W.P. Stewart & Co.

Two years ago, I began acquiring shares of a money managing firm: W.P. Stewart (WPS). I've met with Mr. Stewart and I've known about his investment philosophy for many years. It is similar to ours. He had the courage and foresight to start his firm at the bottom of the 1973-74 bear market and has maintained great returns since then (for the 1993-2004 period, their results are not as good as ours, I must add!). In 2002, the stock was trading at $18. With a dividend of $1.20, the stock's yield was 6% which was quite attractive. I know most of the stock that make up their portfolios and I believe that in the next years, they should earn decent returns, probably better than the S&P 500.

In 2004, the company beat the market by a wide margin. Most important, over 5 years, it has overperformed the S&P 500 by 2% annually. This is impressive in the light that the company manages $9 billions in assets and does not have the flexibility of a smaller firm. EPS were up 41% in 2004 and the stock has done well, climbing to $24. The year 2005 looks promising.

<u>Owner's earnings</u>

At Giverny Capital, we do not judge the quality of an investment by its short term market performance. It our minds, we OWN the companies in which we acquire shares. So we focus on the growth in intrinsic value (mostly EPS growth) of our businesses and on their long term prospects. In 2004, our stocks were up 8% (in constant currencies). But the growth in our intrinsic earnings was 20%. These are satisfy results and they are similar to those of the S&P 500 in 2004.

Last year, I presented to you a table I consider almost as important as the ones of the yearly returns: the yearly growth in our owner's earnings. We compare those with the market performance of our portfolio and with the same numbers for the S&P 500.

	Giverny			S&P 500		
Year	**Growth ***	**Market ****	**Difference**	**Growth ***	**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%
2004	20%	8%	-12%	19%	11%	-8%
Total	224%	274%	50%	74%	123%	49%
Annualized	14%	16%	2%	6%	9%	3%

* Earnings growth (note : it is an approximation)
** Merket performance, dividend included (without currency effects)

The annual 2-3% difference between market performance and earnings growth is mostly due to dividends (the average P/E in 2004 is slightly higher than in 1996). As you may notice, we've done better than the S&P 500 for one reason only: our businesses intrinsically did better. In fact, since 1996, our companies have grown their earnings at a rate of 8% better than the S&P 500. Our portfolio overperformed the index by a similar rate.

We aim at finding companies that grow their underlying value at around 12-14% per year, twice the market average. So far, we have been able to find such enterprises and usually at prices we felt comfortable with. Over many years, market performance will walk hands in hands with earnings growth. So focusing on our owner's earnings should lead to satisfying results. But in the short run, there can be wide gaps between market performance and EPS growth. You can see that in the 1996-2004 period, our portfolio underperformed the underlying businesses four years (1999, 2000, 2002 and 2004). We have to be able to be patient sometimes to reap the reward of good business selection.

Mistakes *du jour*

"*Experience is simply the name we give our mistakes*" - Oscar Wilde

Once again, candidates were numerous for our three mistake medals for the year.

Let's start with an honorable mention: Krispy Kreme. I took a starting position (around 1%) in this company in the spring of this year. Their donuts are divine but the stock was nothing like it in the year just passed. The company encountered serious problems and we decided to sell our shares at a 70% loss. My mistake was – with some hindsights – that I did not realize that their business model was so dependant on new stores openings. Peter Lynch once said "More companies die of indigestion than starvation". This was the case here (without any play on words intended).

You could conclude that an investment that turned out to be a 70% loss should at least qualify for a medal. Not necessarily: Losing 70% on a 1.5% investment represent a 1% loss of capital. I've done much worst in "omission" mistakes. For example, *not* investing our typical 4% weight of our portfolio in a stock that latter has increased by 200% has a cost to us of 8%. You don't see it in our reports but such opportunity costs are real.

For our first two medals, here are two great examples of such mistakes:

Bronze Medal : NVR Inc.

In 2000-01, I got interested in a home construction company based in Virginia: NVR. The company earns incredible returns on capital (in the 80%) and has increased their EPS from $1 in 1995 to $63 in 2004 (a 5000% increase in 9 years). Half of that growth was fueled by a major stock buyback plan (I usually prefer such a plan to an "acquisition" plan).

I thought about acquiring shares of NVR when the stock was $150, four years ago. Its P/E was 7 times. I had two main worries: a high level of stock options (which costs were inflated by the huge reduction in shares outstanding) and the cyclical nature of the construction market.

It was a mistake because I should have use more judgment. First, because even with the expense of stock options included, the valuation was still compelling. And when I find an outstanding business, well managed and with good long term prospects (even with some ups and downs), I should purchase it without worrying about short term events.

Since 2001, the results have continued to be outstanding and the stock is now $770.

Silver Medal: Pixar

In 1995, a new company, specializing in 3D animation movies, came public : Pixar. The new issue was in big demand (thanks to the huge success of “Toy Story”) and climbed to $40 the first few days of trading. This was more than 75 times estimated earnings for 1996 (which turned out to be $0.56), a level that had a very thin margin of safety.

In spite of this, I continued to follow the company closely. In 1996, we owned shares of Disney and I knew their history very well. So I did realize that Disney was losing some of its leadership in the animation industry but also that they had the foresight of making a distribution deal with Pixar. In 1998, “A bug’s life” was another hit. With “Toy Story 2”, this helped Pixar more than double their earnings in 2000 to $1.56 a share. Pixar released a movie every two years and the consequence was that the profits were not linear which clouded the earning power valuation (and so the intrinsic value).

In 2001, Pixar relased the marvelous movie : "Monsters Inc.". When I saw it, I knew instantly that this was the best animated movie of all time and that Pixar was not a fade. So I took a closer look at the stock. It was then trading at $30 (50% lower than its 1998 high). The company had $5 in cash so we were really paying $25 for the movie business which was the equivalent of 16 times 2000 earnings and 15 times those estimated for 2002 (2001 EPS were depressed, remember earnings were not linear!).

But I decided not to invest for two reasons: first because of my fear of profit instability but also because of its dependency on the Disney partnership.

Since then, Pixar has increased the number of movie releases: "Finding Nemo" in 2003, "The Incredibles" in 2004 and "Cars" in 2005. This has helped to stabilize profits. But I also realized that it was not Pixar who was dependant on Disney but the other way around. So in 2006, when Disney’s partnership will end, Pixar will be able to negotiate better profit sharing contracts and revenues per movie will probably be higher in the future. Clearly, I should have been more perspicacious and use better thinking about the long term economics of the business.

This year, "The Incredibles" was another great success (revenues of $340 millions, even more than "Finding Nemo"). The stock climbed almost 200% in the last three years to end the year at $85. I have no excuses: I knew the animation industry’s history in length and I understood Pixar’s strengths.

Gold medal: Yahoo !

The company Yahoo! as a unique privilege in my business career: it has been awarded two golden medals of "mistake *du jour*" in four years.

Let's go back four years in the past. In 2000, I bought shares of Yahoo! at $12.   In the year's annual report, I underlined the fact that I made a huge mistake not to buy it way sooner (and so it got a gold medal mistake). In the quarters that followed, the company had disappointing results. And down the stock went, to a low of $4 in 2002. That price was the total value of their shares in Yahoo! Japan and the cash on hand. All the rest, the market gave it to you for free!   What a bargain!!

But instead of buying aggressively more shares, without being disturbed by the general pessimism toward the Internet industry, I stayed still. I was disappointed by the departure of its CEO and by the 35% drop in revenues for the 2001 fiscal year. At the end of 2002, the stock rebounded to $8 and I decided to sell to buy more shares of Cognex (see the 2002 annual report). Since Cognex has almost doubled in the last two years, it was not a bad purchase. But Yahoo! did way better.

The new management team did a fabulous job. In only two years, revenues have tripled and EPS quadrupled. The stock is now $38, three times my initial purchase price and four times the level I sold it at. The stock trades at a very high P/E, it's true, but only time will time if it's warranted or not. For example, I expected in 2000 that at some point in the future Yahoo! would be able to charge its users fees that would translate their huge customer base in lots of revenues. In 2004, the number of paying users was 7.4 million, 80% more than in 2003 alone.

My mistake, of golden calibre, was simple : I was not patient enough!

That's why I use the expression "long term" so many times in this report!

I wish you all a great year 2005.

François Rochon
CEO and portfolio manager
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