Giverny Capital Inc.

Annual Report 2006

Marc Séguin
Autoportrait en dénie, 2002
Giverny Capital Inc. Collection

For the year ending December 31st 2006, the return of the Giverny Global portfolio was 3.5% in Canadian currency compared with 17.0% for our weighted benchmark. The Giverny US portfolio (in US currency) achieved 3.3% for the year compared with 15.4% for the S&P 500.

Since July 1st 1993, the start of our Global portfolio, our annual return has been 18.0% compared to 10.4% for our benchmark and 10.1% for the S&P 500 (all in Canadian currency).

Our ambitious objective is to maintain an annual return of 5% superior to the indexes over a long term period. We believe that stocks in general (as measured by the S&P 500) will return 7 to 9% per year in the future. In consequence, our long term annualized target should be in the 12-14% area.

We use the term "ambitious" with some insight since we know that less than 1% of managers succeed in achieving such a goal over a 10 years period.

A difficult year

If we are in the right path, the only thing left to do is to keep walking.

- Buddhist Wisdom

We obviously did not achieve our long-term goal in 2006. However, the intrinsic growth per share of our companies was good, an increase of approximately 13% compared to 2005 (14% including the dividends). We will discuss this further in the section "owner's earnings". Thus, contrary to the indexes, our companies' stocks under performed their intrinsic gains. On one hand, our US large-cap stocks group return was similar to the S&P 500. On the other hand, our US small-cap stocks have under-performed the Russell 2000.

Our investment philosophy is to consider ourselves as owners of the companies in which we have bought shares in. (We invite you to re-read the appendix on our investment philosophy at the end of this annual report). The consequence of this philosophy is that we shouldn't be affected by the stock quotes in the short term.

Warren Buffett said these words often: *"The stock market is not there to guide you but to serve you. The key to success is to have a good temperament in regards to its quotations. Sometimes they can be right but often, in the short run, they can be far from the economic reality"*.

Everyone embrace these noble words when the results are good. It is in difficult times – like today – that our commitment to this healthy philosophy is truly tested. It is during such times, that having the right temperament of which so often speaks Warren Buffett is absolutely necessary.

Any wise investor (or at the very least in a quest for wisdom) must at the same time be able to step back and analyze if it is the market that is wrong or if it's him that is blind to reality. One should never underestimate the power of denial. The art work on the cover of our annual report this year, created by the brilliant artist Marc Séguin, is entitled "Self-portrait in denial". In addition to being a masterpiece, it reminds us how important it is to always keep our eyes opened and to not fall into the many holes of denial that the human spirit digs, often unconsciously.

On several occasions this year, we re-examined all the stocks we own with a different perspective. As you know, we do not like to sell. If we look at our most important positions, we have owned them on average four and a half years. Six stocks for more than eight years. On the other hand, it is important to be rational - emotions and stocks don't mix well. We try, at least once a year, to revaluate the quality of all our investments. Because there is a difference between being patient and being stubborn.

Our Yearly Returns since 1993 [1]

Giverny Global Portfolio (in Canadian dollars):

Returns *	Giverny	Benchmark **	+ / -	$ US/Can ***	S&P 500	+ / -
1993 (Q3-Q4)	37.0%	9.5%	27.6%	3.3%	8.4%	28.6%
1994	16.5%	3.7%	12.7%	6.0%	7.3%	9.2%
1995	41.2%	24.0%	17.2%	-2.7%	32.9%	8.3%
1996	28.0%	22.8%	5.2%	0.3%	22.7%	5.3%
1997	37.8%	28.6%	9.2%	4.3%	36.7%	1.0%
1998	20.6%	18.8%	1.8%	7.1%	37.7%	-17.0%
1999	15.1%	16.3%	-1.2%	-5.7%	14.1%	1.0%
2000	13.4%	3.2%	10.2%	3.9%	-4.6%	18.0%
2001	15.1%	-0.4%	15.5%	6.2%	-5.7%	20.8%
2002	-2.8%	-18.3%	15.6%	-0.8%	-22.0%	19.3%
2003	13.6%	14.0%	-0.4%	-17.7%	5.7%	7.9%
2004	1.6%	6.2%	-4.5%	-7.3%	2.8%	-1.1%
2005	11.5%	3.6%	7.9%	-3.2%	1.5%	10.0%
2006	3.5%	17.0%	-13.5%	0.2%	15.7%	-12.1%
Total	831.9%	278.0%	533.9%	-8.8%	264.5%	567.4%
Annualized	18.0%	10.4%	7.6%	-0.7%	10.1%	7.9%

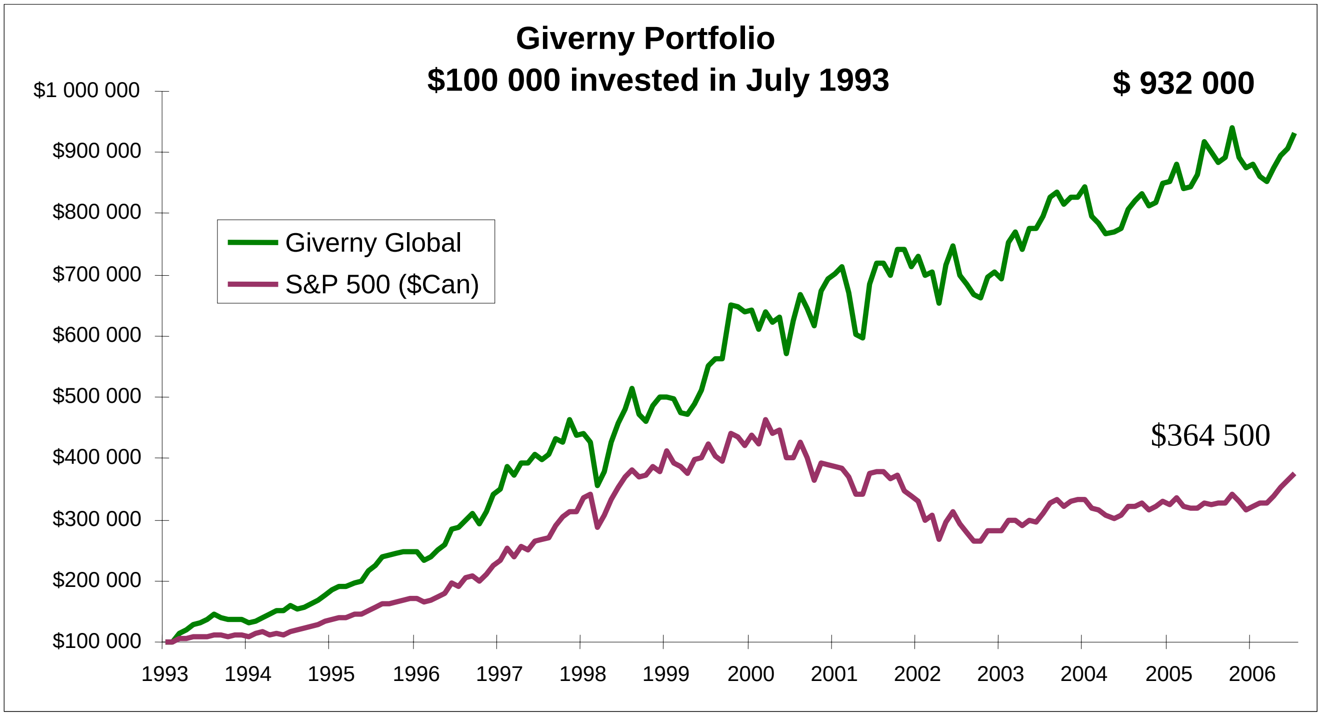
* All return adjusted in Canadian currency
** The Benchmark is a group of indexes (S&P/TSX, S&P 500, Russell 2000, etc.) that reflects the asset mix of the portfolio.
*** Variation of the US currency compared with its Canadian counterpart.

Over the last three years, two years were disappointing. We do not want to blur you with excuses. The losers find excuses, winners find ways! We'd rather go with some explanations:

- First of all, the rise in the Canadian currency erased part of our returns. Since 2003, the return of our stocks was 71% (14% annually) but once brought back in Canadian dollars, it drops to 33% (7% annually). Historically, the effect of the currency fluctuation between the US and the Canadian dollar tends to become insignificant. It is thus necessary to keep things in perspective. Since the beginning of the Giverny Capital portfolio in 1993, the Canadian dollar only reduced our annual returns by 0.7%, nothing really significant.
- Since 2004, our companies' intrinsic value increased by approximately 57% (16% annually) whereas their stocks only climbed 28% (8% annually). These differences are explained by a contraction of their P/E ratios. Our portfolio valuation is at a 10 year low. So we consider several of our stocks undervalued.

[1] All the returns have been audited by the accounting firm PriceWaterhouse Coopers.

- Finally, on a relative basis, the sectors which did best in the last 3 years are those related to the natural resources, industries which we tend to avoid in general.



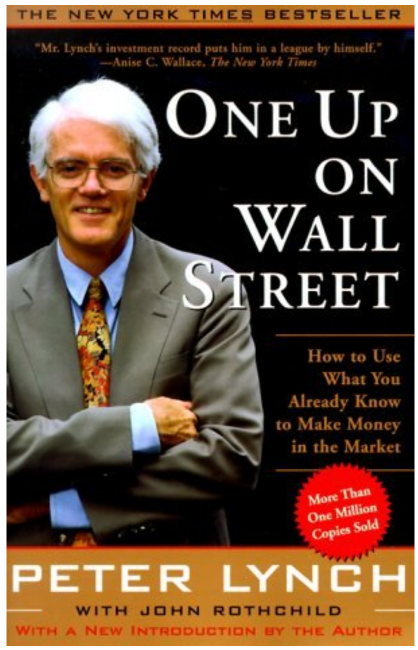
Giverny US Portfolio (in US dollars):

Our US portfolio returned 3.3% in 2006, 12% less than the S&P 500. Since 1993, our US portfolio had a 843% total return or 18.1% on an annualized basis. This compares to 300% and 10.8% for the S&P 500. Our annualized added value was 7.3%. Here are the details since 1993:

Year	Giverny US	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%
2005	12.5%	4.9%	7.6%
2006	3.3%	15.4%	-12.1%
Total	843.3%	299.9%	543.3%
Annualized	18.1%	10.8%	7.3%

A memorable night 15 years ago!

In 1992, I bought the book "One Up one Wall Street" by Peter Lynch. I read it in a few hours and it was an unforgettable night. With "The intelligent investor", by Benjamin Graham, this book is likely one of the best written on investment. I discovered in it a passion for the stock market which has never left me since.



Peter Lynch particularly insisted in this book on the volatile nature of the stock market and that the only way to succeed was to have a long-term horizon. Here are some key points from the book.

- Sometime in the next month, year, or three years, the market will decline sharply.
- Trying to predict the direction of the market over one year, or even two years, is impossible.
- Trying to predict the economy is futile.
- Invest in companies not in the market.
- Forget about market fluctuations in short terms.
- Stock prices often move in opposite directions of the fundamentals but in the long term, the direction of profits per share will prevail.
- Just because the price of a stock goes up doesn't mean you're right.
- Just because the price of a stock goes down doesn't mean you' re wrong.
- There is always something to worry about.

Since reading this book 15 years ago, nothing has changed in the fundamental nature of the stock market (and in the human nature). Also, I quickly understood then that there would be ups and downs in a life dedicated to portfolio management.

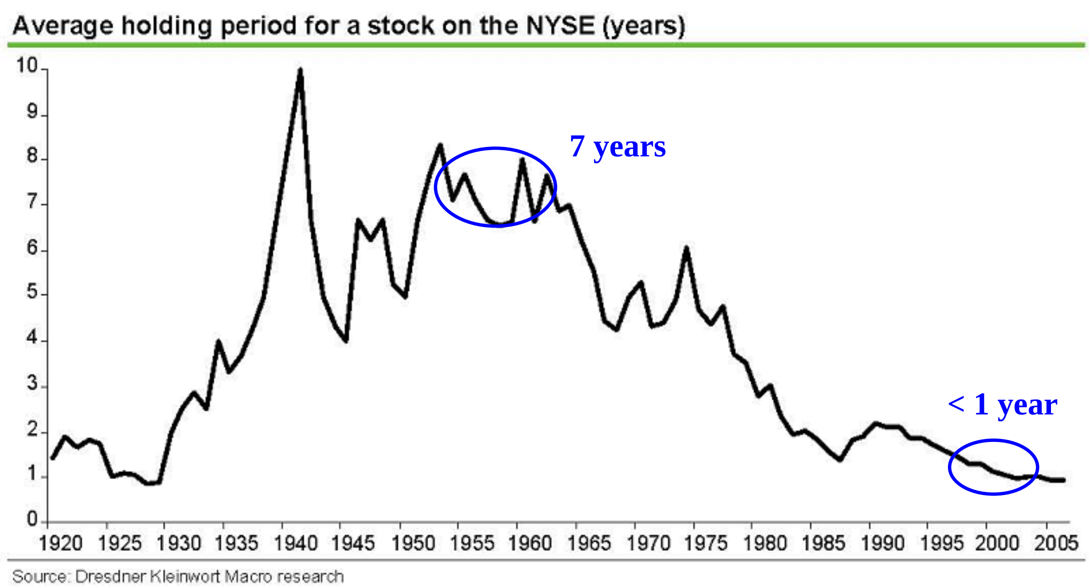
To quote my favourite philosopher Erich Fromm: "The goal in life is not to overcome the inherent insecurity of existing; the goal is to learn to live with it".

The investors returns according to Dalbar (follow up from 2003)

Three years ago, we presented the results of a fascinating analysis by the firm Dalbar Inc. This firm specialized in studying behavioural patterns of market investors. The study showed huge differences between the returns of the S&P 500, of mutual funds in general and especially holders of these mutual funds. Here are the figures for the 20 years period ending in 2005.

Annual return of the S&P 500	12%
Average return of the stock mutual funds	9%
Average return of the holders of these funds	4%

How can such results be explained? The only possible answer is that investors collectively buy and sell their mutual funds (stocks, bonds, etc) at a bad time. They buy what has "worked" in the last few years and sell what hasn't. They have no trouble finding reasons to justify these moves (usually some kind of trend or fad). If they would base their decisions on intrinsic value analysis and not on the stock market quotations in the short run, they would most likely act differently. But that doesn't seem to be in the nature of the "human stock investor". In fact, the behaviour of extreme trading continues to degenerate instead of improving. The holding period of a stock on the New York stock exchange in the 1950s and 1960s was on average seven years. The holding period is now less then 7 months. In less than half a century, the average holding period of stocks by "investors" fell more than 90%.



Resisting the mermaids' enchanting songs

Although stocks in general are the best asset class on the long run, most investors earn low return when they invest in them. It is mostly linked to their behaviour: Switching from one fund to the other or from one asset class (cash) to the other (stocks) at the wrong time is a capital destructive activity. It would be useful to remember the classic adventures of the Greek-roman mythology hero Ulysse. After the Trojan wars, Ulysse wandered through the sea. He crossed the path of singing mermaids that tried to wreck passing ships with their enchanting melody. Warned in advance, Ulysse ordered the crew to block their ears with wax and attached himself to the boat's mast.

Equity investors must also learn to resist the temping and enchanting songs from the "mermaids of short term returns". If not, the reefs of the Dalbar study could await many of them….

Our companies

Behind every stock, there is a company.

- Peter Lynch

Walgreen's

Walgreens had an excellent year in 2006. For the fiscal year ending in August, net income climbed 12%, same store sales 8% and earnings per share (EPS) 13%. The return on equity was 18%. The company still has no debt and $1.5 billion in cash. Few companies succeed in maintaining such a growth rate as long as Walgreen' s. (We invite you to read the chapter devoted to the company in the book "Good to Great"). We bought shares of Walgreen's four years ago at approximately $30. The stock ended the year 2006 at $45. Up to now, it has been a profitable investment (12% per year including the dividend).

This market return is however slightly lower than the intrinsic performance of the company. The stock dropped last fall following the announcement by Wal-Mart of offering generic drugs at $4. Also, the merger of Caremarx and CVS, the prime competitor of Walgreen's, worries many investors. I still believe that Walgreen's has the best game plan and remains the most solid company in its industry.

The first quarter of 2007 was extremely positive; sales climbed 17%, same store sales 10% and EPS 25%. The company also repurchased $343 million of its stock. Walgreen's also announced a new buyback program of $1 billion.

Disney

Disney had an outstanding year. Profits climbed more than 31%. These results are no accident: Robert Iger continues to do a fantastic job as the CEO. The stock has done well since our purchase in September 2005. It climbed from $24 to $35. The market valuation is a little higher than at the time we made our first purchase, but we are still very enthusiastic about the long-term prospects of the company.

Fastenal

Fastenal, of Winova, Minnesota, continues to reward us with impressive results. In 2006 revenues and net profits climbed more around 20%. Fastenal is part of our portfolio since 1998 (the stock climbed 500% in 8 years). We know the company very well and it fits perfectly with our philosophy: a company in a dull sector (nuts and bolts), with an excellent balance sheet, extremely profitable and with an outstanding management team.

Except for October 1998, when we first became shareholders, Fastenal's stock never traded bellow 20 times earnings. The high valuation of the stock, which seems to us justified, makes the stock volatile.

Thus, in spite of an excellent intrinsic performance, the stock dropped by 8% this year. We took advantage of this correction to increase our investment

Bank of the Ozarks

Last fall, we spent a day with the management team of our small bank from Little Rock (Arkansas). The company is in the process of completing an important expansion plan which was started at the beginning of 2006. The timing could have been better: The increase in expenses due to the opening of new branches was combined with pressures on the bank deposit interest rates and a decrease in interest margins (related to the flat yield curve).

Thus, in 2006, EPS slightly improved compared to 2005, in spite of an increase of 20% assets. The first two quarters of 2007 should be similar. In the long term, growth prospects seem to us excellent.

W.P. Stewart

The stock of the portfolio management firm *W.P. Stewart* was our most disappointing investment this year. After two difficult quarters at the beginning of the year, W.P. Stewart obtained adequate returns for the portfolios under management in the last two quarters of 2006. For the year 2006, the accounts returns were 7%, which is lower than the S&P 500. The company thus continues to lose assets.

By looking at the stocks held in the portfolio, we remain confident that the company will be able to beat the indexes in the long run. In the mean time, the dividend of $0.92 gives us a 7% yield.

Microsoft

The top software company in the world had a good year in 2006. EPS roughly increased by 10% and the stock increased by 14%. Profitability is finally in sight for the video game division. The X-Box 360 is without a doubt a great success. And I did my part by purchasing an X-Box system at Christmas.

Microsoft’s stock was volatile this year. It went from $29 to $22 this summer when the company announced additional R&D expenses of $2 billion ($0.20 per action) to improve its competitive position against Google. We took advantage to buy more shares. The stock finished the year at $31.

The 2007-08 prospects are excellent with the near release of the Vista operating system. Microsoft is an extraordinarily profitable company. However, we believe that Google is an exceptional company too and it could become a tough competitor in certain market segments. We’re following the story closely.

Wells-Fargo

This large San Francisco based bank had another excellent year in 2006. EPS climbed 11% in spite of the difficult flat yield curve (to our knowledge it is the bank that best managed the effect of the flat curve on its loan portfolio). After having been shareholders in the nineties, we repurchased shares in 2005 and continued to increase our position last year.

Wal-Mart

Wal-Mart had a more difficult year. EPS climbed only 9%, under our target of 12%. The weakness in retail sales (in part because of the rise in the price of gas) affected the company. The competition is intense in the United States (Target is a solid competitor), in Great Britain (Tesco PLC) and in Germany (Metro AG).

On the other hand, the company is doing very well in Mexico and in Canada. In India, the company is about to sign an important partnership agreement with Bharti to develop stores in this country.

Wal-Mart also announced many environmental initiatives and an increase in benefit packages granted to employees. Even if the results are slightly weaker than anticipated, the stock seems undervalued: It trades at only 15 times the estimated profits for 2007.

Resmed

Once again, Resmed was our fastest growing company in 2006. Revenues climbed 32% and EPS 27% (including the stock options expenses). The stock did well in 2006: it climbed 28%. Since our purchase in 2004, the stock of this wonderful Australian company has doubled. It is not a cheap stock (trading at 30 times estimated EPS), but we believe that the long-term prospects are excellent.

Brown & Brown

Our Daytona Beach (Florida) insurance broker continues to carry out its ambitious objective to grow profits by 15% per year (over 5 years and 10 years, its annual growth rate exceeds 20%). We bought Brown and Brown shares in 2004 when the leader of the industry, Marsh & McLennan, found itself in a turmoil. At that time, the stock of BRO dropped by 20% in sympathy with M&M.

Since then, Brown & Brown EPS and its stock climbed 40%. As it is the case often, this raise was not linear. In 2006, for example, the stock went down by 8%. That is a 23% lower return than the increase in its intrinsic value. This had contributed to our underperformance to the Russell 2000. We believe that nothing has changed in this exceptional company.

Mohawk Industries

In Peter Lynch's second book "Beating the Street", written in 1992, he talks about *Shaw Industries*. It was one of the first companies which I studied in detail. In 1999, I even wrote an article in the newspaper "Les Affaires", about to the excellent prospects for the company. We did not buy any shares at the time (God knows why!). A few weeks later, Warren Buffett's company, Berkshire Hathaway, acquired Shaw.

When I studied Shaw, Mohawk Industries was its closest competitor. Over the years, Mohawk became as a dominant company as Shaw. Its diversity in the hard surface floors (hard wood, floating and ceramics floors) was very beneficial. Moreover, the company is very well managed.

The stock went from $90 at the beginning of 2006 to $75 this fall because of uncertainties regarding the slowdown in the US residential housing market. However, only 15% of the revenues are related to the new housing market. It was the opportunity we were waiting for to buy shares.

Owner's earnings

Each year, we present a table as important as the one of the returns: the growth of our owner's earnings. This year, we will go through the usual table. But we will also add another one that will detail the performance of our companies in 2006 compared to the growth in their respective owner's earnings.

	Giverny			S&P 500		
Year ***	**Growth ***	**Market ****	**Difference**	**Growth ***	**Market ****	**Difference**
1996	14%	29%	15%	13%	22%	9%
1997	17%	35%	18%	11%	31%	20%
1998	11%	12%	1%	-1%	28%	29%
1999	16%	12%	-4%	17%	20%	3%
2000	19%	10%	-9%	9%	-9%	-18%
2001	-9%	10%	19%	-18%	-11%	7%
2002	19%	-2%	-21%	11%	-22%	-33%
2003	31%	34%	3%	15%	28%	13%
2004	21%	8%	-12%	21%	11%	-8%
2005	14%	15%	0%	13%	5%	-8%
2006	14%	3%	-11%	15%	16%	1%
Total	356%	342%	-14%	161%	170%	10%
Annualized	15%	14%	0%	9%	9%	0%

* Earnings per share growth for the entire portfolio (note : it is an approximation) with dividend
** Market performance, dividend included (without currency effects)
*** All the results are estimated without the currency variations

There are two extremely different periods in the last 11 years: the five years period from 1996 to 2000 and the six following ones from 2001 to 2006.

	Giverny			S&P 500		
Year	**Growth**	**Market**	**+/-**	**Growth**	**Market**	**+/-**
1996-2000	15%	19%	4%	10%	18%	8%
2001-2006	14%	11%	-4%	9%	3%	-6%
1996-2006	15%	14%	0%	9%	9%	0%

During those two periods, the growth in intrinsic value was similar (ours like the one of the S&P 500). But the first period was characterized by an expansion of the price-to-earning ratios whereas it was the reverse during the second period.

Over the 11 years period, the stock market performance followed, as it rightfully should, the underlying intrinsic performance of companies. Both for our holdings and the ones of the S&P 500.

Market and intrinsic performance in 2006 details

This year, their has been enormous differences between the intrinsic performance (growth in EPS) of our businesses and their market performance. Here are the details for our top holdings:

Stock	2006 stock market	EPS 06/05 Est.	Difference
Berkshire Hathaway B	25%	21%	4%
Walgreen	4%	17%	-13%
O'Reilly Automotive	0%	11%	-11%
Knight Transportation	-18%	20%	-37%
ResMed Inc.	28%	27%	2%
Fastenal	-8%	21%	-29%
Brown & Brown	-8%	15%	-23%
Microsoft	14%	10%	5%
Disney	43%	31%	12%
M&T Bank	12%	10%	2%
American Express	18%	18%	0%
Pason Systems	-8%	38%	-46%
Wells-Fargo	13%	11%	2%
Progressive Corp	-17%	23%	-40%
W.P. Stewart & Co	-33%	-35%	2%
Wal-Mart	-1%	9%	-10%
Bank of the Ozarks	-10%	4%	-14%
Expeditors Intl.	20%	24%	-4%
Average	**4%**	**15%**	**-11%**

For these 18 stocks, they realized on average a 15 % growth in their EPS in 2006. This compares to a performance of only 4% in the stock market. We have discussed at several times this year, the special case of W.P. Stewart. Except for W.P.S., all our companies had a record year in profitability.

How should we react when facing such disparities? It isn’t constructive to react with frustration. It is better to verify that the fundamental of our companies remain solid and then accept that certain factors in business are out of our control. Market quotations in the short run belong to that group.

This acceptance is not passive. In fact, it is the opposite. We make a constant effort to better understand the nature of our companies and of the stock market. The reality is that several of our stocks are simply not “in fashion” in spite of their excellent intrinsic qualities. The only sensible thing to do is to wait until the stock market reflects them.

Flavour of the day

We are often asked what is the most dangerous thing on the stock market (the “Flavour of the day”). A few years ago in Canada, Nortel and the other techno superstars were highly popular. Whereas today, nothing seems to us more popular than the Canadian banks. Ironically, at the time where Nortel was king of the Canadian market, we bought shares of two banks: the Scotia Bank and the Bank of Montreal, two stocks that were unpopular at the time.

We sold our shares approximately two years later at a price 60% higher but we would have done way better if we had kept them longer in the portfolio (it is easier said *afterwards*). On a comparative basis, here is a table which shows the fundamental differences between the situation in 2000 and in 2006.

Bank of Montreal	2000	2006		Scotia Bank	2000	2006
Return on assets	0.72%	0.82%		Return on assets	0.76%	0.95%
Reserves / net profits	21.4%	6.7%		Reserves / net profits	39.7%	6.0%
Tax rate	36.5%	23.1%		Tax rate	33.2%	19.2%
P/E ratio	8x	14x		P/E ratio	8x	14x

We can see that in six years, the level of profitability has strongly improved. It is in part linked to a decrease in the allowance for credit losses. In the case of the Scotia Bank, the rate went from 40% of net profits to 6%, a drop of 85% (in fact, in 2006, Scotia took reserves of only 0.1% of loans). Moreover, the tax rate was lowered by more than 1400 basis points which also contributed to improve the level of profitability, partly helped by an international diversification. Without a doubt, it will be impossible for the next years to reduce the rate of bad loans (it would become "gains for bad loans") nor to continue to reduce the tax rate in a substantial way.

How did the stock investors react to these gains realized in an ideal (and probably not sustainable) environment? The price-to-earning ratio climbed 75% passing from 8 times in 2000 to 14 times in 2006. In the long run, in a Canadian economy which grows at 5% per year, it seems to be unrealistic to believe that all the players of the banking industry will be able to do much better than this growth rate.

Five years Postmortem : the year 2001

Each year, we undergo a post-mortem of our decisions from five years ago (since it's our time horizon in general). In 2001, we were in the middle of the Enron scandal and the market crash of technology stocks. In the fall, the attacks of September 11 took place. Here is a graph of the S&P 500 since:

As you see in the graphics above, when the Stock Exchange reopened, a few days following September 11, it dropped 6% in one day. Unfortunately for those who sold at this moment, the S&P 500 is 40% higher today. To sell in a panic is not a winning strategy.

We had decided to make some purchases following this correction. We bought shares of American Express (it slipped from $50 to $25 in a few months) following 911. It was the stock that I recommended during an interview on the radio station Webfin following the attacks. As Amex is now at $58 (without counting the bonus "spin off" of Ameriprise), one can come to a conclusion, five years later, that it was a good purchase.

We had also bought shares from the Canadian company Wesjet Airlines after 9-11. Stocks of airline companies collapsed everywhere in the world at the end of 2001. Westjet was at the time a profitable company with a beautiful balance sheet. We sold our shares a few years later, doubling our money.

The Canadian Stock Market 2001-2006

Today, after the Canadian index TSX has doubled during the last five years (thanks to the bull market in the resource industries), several people want to invest in the Canadian market. All the risks they saw into 2001-2002 have disappeared like magic. Paradoxically, it is exactly then, when investors don't see any risk in a market that it becomes the riskiest. But this is usually realized later…

Mistake of the day

All men make mistakes. But only wise men do learn from their mistakes.

- Winston Churchill

Bronze medal: Cognex

We had own Cognex for 10 years. We bought and sold the stock at different prices, but I would say that on average our annual returns was around 4% per year, which is extremely disappointing. In this case, our patience was not rewarded. As you know, I always admired this beautiful Boston based company and its founder, Robert Shillman.

I hesitated a long time before classifying this investment in the error box. I knew the company well and had evaluated the potential and the risks. But I finally realized that Cognex was missing an important element. The managers at Cognex treat their employees extraordinarily well (what I had always admired). The "stock options" program is very generous. When the company had a growth of 25% per year, giving approximately 3% of the company to the employees each year didn't have a huge impact. But, when the growth rate slowed and the company did not reward its shareholders for several years, it seems to me that an important reduction in the option program to the employees would have been appropriate.

I always said that we look for managers who have reached a balance in treating fairly the customers, the suppliers, the employees and the shareholders. We have to admit that the last category did not receive the same degree of fairness as the others. For example, Cognex had $6 in cash per share on its balance sheet. Giving a special dividend or repurchasing its stocks (instead of giving away some) would have been rewarding for the shareholders.

When we started to realize that while reading the 2005 annual report, we reduced our position; Without selling it completely. Then we finally sold the remaining shares in the fall. It was a mistake because the stock slipped 20% between the two moments.

Silver medal: Ominicom

Omnicom is the second largest publicity agency in the World. Warren Buffett made great purchases in the 1970s with his investments in Interpublic Group of Cies (IPG) and Ogilvy & Mather, a company acquired by WPP some 20 years ago. I've always kept a close look at this industry.

At the beginning of the years 2000, IPG made some bad acquisitions and Omnicom became, in my opinion, the best company in the industry. In 2002, IPG had a rough year. At the same time Omnicom was at the center of an accounting controversy, which I considered minor.

But Omnicom's stock dropped from $97 to $37 in a few weeks (the market was very nervous at that time). At this price, Omnicom was trading at only 11 times earnings. It is not every day that we can purchase shares of such a solid multinational enterprise at such ratios. I studied the company's financial statements and everything seemed in order.

But in spite of this, I didn't buy any stock. Why? I believe I didn't want to take the chance that the company would be at the center of a scandal. Our partners were very worried about the quality of the financial statements of our companies (as Enron and Worldcom made the headlines daily).

It was an error because the probabilities were largely in our favour. I should have bought shares in spite of the alarmist headlines and worries of our clients. It is my responsibility to evaluate the risk/return ratio. When it seems to favour us by a wide margin, we must go forward. The stock today is $106. We could have had a return of nearly 200% in 4 years.

Gold medal: Children's Place

Two years ago, Disney decided to sell its Disney stores to Children' s Place. I had been following Disney for many years: I knew that the store chain would be more profitable if it would be run by a specialized retailer. This acquisition was important for Children' s Place: it increased by almost 50% its revenues. Moreover, the price paid was very reasonable.

I studied this company which I knew only by name. Children's Place had approximately 700 stores specialized in children's wears. Children's Place had had its shares of problems in 2002: margins went down and EPS had fallen drastically. But in 2004, the company had solved its margin problems and generated good return on equity. Its balance sheet was debt free and the company had a very good outlook. I believed that the combination with the Disney stores was particularly suitable.

The stock quickly climbed from $20 to $30 following the acquisition announcement. I thought - as an amateur - that I had missed the stock. In the last two years, EPS went from $1.67 to $3.15. The stock today trades at $57.

Conclusion

The next years are promising. Our companies are leaders in their respective industry, have excellent growth prospects and theirs stocks are reasonably valued in the market. We have all the reasons to be optimistic toward the future.

We want to thank you again for your trust.

We wish a great year 2007 to all our partners.

François Rochon

François Rochon and the Giverny Capital team.

APPENDIX

Investment philosophy

In 2006, we saw a large increase in the number of Giverny Capital partners (the term we use for a client). With all these new comers, it is imperative that we write again (and again) about our investment philosophy.

Here the key points:

- We believe that over the long run, stocks are the best class of investments.
- 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, honest, dedicated and altruist 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 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 <u>allies</u> 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 stock market rule that I called : The Rule of Three. This three parts 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.
- One year out of three, we will underperform the index.

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