Giverny Capital Inc.

2007 Annual Report

Pascal Grandmaison
Glass #7, 2004
Giverny Capital Collection

For the year ending December 31st 2007, the return of our portfolio was -14.4% compared to approximately -12.0% for our weighted benchmark. It is an added value of -2.4%. These returns both include a loss of 14.1% related to the fluctuation of the Canadian currency. Without the effect of the currency, our return was approximately -0.3% in 2007.

Since our beginning on July 1st1993, our annual compounded return is 15.4% compared to 8.6% for our comparative index group. If we exclude the increase of the Canadian currency, our portfolio would have generated an annual return of 17.4% compared to 10.5% for the indexes. Our long-term (and ambitious) goal is to maintain an annual return of 5% higher than the indexes. If stocks in general achieve an annual return of 7 to 9% in the future, our long term objective would be to maintain an annual return of 12 to 14%.

We are going through a rough phase. We want with this report to explain the causes of the disappointing results of the last two years. We will take the time to provide all the necessary information to understand these results, the measures taken to improve them, and mostly the potential of the coming years for our investments. The theme of our annual report will be “transparency”, a quality we have always valued since the beginning of our business. Therefore, this year we have chosen to illustrate the cover page of our report with a artwork named “Glass” by Pascal Grandmaison, a Montreal artist.

The Giverny portfolio (in Canadian currency): Our returns since July 1st 1993.

Returns *	Giverny	Indexes **	+ / -	$US/Can	S&P 500	+ / -	Giverny ***	Indexes ***	+/-
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	3.3%	8.4%	**28.6%**	**34.4%**	7.4%	**27.0%**
1994	**16.5%**	3.7%	**12.7%**	6.0%	7.3%	**9.2%**	**12.0%**	-0.3%	**12.3%**
1995	**41.2%**	24.0%	**17.2%**	-2.7%	32.9%	**8.3%**	**43.8%**	26.3%	**17.5%**
1996	**28.0%**	22.8%	**5.2%**	0.3%	22.7%	**5.3%**	**27.7%**	22.5%	**5.2%**
1997	**37.7%**	28.6%	**9.2%**	4.3%	36.7%	**1.0%**	**33.4%**	24.5%	**8.9%**
1998	**20.6%**	18.8%	**1.8%**	7.1%	37.7%	**-17.0%**	**14.5%**	12.8%	**1.7%**
1999	**15.1%**	16.3%	**-1.2%**	-5.7%	14.1%	**1.0%**	**20.6%**	21.9%	**-1.3%**
2000	**13.4%**	3.2%	**10.2%**	3.9%	-4.6%	**18.0%**	**9.7%**	-0.2%	**9.9%**
2001	**15.1%**	-0.4%	**15.5%**	6.2%	-5.7%	**20.8%**	**9.4%**	-5.3%	**14.7%**
2002	**-2.7%**	-18.3%	**15.6%**	-0.8%	-22.0%	**19.3%**	**-2.0%**	-17.7%	**15.7%**
2003	**13.6%**	14.0%	**-0.4%**	-17.7%	5.7%	**7.9%**	**33.7%**	34.1%	**-0.5%**
2004	**1.6%**	6.2%	**-4.5%**	-7.3%	2.8%	**-1.1%**	**8.3%**	13.1%	**-4.8%**
2005	**11.5%**	3.6%	**7.9%**	-3.2%	1.5%	**10.0%**	**14.5%**	6.7%	**7.8%**
2006	**3.5%**	17.0%	**-13.5%**	0.2%	15.7%	**-12.3%**	**3.3%**	16.8%	**-13.5%**
2007	**-14.4%**	-12.0%	**-2.4%**	-14.9%	-10.0%	**-4.4%**	**-0.3%**	2.4%	**-2.7%**
Total	**698.7%**	**234.7%**	**464.0%**	**-22.4%**	**228.3%**	**470.4%**	**922.1%**	**326.5%**	**595.5%**
Annualized	**15.4%**	**8.6%**	**6.8%**	**-1.7%**	**8.5%**	**6.9%**	**17.4%**	**10.5%**	**6.9%**

* Green section: All the returns are adjusted in Canadian dollars
** Indexes are a hybrid index (S&P/TSX, S&P 500, Russel 2000) which reflects the asset class weight
*** Estimated without the effect of the currency.

Note: the returns in Canadian dollars were audited by Price Waterhouse Coopers.

The US Giverny portfolio

Since 2003, we also publish the Giverny portfolio returns in US dollars. It mostly corresponds to the American part of the Giverny portfolio. In 2007, the US Giverny portfolio returned -1.7% compared to 5.5% for the S&P 500. Since the beginning of the portfolio, our return is 827.3% which is 16.6% annualized. During the same period, S&P 500 returned 321.9%, which is 10.4% annualized. Our annual added value is therefore 6.2%.

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%
2007	-1.7%	5.5%	-7.2%
Total ($US)	827.3%	321.9%	505.4%
Annualized	16.6%	10.4%	6.2%

Note: these returns were audited by Price Waterhouse Coopers.

Long term returns of equities

The S&P 500 return of 10.4% since our beginnings in 1993 is very much in line with the long term historical return of US equities. It is the average annual return of the last forty (40) years but also it is the same level than the longer term average. Indeed, since 1900, the annual return of American equities is 9.8%. No class of assets produced a return even close to this return over such a long period. In fact - adjusted for inflation – the real return of US equities is 6.6% since 1900, which is an incredible creation of wealth.

It is interesting to note that the real return of equities in different countries does not vary much over a long period of time. Since 1900, equities in countries other than United States generated an average real return of 5.3% per year. During the same period of time, bonds generated an average real return of 1.1% (and gold approximately 0%).

Country	Real return	Country	Real return	Country	Real return
United States	6.6%	Holland	5.4%	Japan *	4.5%
Great-Britain	5.6%	Spain	4.0%	Switzerland	4.6%
Canada	6.3%	France	3.7%	**World exc-US**	**5.3%**

Source: ABN AMRO

*including -96% in 1939-48

The year 2007

Even if we did not reach our return objective in 2007, the earnings growth of our businesses (see definition below) was quite good: a growth of approximately 9% compared to 2006. Adding an average dividend of 1%, we come up to a 10% increase of the intrinsic value of our businesses. Considering that companies making up the S&P 500 saw their earnings decrease by 3% this year, (intrinsic return of -1% if we include the dividend) our companies did better than the average.

2007 was characterized by a financial crisis created first by a drop in residential construction in the United States and then, by rebound, huge losses related to loans usually called “sub-prime”. Also, the breathtaking raise of the price of oil affected even more the consumer already pressured by the real estate slowdown. As I am writing these lines, it is possible that the actual slowdown will develop into a recession. The forecasts of economic growth for the United States, Europe and Canada are reviewed downward. In the middle of January 2008, stock markets around the World went down on average 20% (the definition of “bear market”). Even if we do not own any residential construction businesses and that both our banks took low reserves, a lot of our businesses saw their stock market quotes suffer from this crisis.

We’ve been there before! We survived through the crisis of 2000-2002. Also, in the fall of 1998, the stock market took a plunge of over 20% during the Asian crisis (time passes by, so do crisis). There was lots of bargains then. We made investments which turned out to be excellent such as JDS Fitel (sold in 1999 with a large profit), Templeton Dragon Fund, Bed Bath & Beyond as well as Fastenal. Fastenal was the big winner: the stock went up 700% in nine years.

I wrote the following lines in the 1998 annual report :

> *…Such situations of crisis and panic that regularly affect the investors are our <u>partners</u> in the quest of our long term objectives…*
>
> *…To have good opportunities of enrichment, we therefore need a climate of pessimism that brings good businesses to prices well bellow their intrinsic value. The higher the pessimism and related market fluctuations better are the opportunities to enrich ourselves. So the next time someone asks you “does the stock correction affects you?” you can answer: “Certainly, it improves my chances of getting richer”.*

I wrote these lines when we were eight partners at Giverny Capital. We are over 600 partners nine years later. Many of our new partners don’t enjoy corrections to the same degree I did in 1998, when I wrote those lines.

But like it or not, we must all accept that market corrections are part of the life of an equity investor. The good temperament towards market quotations that Warren Buffett frequently talks about makes the difference in the end between those who get richer with equities and those who throw in the towel during crisis.

We don’t belong in that last category.

Owner’s earnings

It is not easy to have the right temperament toward market quotes. The vast majority of investors perceive the daily market quotes as an ultimate judge of value. At Giverny Capital, we do not evaluate the quality of an investment this way. In our mind, we are owners of the businesses we invest in. Consequently, we study the growth in underlying earnings of our companies and their long-term perspectives. Every year, we submit a table showing the growth of the intrinsic value of our businesses that we measure using the term invented by Warren Buffett: owner's earnings.

We therefore come to an estimate of the intrinsic value increase of our portfolio by adding to the growth in owner's earnings, our average dividend rate (which is around 1% presently).

	Giverny			S&P 500		
Year * **	**Intrisic Value ***	**Market ****	**+ / -**	**Intrinsic Value ***	**Market ****	**+ / -**
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%
2007	10%	0%	-10%	-1%	6%	6%
Total	401%	342%	-60%	158%	184%	26%
Annualized	14%	13%	-1%	8%	9%	1%

* Owner's earnings growth (approximately) plus dividends
** Stock Market performance, including dividends
*** All the results are estimated without currency fluctuations

We can observe major differences between the growth in intrinsic value and the market performance over a short period of time. But after twelve years, the market performance – both for our securities and for the S&P 500 - has followed the intrinsic performance of the businesses.

Post-mortem: 2002

Every year, we go back five years in the past and do a post-mortem. During the period of 2000 to 2002, we had what we consider our best period (yet). We then beat the S&P 500 by 60% over those three years.

At the end of 2002, I then set forth a new rule that was labelled "the rule of three":

1. One of three years, the market will drop at least 10%
2. One of three securities bought will be disappointing
3. One of three years, our performance will be inferior to the indexes

I also added: "The rule of three is not linear. We can experience three good years in a row (as was our performance of the last three years) and afterwards have two, even four bad years in a row". It turned out that we underperformed the indexes for three of the last five years. Yet, we are using the same approach we did at the beginning of the millennium. I also believe we improved the art of selecting market securities.

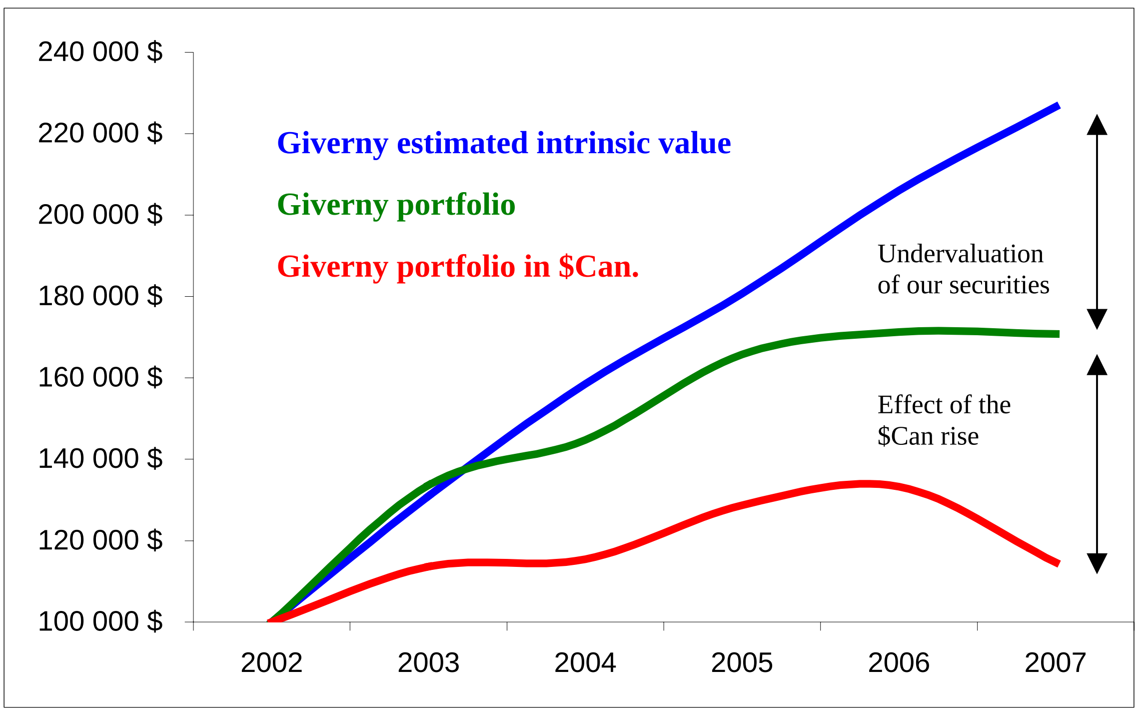
To understand our underperformance, there is no need to dig very far. The most recent bull-market was centered around the different sectors of natural resources, sectors in which we historically had very little participation. From 2003 to 2007, the S&P 500 achieved a return of +70% (84% including dividends) but the energy sub-index realized a return of +250%. In 2007, the energy and material sectors realized +26% and +20% respectively against -23% and -21% for the financial and retail industry, two sectors in which we have several investments.

In addition, our returns were distorted by the incredible rise of the Canadian currency which went from $0.65 US at the beginning of 2003 to $1.00 US at the end of 2007, an increase of more than 53%. Since approximately 90% of our assets are invested outside Canada, this last aspect affected our returns significantly.

Therefore, for the last five years, we come to this summary:

- Our businesses increased their intrinsic value by 128% (18% annually)
- Our portfolio market return was 71% (11% annually)
- In Canadian currency, our return decreased to 15% (3% annually)

Here is a diagram showing a theoretical amount of $100,000 invested with us at the end of 2002:



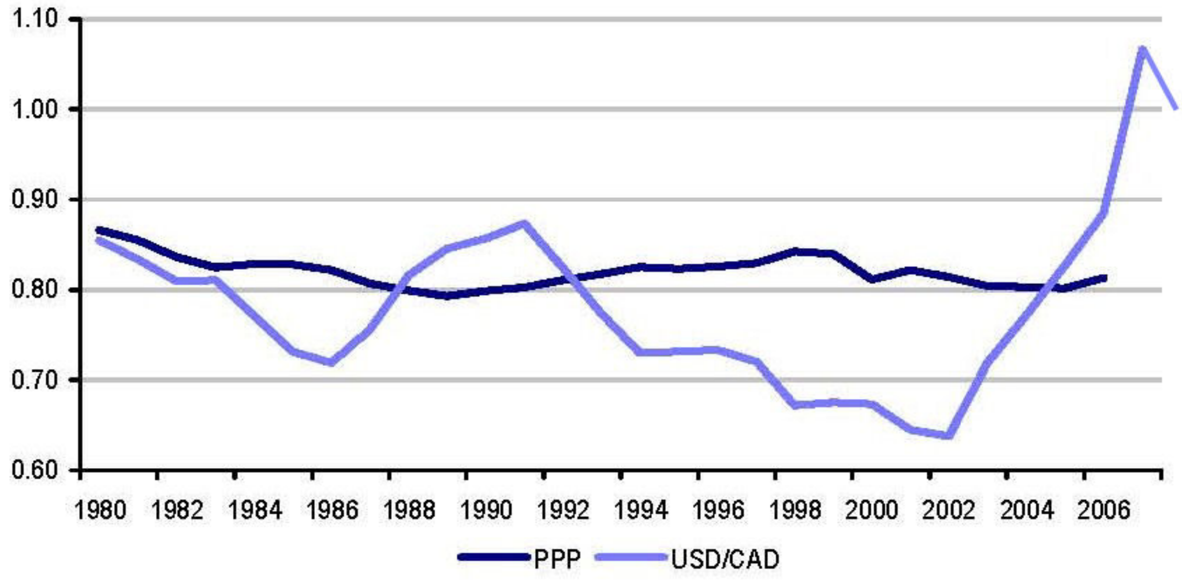
Our securities are presently traded at their lowest level since 1994 in terms of market valuations: the median P/E of our stocks stands at around 15x. But there is a great difference with 1994: at the time long-term interest rates were at 7% whereas today they are at around 4.67%. We believe our securities should be trading at around 20 times earnings, therefore approximately 30% more than their actual level.

The Canadian currency

The other element that affected us was the rise of the Canadian dollar which is no stranger to the bull-market of natural resources. We never believed that we could predict the fluctuation of currencies in general. In Canada, we believe that eventually it is an element that in the long run will have little effect. Over a long period of time the Canadian currency tends to stabilize compared to its American counterpart.

At the request of several partners, we took the time to make a study of the intrinsic value of the Canadian currency. An impartial international organization is taking care of this: The OECD (Organization for Economic Co-operation and Development). This organization reaches a PPP value (Purchasing Power Parities) of .81¢ US - .82¢ US. Another field study reaches a similar valuation: The Journal de Montréal made two identical purchases in Montreal and Plattsburgh and ended up with a shopping cart at 25% cheaper in the United States with the currency at par.

We don't pretend to be currency specialists or strategists, but it is thinkable that the Canadian currency may stabilize at approximately around its PPP at some point in the future.



Source: Bank of Canada, OECD, UBS

Five years prospects for our portfolios

In this section, we will not try to predict the future but to give you an approximate outlook of the future potential return of our securities. As detailed above, there are mostly three factors to consider. The most important one is the long-term growth in the intrinsic value of our businesses. The second is the market valuations (P/E) of our securities. And the third is the Canadian currency level (for our Canadian partners).

In the following chart, we laid out three scenarios. The most cautious of the three anticipates that the actual situation will last: a smaller growth rate of increase in the intrinsic value of our businesses, a small P/E (compared to interest rates) and a Canadian currency remaining at par.

2007-2012 Scenario Annual return	Intrinsic value growth	Increase in the price-earnings ratio	Canadian dollar effect	Annual returns combined
1st scenario	10%	@ 16x (0%)	1,00$ (0%)	10%
2nd scenario	12%	@ 18x (3%)	0,90$ (2%)	17%
3rd scenario	14%	@ 20x (5%)	0,82$ (5%)	24%

The most optimistic scenario – which would provide an annual return of 24% - includes the historical intrinsic growth of our businesses in estimates, a historical average P/E for our securities and a Canadian currency level which would be back in line with its PPP. Therefore, without making any prediction what so ever, we believe that it is realistic to conclude that our securities can provide an annual return 17% per year by 2012.

Measures to improve the returns

The art of investing wisely in the stock market is complex and always in progress. At the last meeting of Berkshire Hathaway, Charlie Munger was saying that the greatest quality of Warren Buffett was his ability to always keep learning. We are therefore constantly working to improve our approach. During the next few years, this progress will be made by opening onto several other stock markets around the world. Also, we will try to discover new business candidates for our portfolios in different – sometimes new – industries. All this will be done within the boundaries of our expertise. And most important, we will continue to search for businesses with a competitive advantage, which remains the cornerstone of our investing philosophy.

Opening up to the World

We learned over the last few years that our portfolio was dependent of the US market (and the US currency). Although we always refused to see ourselves as "US specialists" only, it remains that the best businesses were found in the United States most of the time. Also, the US market has the most rigorous compliance rules and regulations in the world. Presently, we have 10% of the portfolio invested in Canada and approximately 10% in international businesses. We have to underline the fact that in our US securities, several businesses such as Johnson & Johnson, American Express and Procter and Gamble, have an important part of their revenues coming from outside the US. These businesses take great advantage of the weakness of the US dollar.

Canada corresponds to only 3% of the world capitalization: it is normal to find fewer opportunities than in the United States, a reservoir of businesses almost fifteen times greater. Still, we acquired three new businesses from the Quebec province this year.

We are resolutely turning towards the future: there are more and more investment opportunities everywhere on the globe. The Internet and the broaden use of the English language made access to information much easier. We also have access to more research from foreign brokerage firms than previously. In 1998, we invested in Hong-Kong during the Asian crisis. In 2004, we acquired shares from an Australian business and this year, shares from a Japanese company (see below). We are also looking at the Irish stock market which has the lowest price-earning ratio of the Occidental stock markets.

We will continue our selection of the best businesses in the World and it will be done in an expanding pond.

Railroad companies, aggregate quarries and solar energy

We took the time to analyze a sector that we always perceived as capital intensive (fixed and workforce based): the railroad sector. The incredible success of Canadian National Railway in the last ten years has opened our eyes on the fact that this industry has changed significantly. Warren Buffett recently mentioned their structural changes: operating costs were reduced, the utilization of double wagons and software allowed more optimized railroad networks and the increase in fuel prices affected the rails three times less than the motorized vehicles. Railroad is in many instances an alternative much more profitable than trucking. Therefore, we are looking at investment opportunities in this sector.

By ricochet to aggregate quarries, the increasing cost of freight charges makes the geographical location an important competitive advantage. Companies such as Martin Marietta and Vulcan Materials are therefore able to increase their price-per-ton by a large amount over the last few years. Growth prospects for the residential construction sector are not positive these days but the highway infrastructures investment scheduled (and necessary) for the next few years should over-compensate. Many years ago, we invested in Simard Beaudry. Consequently, it is an area we are familiar with.

Finally, solar energy seems destined to a promising future. The recent energy crisis is different than the one in the seventies. Even if the oil needed to produce $1000 of GDP were cut in half over the last 35 years, the fact remains that humanity will eventually have to find other sources of energy. Furthermore, the awakening of our civilization to environmental consequences (an awakening not evenly shared among all the citizens of the planet) leads towards solutions where GES (Greenhouse Effect Gas) will be lower compared to traditional ways of producing energy.

Solar energy is an obvious alternative (the sun should exist for another billion years). The problem is that solar panels made of silicon produce energy at a much higher cost than conventional methods. The American company First Solar, on the other hand, proposes a different solution: it manufactures thin-film photovoltaic solar modules. These modules allow the production of energy at a lesser cost than other solar procedures.

The problem with investing in this industry is similar to the Internet industry ten years ago: it is hard to predict which company will come out a winner and market valuations are very high. On the other hand, it is possible to find businesses that will benefit indirectly from this industry.

Oil sands in Alberta

We had quite a few “recommendations” from our partners to invest in the petroleum sector, more specifically the oils sands industry of Alberta. Even if we avoided the oil business historically, we are closely observing what is going on in this sector. With our investments in businesses servicing energy companies, such as Pason Systems, we are aware of the actual evolution of this industry in Western Canada. It is clear that oil sands in Alberta represent a source of fabulous wealth. The reserves are astronomical and everything seems to be in place for a profitable exploitation (after several years of difficulties). This industry could become the most important source of economic growth in Canada for the next decade.

But this exploitation is not as simple as conventional fuel: besides requiring a large quantity of capitals and a complex procedure, the transformation of oil sands into synthetic petroleum requires a very polluting procedure. GES are produced in large quantities. Also, the disposal of wastewater could become a major environmental problem. Indeed, to produce a barrel of petroleum from oil sands requires two to four water barrels, and the waste must be stored somewhere (there are two gigantic lakes of wastewater existing already).

At the end of 2007, the American government passed the «Energy independence and Security Act». It stipulates that federal agencies cannot initial fuel procurement contracts anymore that are more polluting than conventional sources of oil. Experts estimate that GES emissions related to oil sands are approximately 20 to 25% higher than conventional petroleum sources. This political element is added to the increase of royalties ordered by the government of Alberta last fall. The growth prospects of this region are impressive but there are numerous possible unexpected circumstances (including huge reliance to the price of crude oil). We are monitoring the major players of this industry, but for now, we just remain curious spectators.

Our businesses

The best time to plant a tree was 20 years ago.
The second best time is today.

- Chinese proverb

Walgreen's

Walgreen's, the largest drugstore chain in the world, has experienced highs and lows in 2007. The business had a bad quarter (the one ending in August) with earnings slightly lower than the previous year. The company miscalculated the reimbursements of an important generic drug and gross earnings were under their forecasts. Things were stabilized the next quarter and the earnings increased by approximately 8% for the year. But the stock was punished by Wall Street and it dropped from a high of $50 to $37.

The good news is that Walgreen's increased the number of drugstores as planned to about 6000 (a 10% increase). It also succeeded in increasing its same stores sales by approximately 6%. In the actual environment of retail sales downturn, it demonstrates the strength of its business model. This organic growth was higher than its closest competitor, CVS Caremark. Its prescription revenues continue to be the highest in the industry (see below). Also, the sales of non-pharmaceutical products (front end) jumped to $282 per square foot, approximately 30% more than its competitors.

Revenues per drugstore

Walgreen's	5 600 000 $
Longs Drug	5 100 000 $
CVS	5 000 000 $
Rite-Aid	3 500 000 $
Duane Reade	3 000 000 $

Source: MVI, UBS

We believe that Walgreen's is a solid business and in a growing market sector for many years to come. Competition is fierce and the political part of medication reimbursements has an unpredictable side. Still, we believe that Walgreen's should continue to increase its long-term earnings by 12 to 14% every year.

American Express

AMEX is the oldest security in the portfolio. We own shares since 1995. We reduced our participation occasionally when the stock got a little pricey. And we bought some stock back after September 11th 2001 and finally a third time in the summer of 2005 after the company won its battle against VISA and Mastercard.

American Express owns probably the best brand of the financial industry in the world. Its international growth is very high and the long-term prospects, quite solid.

From 2004 to 2006, earnings per share increased 18% per year. In 2007, the growth went down to 13% because of the economic slowdown in the United States. AMEX should also experience a tougher year in 2008. Its clientele has a credit score higher than average: the company should then be less affected than its competitors as to potential payment defauls. But it is not immune from charges for bad loans during an economic slowdown. Wall Street, having its typical short-term vision, has severely punished the stock these last few months. On a longer term, the company continues to maintain a growth forecast of 12 to 15% per year.

Historically, the stock has traded at P/E ratios of about 18-20x, which makes sense for such a quality business. At the present time, the P/E is 13x, a level that we consider to be much lower than its intrinsic value.

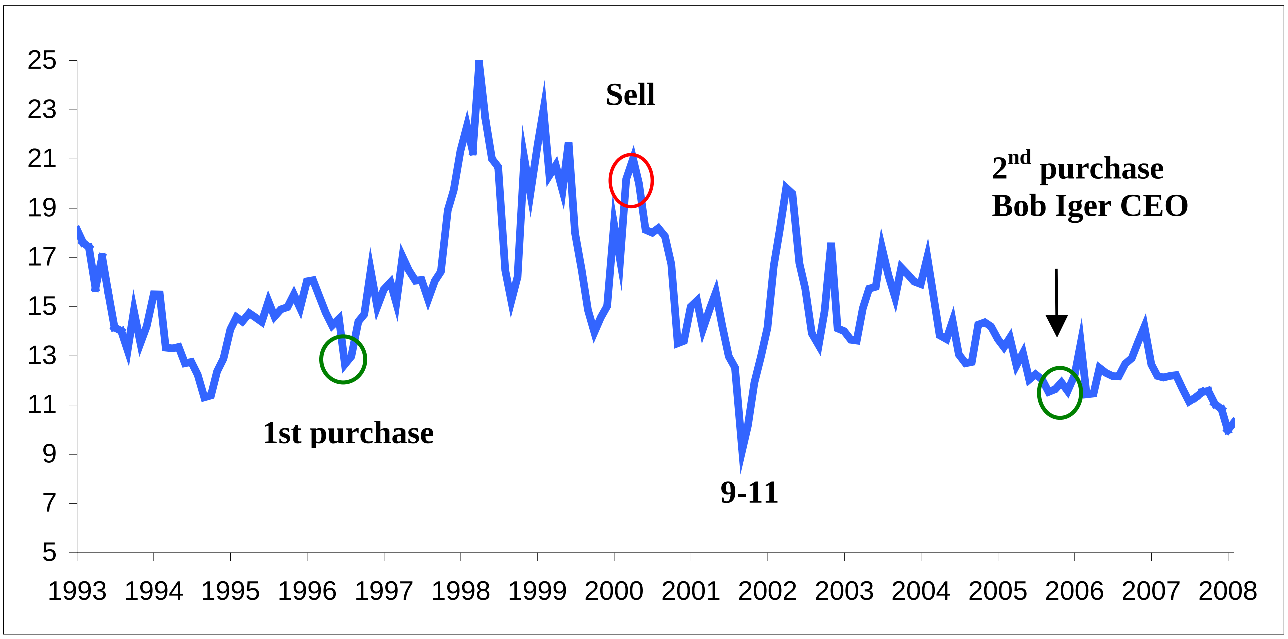
Disney

Our history with Disney goes back to 1996. Following the acquisition of Capital Cities ABC, we decided to buy some stock. At the beginning of 2000, we sold for two reasons: first, the market valuations looked too high and we were also getting less comfortable with the top executives.

Five years later when Bob Iger became President of Disney, we bought shares again. We knew Bob Iger formerly from Capital Cities ABC: he was the choice of Thomas Murphy to replace him, the then CEO (Mr. Murphy was refered to as the best manager in the world by Warren Buffett). Since our acquisition at $24 in September 2005, earnings per action have increased by 50% but the stock is up only 25%.

On the graphic below, we can see that the price to cash-flow is at a low in the last fifteen years. In fact, at the present level, Disney is traded at 10 times cash-flow and 14 times earnings, a level quite inferior to its intrinsic value. Disney has everything to be an excellent investment: a magnificent business, an exceptional CEO and an attractive valuation.

Disney (DIS) valuations over 15 years: price to cash-flow



O'Reilly Automotive

Our auto parts retailer saw its revenues and earnings increase by 11% and 9% respectively in 2007. We believe that O'Reilly is the best business in this sector. We admire its leadership team and their discipline in the execution of their development plan. In spite of the retail sale slowdown in the US, O'Reilly continues to invest in new stores (200 are anticipated for 2008), in advertising and most importantly in customer service.

O'Reilly is a good example of what has happened to our portfolio in the last few years. We bought the first shares in August 2004 at $20. The company increased its earnings per shares from $0.92 in 2003 to $1.67 in 2007 for a total growth of 82% (16% annualized). The stock is trading at $28 today, only 40% higher. The average P/E was 21x for the last four years but is at 17x today (15x 2008 estimated earnings).

We believe O'Reilly's stock is undervalued. We don't know when it will go up but we think the company can double its intrinsic value in the next five to six years. The stock should at least follow. Should it return to its historical P/E of 21x, the total return would be 140% for that period. We are therefore quite optimistic.

Brown & Brown

Our insurance brokerage business has experienced a more difficult year in 2007. Earnings went up by 10%. Not bad, but it is far from the 25% annual rate of the five previous years (2001 to 2006). The problem was insurance premiums in Florida. A few years ago, the state government set up a company, Citizens Insurance, in order to offer property insurance to Floridians without insurance. The problem is the insurance was sold at a discount price (sort of disguised subvention). After the hurricanes of 2005, Citizens increased its volume at the expense of traditional competitors. As Brown & Brown receives a share of premiums from different players, if these amounts are decreasing, generally, the revenues of B&B are decreasing. This situation is probably temporary (Citizens will not be able to operate at a loss for very long) but this situation has affected the organic growth of B&B downward.

The company continues to grow by acquisition but this year it was not sufficient to prevent a drop in earnings during the 4th quarter and a small growth for the year. The stock went down. We still believe that B&B is the best business in the sector: its margins highly exceed its competitors. We also believe the possibilities to consolidate this huge fragmented market are excellent over the coming years.

MTY Food Inc.

For many years, I stipulated that the best public company in Quebec was BMTC Group. I still have BMTC – and the CEO Yves Desgroseillers – in high esteem. But I also became a great admirer of Stanley Ma, the President of MTY Food.

The company is a leader franchisor of restaurant chains (mainly located in shopping malls). The network consists of 809 restaurants through nineteen banners such as La Crémière, Thaï Express, Croissant Plus, Tiki Ming and Sushi Shop. MTY is very profitable and growing fast (approximately 30% per year). Mr. Ma takes a reasonable salary and owns an important part of the company shares (26%).

Bank of the Ozarks

Our bank from Arkansas had a good year in spite of the difficult environment. As anticipated, earnings per share were stable in 2007 because during most of the year the bank had to deal with a flattened yield curve. The good news is that recently the curve changed drastically (Fed lowered its short-term interest rate by 2%). We are expecting a more profitable year in 2008. Another good news is that the bank took no sub-prime reserve in 2007. This is no coincidence: we favoured this bank for its loan conservatism. The CEO, George Gleason, owns 23% of the shares. Therefore, it is in his best interest to nurture a culture based on cautiousness.

In spite of this, to this date, our investment in Bank of the Ozarks has been disappointing. The P/E we paid was a little higher than usual for a bank. On the other hand, we invested a weight of only 2% of the portfolios (approximately half of a typical weight) being aware of this valuation slightly higher. Our experience tells us that refusing to invest in an exceptional business because the price seems a little too high is often a mistake. On the other hand, when the growth scenario takes longer than expected to materialize, the security can be punished by Wall Street (not reputed for its patience). We believe that Bank of the Ozarks is an excellent bank and we are keeping our shares.

Knight Transport

Our trucking company in Phoenix (Arizona) has experienced a difficult year. Earnings per share went down 12%. The problems are not specific to Knight: the trucking industry in general had a difficult year. We believe Knight is an exceptionally well managed business in a difficult sector (an “oasis in the desert”) and we think we will be rewarded when the cycle comes up again. Knight has a good balance sheet and could take advantage of the present downturn to make acquisitions at decent prices. We should also keep in mind that Knight’s top management own a third of the shares. We’re in the same vehicle as them !

Microsoft

Microsoft had a remarkable year. The release of Vista is a huge success. Earnings per share were 33% higher than in 2006. Also, the stock jumped 20% in the market during 2007.

In February 2008, MSFT dropped to $28 following the news of an unfriendly offer to acquire Yahoo!, an offer that was refused. Even if the conclusion of the saga is unpredictable, it does not change the fact that Microsoft (with or without Yahoo!) is probably worth $40 a share, according to us. Its P/E of 14x looks quite low to us.

Nitori

Nitori Co. is a Japanese retailer with 160 stores offering articles for the home (furniture and accessories). Their stores are similar to IKEA (which tried to challenge Nitori with little success so far). At a time when retail sales seem to have stagnated in Japan for several years, Nitori sustained an impressive growth. Its net income increases 18% per year and the return of equity stoods at 17%.

Unlike other Japanese exporters (vehicles and technology), Nitori takes advantage of the raise of the yen since their furniture are bought in China and sold in the domestic market. The company was founded in 1972 by Akio Nitori who was only 28 years old at the time. He is still the CEO and manages the company brilliantly (and he owns 12% of the shares).

During the last month, in spite of a difficult retail environment everywhere in the world, same store sales grew 6%. The company intends to continue opening twenty stores per year in Japan. We believe the company can increase its EPS by 15 to 20% per year in the future.

Johnson & Johnson

J&J had an excellent year in 2007. Revenues jumped 15% thanks to the acquisition of Pfizer's consumer product division, among other things. The weakness of the US currency also contributed to the growth of revenues. Earnings per share increased 10%. At the end of 2007, the company lost the exclusivity of the important drug Risperdal (approximately 6.5% of revenues). We expect a slower growth rate in 2008, which should be in the order of 7%.

J&J is one of the best health care companies in the world (and is almost immunized to economic cycles). Its market valuation is 14x and seems much lower than its intrinsic value and its P/E average of the last ten years (25x).

Morningstar

We acquired shares from Morningstar last spring. We mentioned it in the second quarter of this year (in reply to a question from a partner). For many years, we used the financial information services of Morningstar. We like the long-term vision they demonstrate in their research, a rare commodity at Wall Street. We are ready to pay for their different services, particularly their analysis of competitive advantages of the businesses they are appraising.

Reading the first annual report of Morningstar, we became great admirers of the CEO and founder Joe Mansueto. He takes an annual salary of $100,000 with no bonus and no options. He owns 68% of the Morningstar shares (you are beginning to see a common point in our company choices?). In 2007, Morningstar revenues increased by 37% and EPS by 40%. It is certainly one of our most profitable businesses we own and we hope to be partners with Mr. Mansueto for years to come.

Fastenal

We rarely keep an investment for ten years in our portfolio. But next October, it will be a decade since we became shareholders of this fabulous business in Minnesota. In 2007, the company ignored the economic slowdown and increased its profits by 17%. Since our acquisition, EPS went from \$0.35 to \$1.55 (18% per year). The stock followed the profit growth and increased by 700% as indicated above.

But we had to be patient to get this huge reward. Earnings stagnated from 2000 to 2003 and the stock did nothing for three years. Recently, in spite of excellent results, the stock is at the same point it was two years ago.

We believe our patience should be – once again – rewarded in the future.

Mistake "du jour"

Success seems to be linked to action. Successful people keep moving.
They make mistakes, but they don't quit.

- Conrad Hilton

Keeping up with Giverny's tradition, here are our three annual medals for the "best" mistakes of 2007. As always, it is with a constructive attitude – hoping to always become better investors – that we make detailed analysis of these mistakes.

Bronze medal: Garmin

As often the case, the worst mistakes are not the securities we bought but the securities we did not buy. In 2004, we looked at Garmin, a leading company in the growing world of GPS (Global Positioning System). GPS are ever present in our life and Garmin seemed to be the best positioned player in the industry.

We had an apprehension that the high margins of the company could not be maintained in the long term. The anticipated volume increase of units sold could increase the risk of commoditization that would follow. From 2003 to 2007, operating margins did bend indeed from 43% to 37%. But the revenue growth largely compensated. From 2004 to 2007, earnings per share tripled and the stock did the same (including the recent 50% drop of the stock).

Silver medal: W.P. Stewart

Our investment in W.P. Stewart was extremely disappointing. WPS is an asset management firm with an approach similar to ours (even though they are more concentrated on US blue chips). It has been in existence since 1975 and has substantially enriched his clients during three decades (an investment of \$10,000 with them in 1975 would be worth \$2,000,000 today).

In the last few years, the returns are not as good as they were in the past. Indeed, from 2002 to 2007, the annual performance was 10% compared to 13% for S&P 500. In the last five years, the trend of investing in quality securities at a fair price was not as rewarding as in the past. Unfortunately, what emphasized the problem is that certain employees decided to leave the firm (taking part of the assets with them). WPS lost more than half of its clientele these last two years. Revenues dropped by half and earnings were reduced to almost zero in 2007.

Our investment in this company was about 4% of our capital and to this date, we cumulated a loss of 80%. Since we got a 5% dividend during many years, the actual loss is smaller. But nonetheless, we lost the equivalent of 3% of our capital, which is our worst loss ever.

I have no problems acknowledging my mistakes; there would be a problem if they would not be recognized and not acted upon. But in the WPS case, our analysis was well done. We perfectly understood the company and followed quite regularly their portfolios composition. At the beginning, I estimated the assets would yield around 10% a year and I was not far from reality. In our original scenario, the earning growth of 10% that would follow combined to the 6% dividend should have brought us a very acceptable total return.

What I underestimated was the impatience of their clientele, the pressure of the intermediaries and the attraction of Hedge Fund (and their often speculative method of realizing short-term high returns). Of course, a perspicacious partner could blame us for not selling as the bad news were coming. Certainly, the company made changes to rectify things. We thought the problems would be temporary and the situation would improve eventually. We were wrong.

At the very end of February, we learned that WPS hired Merrill-Lynch to find a potential buyer. So we should know the outcome of this investment probably in the months to come.

It is a good thing to learn from our mistakes. I can assure you that my knowledge of the investment management industry is much better than it was five years ago. It was a mistake but, at the same time, we have to recognize with humbleness and realism that it is in the nature of the business world to have occasional unsuccessful investments.

Gold medal: Shoppers Drug Mart

I've been following Shoppers Drug Mart since the time the business was part of Imasco many years ago. In November 2001, the company came public at $18 per share. I knew that, when becoming independent, SDM could greatly improve its margins. Therefore, the earnings per share of $0.41 realized in 2001 did not reflect the true earning power of SDM. Not even the EPS of $1 then expected for 2002. Therefore, I should have disregarded the high P/E of the stock. I knew the drugstore industry very well and thought SDM had the potential to become an even more dominant leader in Canada.

In 2003, we bought shares of Walgreen's. Its very long-term growth perspectives seemed higher than SDM. At that time, we observed Jean-Coutu venturing in the US, knew that they would meet more problems then expected and that it would be a good opportunity for SDM to take on Quebec's market even more aggressively. Jean Coutu did encounter difficulties in the United States eventually. During that time, in Quebec, SDM opened impressive drugstores that were really successful.

The fact that we invested in Walgreen's should not have prevented us from investing in SDM as well. Even if the growth rate of new drugstores was higher at Walgreen's than SDM, they succeeded better in improving their margins (due mostly to the success of their private label). In 2007, SDM earned $2.28 a share (more than double those of 2002) and the stock is at $51 today. We would have tripled our money in an investment where the risk was very small.

This deserves a gold medal.

Conclusion

Despite errors inherent to the investment world and the business world in general, we know that owning stocks is the best wealth creator in our capitalist world. On the long-term, equities have generated approximately 10% per year in return and our own experience since 1993 was even more positive. But the price to pay for better returns is to live with fluctuations – sometimes quite pronounced – of the stock market world. The other essential ingredient is patience, the catalyst to make it through difficult times.

If there is a recession in 2008, we are ready. Historically, recessions in North America were temporary. More importantly, they always represented incredible opportunities to buy shares from solid companies at great prices. It is futile to try to time these purchases: the stock market has a tendency to drop a lot sooner than the recession becomes official and to climb six to twelve months before recovery.

Our businesses have good balance sheets and they will profit from slowdowns by taking market shares from weaker competitors or make acquisitions at good prices. Moreover, a lot of our businesseses can take advantage of the market weakness to repurchase their own stock. We believe that presently our group of businesses is the most solid we ever owned and their market valuations have never been so low.

We are therefore very enthusiastic about the long-term return prospects of our portfolio.

I wish a very good year 2008 to all our partners!

François Rochon

François Rochon and the entire Giverny Capital team