Giverny Capital Inc.

Letter to our partners 2008

Dil Hildebrand
Untitled (dusk), 2008
Collection Giverny Capital Inc.

If you don’t have time to read the complete letter, please read this :

The opportunity of a generation

To Giverny Capital’s partners,

2008 was a difficult year in the stock market, to say the least. We believe that the market drop – and the high level of pessimism – has created great investment opportunities, to a degree we have seldom seen in the modern history of financial markets.

From these depressed levels, we believe that the potential rewards for stocks are very high. We believe that the potential returns for stocks in general have not been that promising since 1979:

- Valuation for stocks in general are very low. The price-earnings ratio to normalized profits is around 9 times for the S&P 500.
- Consumer confidence in the US is at an all-time low of 25 (1985=100). The lowest it had reached before was 42 in 1974.
- Just in the US, there are around 7000 billions of dollars in cash (waiting to get back in the market). This is a sufficient amount to acquire all the S&P 500 companies.
- Interest rates on treasury bills are almost zero. The bond alternative is far from attractive.
- Most investors are pessimistic. Institutions have a very low asset allocation for stocks. Historically, these were signs of future great returns for stocks.
- We can purchase shares of outstanding companies at a third of their intrinsic value, a situation we have rarely seen.
- Finally, the legendary investor Warren Buffett is very optimistic toward stocks: he urged investors to invest for the first time since 1979. He wrote: *“A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors.”*

At Giverny Capital, we’re ready for the next bull market !

François Rochon

François Rochon and the Giverny Capital team

For the year ending December 31st 2008, the return of our portfolio was -5.5% compared to approximately -22.0% for our weighted benchmark. It is an added value of +16.5%. These returns both include a gain of 16% related to the fluctuation of the Canadian currency.

Since our beginning on July 1st 1993, our annual compounded return is +14.0% compared to +6.4% for our comparative index group. If we exclude the increase of the Canadian currency, our portfolio would have generated an annual return of +14.4% compared to +6.7% for the indexes.

Our long-term (and ambitious) goal is to maintain an annual return of 5% higher than the indexes.

The art work on the cover of our letter

Since 2004, we illustrate our letter with an art work from our corporate collection. This year, we choose a work on paper by the Quebec artist Dil Hildebrand titled "Dusk". We do believe that the bear market could be near its end and we could soon see the lights of the next bull market.

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

Returns *	Giverny	Index **	+ / -	$US/Can	S&P 500	+ / -	Giverny ***	Index ***	+/-
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%**
2008	**-5.5%**	-22.0%	**16.5%**	23.1%	-21.7%	**16.2%**	**-21.5%**	-35.4%	**13.9%**
Total	**654.7%**	**159.4%**	**496.8%**	**-4.5%**	**157.4%**	**500.1%**	**701.9%**	**175.2%**	**526.7%**
Annualized	**13.9%**	**6.3%**	**7.6%**	**-0.3%**	**6.3%**	**7.7%**	**14.4%**	**6.7%**	**7.6%**

* 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 2008, the US Giverny portfolio returned -24.3% compared to -35.7% for the S&P 500. Since the beginning of the portfolio, our return is 600.7% which is 13.4% on a annualized basis. During the same period, the S&P 500 returned 171.4%, which is 6.7% annualized. Our annual added value is therefore +6.7%.

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%
2008	-24.3%	-35.7%	11.4%
Total (en $US)	600.7%	171.4%	429.3%
Annualized (en $US)	13.4%	6.7%	6.7%

Note: these returns were audited by Price Waterhouse Coopers.

Portefeuille Giverny Canada

In 2007, we started the Giverny Canada portfolio. It mostly corresponds to the Canadian part of the Giverny portfolio. In 2008, the Giverny Canada portfolio returned -24.6% compared to -32.9% for the S&P/TSX. Since the beginning of the portfolio, our return is -9.7% which is -5.0% on a annualized basis. During the same period, the S&P/TSX returned -26.3%, which is -14.2% annualized. Our annual added value is therefore +9.2%.

Year	Giverny Canada	S&P/TSX	+/-
2007	19.7%	9.8%	9.9%
2008	-24.6%	-32.9%	8.3%
Total	-9.7%	-26.3%	16.6%
Annualized	-5.0%	-14.2%	9.2%

Note: these returns were audited by Price Waterhouse Coopers.

The year 2008 in review

Last year, we ended our letter with these words : “If there is a recession in 2008, we are ready”. We did enter into a recession last year. Here is a review of some of the main news of a year that was far from ordinary:

- From their peak, World markets were down by more than 50%. Even those that were considered (wrongly it seens) “decouple” from the US economy went down. Markets in China, Brasil, Russia and India were down form 50 to 75%.
- Most industrialised country went into recessions.
- Housing prices were down by 20% in most industrialised countries.
- Three of the top five stock brokers in the US have vanished or have been forced to merge into a new entity (Bear Stearns, Lehman Brothers and Merrill Lynch).
- The three financial titans AIG, Freddie Mac and Fannie Mae collapsed.
- Short term Interest rates in Canada and US are almost zero.
- The S&P 500 dividend yield is higher than 10 year treasury bonds by more than 1%, something that last happened in the mid 1950s.
- It is estimated that around one of three hedge funds could close because of the crisis.
- Oil prices went from a peak of 147$US in July to a low of 35$US in December.
- The Canadian dollar dropped 23% compared to its US countepart.
- The Canadian stock market was not immuned : from its peak, the S&P/TSX dropped 50%, the small-cap index by 60% and the TSX Venture by 75%.

We are always psychologically ready for recessions or market corrections. At the same time, we share the same agnosticism as Warren Buffett’s as for the capacity to predict them (we leave that to astrologists, market strategist and other fortune-tellers). We have accepted since the start that market and economic cycles are parts of our capitalist systems and manage our assets accordingly.

Since 1945, there have been 11 recessions. Four times, the stock market dropped by more than 40%. And crisis have one thing in common: they all ended !

The recent economic crisis originated from the drop in real-estate prices and in the huge consequences on the financial institutions, worldwide. Afterward, the crisis spread to all industries. The market correction was then amplified by the huge number of speculators that crowded the investment world in the years 2006-2007. For example, we wrote to you last year that at some point, there were $200 billions of oil contracts owned by investors. These were not destined to utilisation. Speculators were hoping to find “other” buyers to purchase their contracts before the delivery date. Forced to sell, losses were tremendous for most of them. There was also, the private equity firms (a new name for LBOs) that acquire companies by leveraging them to a dangerous levels. Many of them were forced to sell securities to improve their balance sheet. All this deleveraging process is still hurting the economy.

And as always, market drops created by the selling of speculators have created more fears for many other investors (even those that don’t need to sell). It is hard for many investors to keep a long term view during market corrections, especially when it lasts many months. But they have to. It is impossible to know when but this crisis will pass too we can be certain of that. Our civilization have went through tougher times! A wise man once said that history doesn’t repeat itself exactly the same way but it rimes!

Our portfolio did pretty well in the circumstances. We always have focussed our capital in solid companies with great balance sheets and good profit margins. They also share an important ingredient: honest and accountable people at the helm. Our companies are not immuned to recessions. But we believe that they have what it takes to pass through them. Some of them will emerge even stronger! Finally, we are prudent in the price we pay for stocks. That helps in bear markets.

Some of our companies were quite hurt by the recession but in general our investment philosophy has helped us this year to beat the market, the same way we have done it since 1993. And we are taking advantage of the market crash to purchase great bargains. As Warren Buffett would say: "*be greedy when others are fearful*"

The level of undervaluation of stocks in general

Although we're stock pickers (not investors in the market per se), we do closely follow the general valuation level of the S&P 500 (in our opinion, the most important index in the World).

To value the S&P 500, we take into consideration three parameters: operating earnings, normalized earnings to smooth out the economical ups and downs and long term interest rates in the US. The last parameter is used to compare price-earnings ratio (P/E) to bond alternatives. Over a long period of time, the market P/E tends to follow the inverted yield of interest rates. Of course, in periods of optimism, the normalized P/E of the S&P 500 can be way higher than interest rates would justify. And in periods of pessimism (like right now!), P/Es can be way lower than their intrinsic value.

If we look at the following chart, the S&P 500 seems to us undervalued by more than 50%, a discount rarely seen (note: in 2008 we use a 4% level for the 10 years bond although it was 2.5% at year end).

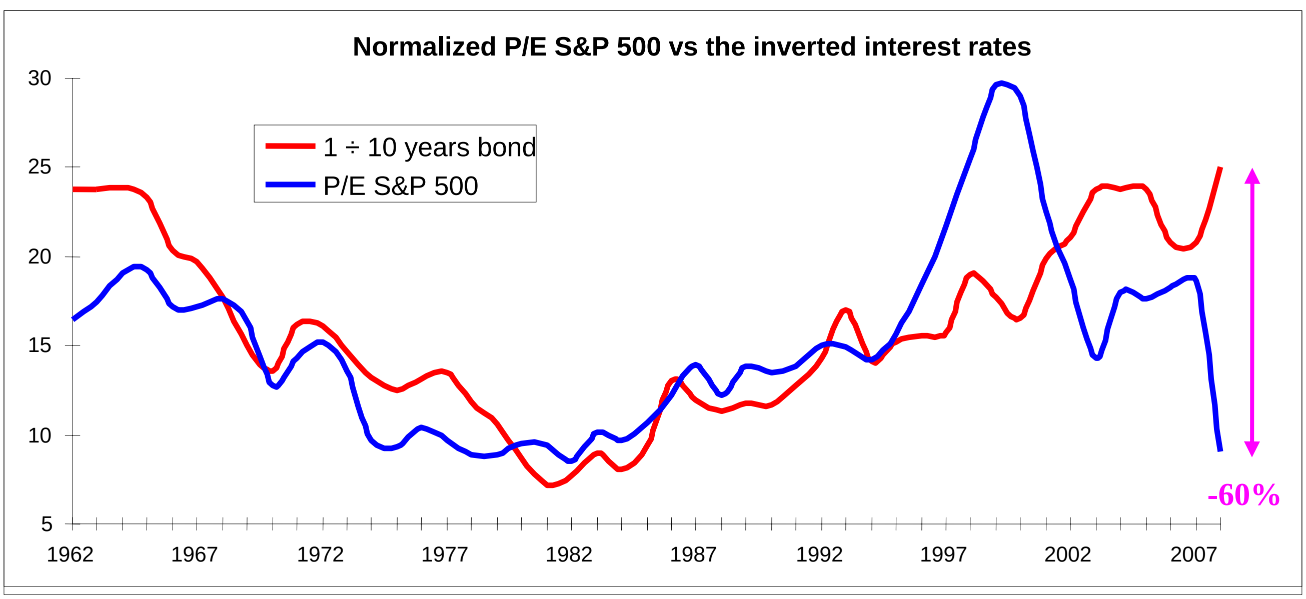


Figure 1 : Normalized P/E of the S&P 500 compared to the inverted interest rates of 10 year treasury bonds.

Such a level of undervaluation for stocks – and a huge potential of future appreciation attached to it – usually happens once per generation. So we are quite optimistic for the years to come. We don't know what the market will do in the next few quarters, but over the next 5 years or so, the potential returns seems to us way higher than the historical norms.

Historical returns and their fluctuations

There is one reason – and only one – that stocks have created so much wealth to their owners in the last century: on average, companies have maintained a 12% return on equity (ROE). After dividends, this ROE has translated into a 7% annual increase in corporate earnings. This annual increase, combined with the average dividend of 3%, have yielded a total annual return for stocks of 10%. This is better than any other asset class. All equity owners should then have been rewarded at such a rate over time. In reality, this is far from the case.

The stock market is an entity created and composed by human beings. So it has some of its qualities and flaws. The market has periods of huge optimism followed by periods of huge pessimism (although not in a linear fashion). For example, the S&P 500 increased by three fold in 5 years from 1995 to 1999. And it has dropped by 50% in 2008. Usually, the patern of behavior is more or less similar : in periods of increases, investors tend to forget that stocks can also go down and buy them at any level without consideration of their intrinsic values. And then, after a big drop, they sell believing that never again stocks will be a rewarding source of wealth (or they wait for a "better" time to buy time, meaning when they will have gone up a lot). They make the same mistake as in bull markets: they do not focus on intrinsic value.

We believe that the nature of financial markets do not favor such timing investment strategies. In fact, historically, 90% of stock returns happened during 1.5% of trading days. Statistics are way against those that think they can outsmart the market over a long period of time.

We do realize that the last 10 years have been quite difficult for investors in general. It even gives them the impression that stocks ownership is not a rewarding activity (and enjoyable even less). We can look at the following graphic to realize how tough were the last 10 years:

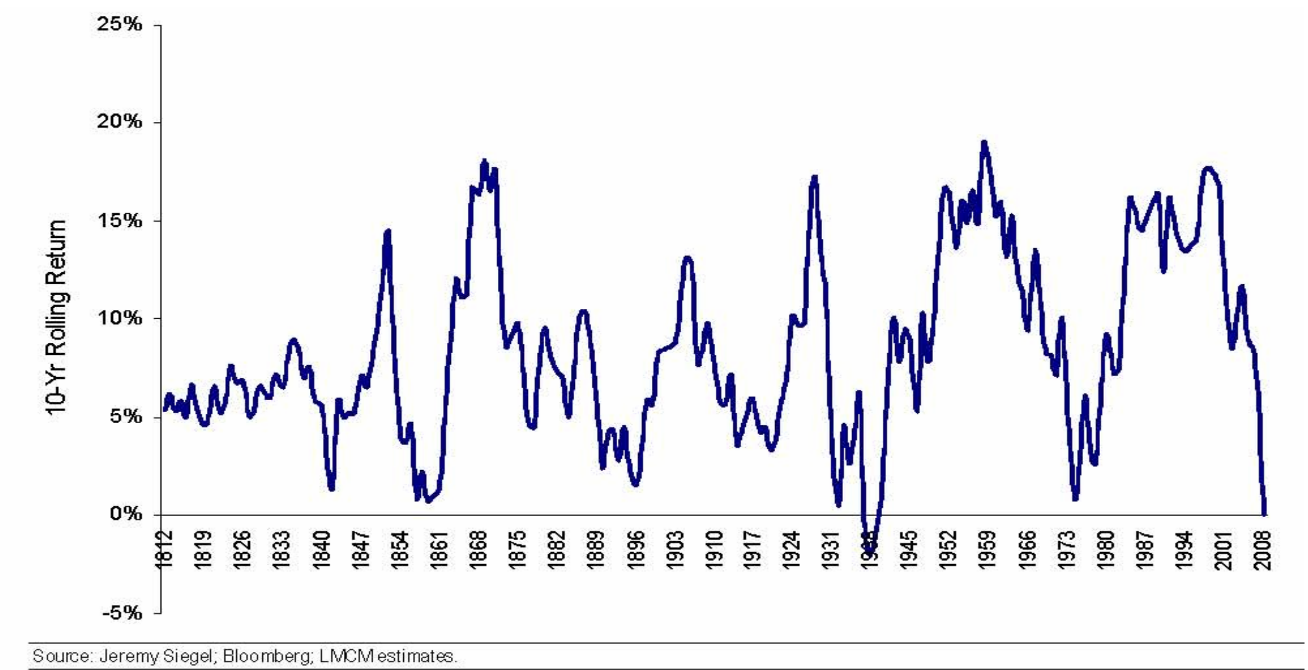


Figure 2 : The S&P 500 annual returns for the previous 10 years since 1812.

In 2008, the rolling 10 years average returns of the S&P 500 was less than -1%. It was only the second time in the last 200 years that this return was bellow 0% (the other time was for the 1929-1939 period). In 10 years, the market has gone from overvalued to undervalued.

But in the end, the only way to lose money in the stock market over the long run is to sell during corrections or recessions. So the emotional goal of the typical investor is not to fall into the "trap" of bear markets. This "trap" awaits those that can not be impervious to stock market fluctuations. Although it is far from easy, the key to attain such wisdom is to consider stocks as parts of businesses. And – big news ! – that's what they are. Nothing else!

Owner's earnings

If the vast majority of investors perceive the daily market quotes as an ultimate judge of value, we have a different view. 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 yield. In 2008, our owner's earnings decreased by 3%. It is not a great accomplishment but it was way better than the 30% drop in the S&P 500 operating earnings (note: earnings in 2008 for the S&P 500 varies a lot depending on how we account for them. We have used the one calculated by the firm Standard & Poor's)

	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%
2008	-3%	-22%	-19%	-30%	-36%	-6%
Total	386%	247%	-140%	73%	82%	9%
Annualisé	13%	10%	-3%	4%	5%	0%

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

According to this calculation, our companies have increased their intrinsic value by 386% (almost 5 fold) but their stocks – in aggregate – increased by 247%. The main difference can be explained by the median P/E contraction from 16x to 11x. We must add that this year's corporate earnings – ours and those of the companies making up the S&P 500 – are depressed because of the recession. In some way, they distort the calculation of intrinsic value. Only time will tell to which degree.

Besides ups and downs in the economy, over the long run, market quotes will follow the increase in the earnings of the underlying companies.

The flavour of the day in 2008: guaranteed impoverishment

Regularly, we try to assess what is the flavour of the day, in other words what needs to be avoided. The stock market tends to get excited from time to time by all sorts of financial assets: it could be a sector, a country, an asset class, a new major "trend", etc. In 1999-2000, it was all about tech stocks. In 2006-2008 (first six months), it was all about commodity and resources stocks. Today, what looks to us very dangerous are – ironically – the treasury bills.

Today, there are around $7000 billions in liquid assets in the US alone. This is enough money to purchase all the companies of the S&P 500 (or 5 times the complete Canadian stock market). At year's end, the interest rate on those liquid asset was 0.07%. The interest rate on 10 years government bonds was 2.2% and the 30 years bonds 2.7%. Those that purchase those assets – in a some sort of collective delusion – believe that they are acting in a prudent way while in fact it could be the riskiest! It is so because it guarantees yearly impoverishment because the yield that they receive will be lower than the inflation rate.

Historically, the inflation rate has been around 3% per year. Although, in 2009 it will probably be lower, investors have to realize that the politic of many governments to inject huge sums of money in the banking system will probably create inflation. In the next 10 years, it could even be a little higher than historical norms, perhaps around 4% a year on average. If we use 3.5%, it means that the bonds yielding 2% will in fact be creating a LOSS of 1.5% per year in real terms. Over 10 years, this is total loss of 14%. Moreover, if that 2% is taxed, the total loss climbs to 21% (not bad for a riskless asset). For 30 years bonds, it's even worse: a non-taxable account will lose 26% of its purchasing power and in a taxable one, 45% !!

That is why we believe that the risk of owning treasury bills has rarely been so high. Impoverishment is guaranteed !

<u>Our companies : 2008 in review and their future potential</u>

In 2008, many of our companies saw their earnings reduced or stagnated. In some cases, the reduction was significant. Some of our businesses, we must add, did increase their earnings and some other made important acquisitions while their competitors were paralysed with fear.

Nitori Co.

Our best stock in 2008 was Nitori, a Japanese company we acquired last year. Nitori is a retailer of household products (furniture and accessories). It has an everyday low price strategy so it has been gaining market shares in these difficult times. In 2008, earnings were up 13%. The stock went up 30% (to 7000 yens) and we got a little bonus because the yen gained 40% against the Canadian dollar.

Wal-Mart

Wal-Mart increased its profits by 6% in 2008. Its same store sales (SSS) were up 3%. In this very tough environment, it was quite an accomplishment. For example, Target saw its SSS decreased by 3%. Wal-Mart is one of the rare retailers that increased its traffic and SSS in 2008.

The top management's decision to reduce the level of new store openings and instead buy back shares looks to us like a wise decision. The stock has been quite resilient this year as it increased by 18% compared to last January.

Bank of the Ozarks

Our little bank of Little Rock (Arkansas) accomplished what very few of the 4000 or so banks in the US did this year : increase profits. Assets were up 19% and earnings were up 9% (even after a large increase in loan reserves). The efficiency ratio was down to 42.3%, an exceptional performance. Return on assets was a solid 1.14%.

I've met with the management of Bank of the Ozarks in 2006. I came back from Little Rock quite enthusiastic. Its CEO, George Gleason, acquired the bank for $10 000 at age 25 some 29 years ago. Bank of the Ozarks had then 28 employees et $28 millions in assets. In 2008, assets were $3 billions (an increase of 10 000%) and the bank was worth $500 millions. Mr. Gleason still owns some 22% of the outstanding shares and is paid a very reasonable salary. The culture he has impregnated onto the bank is based on conservatism and a long term horizon. Ozarks did not participate in the "sub-prime" madness and was prudent with its real-estate loan portfolio (there was few speculation in Little Rock considering that the median price of a home is $130 000).

Mr. Gleason is our kind of businessman and we're happy to be partners with him!

Wells-Fargo

Wells-Fargo (WFC) made a bold acquisition in 2008 by acquiring Wachovia at a very good price. They paid around $15 billions. This was the equivalent of 17% of its own market cap. In return, WFC doubled its assets. Moreover, we believe that with the charges that they will make to Wachovia books, they could save billions in future income taxes, that could prove to be almost the level of the purchase price.

WFC is so big, it could hardly escape the recession linked problems in 2008. It increased its level of reserves but still was profitable. Earnings were down 25% and we believe they will be lower by as much – at the very least – in 2009.

As always, we look beyond the next few quarters. We believe that once the economy gets back on the growth track, WFC will be able to double its earnings. So we believe that in next cycle, WFC could earn $4 a share. The stock could then reach the $60 level. This is many times the current level of the stock so the potential of appreciation is quite high.

Allied Irish Bank

In 2008, we had acquired a small weight in the largest bank in Ireland: Allied Irish Bank (AIB). At its average price of $25 in 2008, the stock was trading at 3 times earnings! AIB had two large investments: $3 per share in a minority holding of M&T Bank and $4 per share in Zachodni WBK, one of the most important bank of Poland. So in fact, we were paying $18 for $6 of EPS. And the dividend was 10%. It looked to us as a very rewarding opportunity.

But it did not turned out the way we had hoped. The economy of Ireland went down in turmoil and its three banks collapsed in the stock market. AIB ended the year at $5. At this price, we were *paid* $2 to own the most important bank in Ireland (with 41% market share it is the Irish equivalent of a combined Bank of Montreal and Royal bank of Canada).

In the beginning of 2009, there was an incredible event: the Irish government nationalized the third most important bank, Anglo Irish Bank, something very unimaginable just a year ago. Ireland is not a socialist country or a third-world country. Its GDP per capita is 15% higher than in Canada! But political interference makes our analysis futile and predicting the outcome quite impossible. Clearly, at today's price, investors believe that AIB will be almost totally diluted. We follow the situation closely but for the moment, we decided to just keep our shares.

Disney

Walt Disney Co. had a good year in 2008. EPS were similar to those of 2007. The recession should impact 2009 EPS but in the long run, this is one of the best companies we own. Moreover, it is brilliantly managed by its current CEO Robert Iger. The stock was a bargain at $30 at the beginning of the year but that did not prevent it from going down to $20. Obviously, in times of great pessimism, a stock trading at half its intrinsic value can go down to a third of its value. At today's level, Disney trades at 10 times earnings, a level not seen since the mid 1960s. We are still buyers of the stock.

American Express

AMEX owns a solid brand name, probably one of the best in the financial sector. But the year 2008 was very difficult for the company. Reserves had to be increased and EPS went down by 28%. The year 2009 doesn't look better. The stock went down to $19. At this level, it trades at around 7 times earnings.

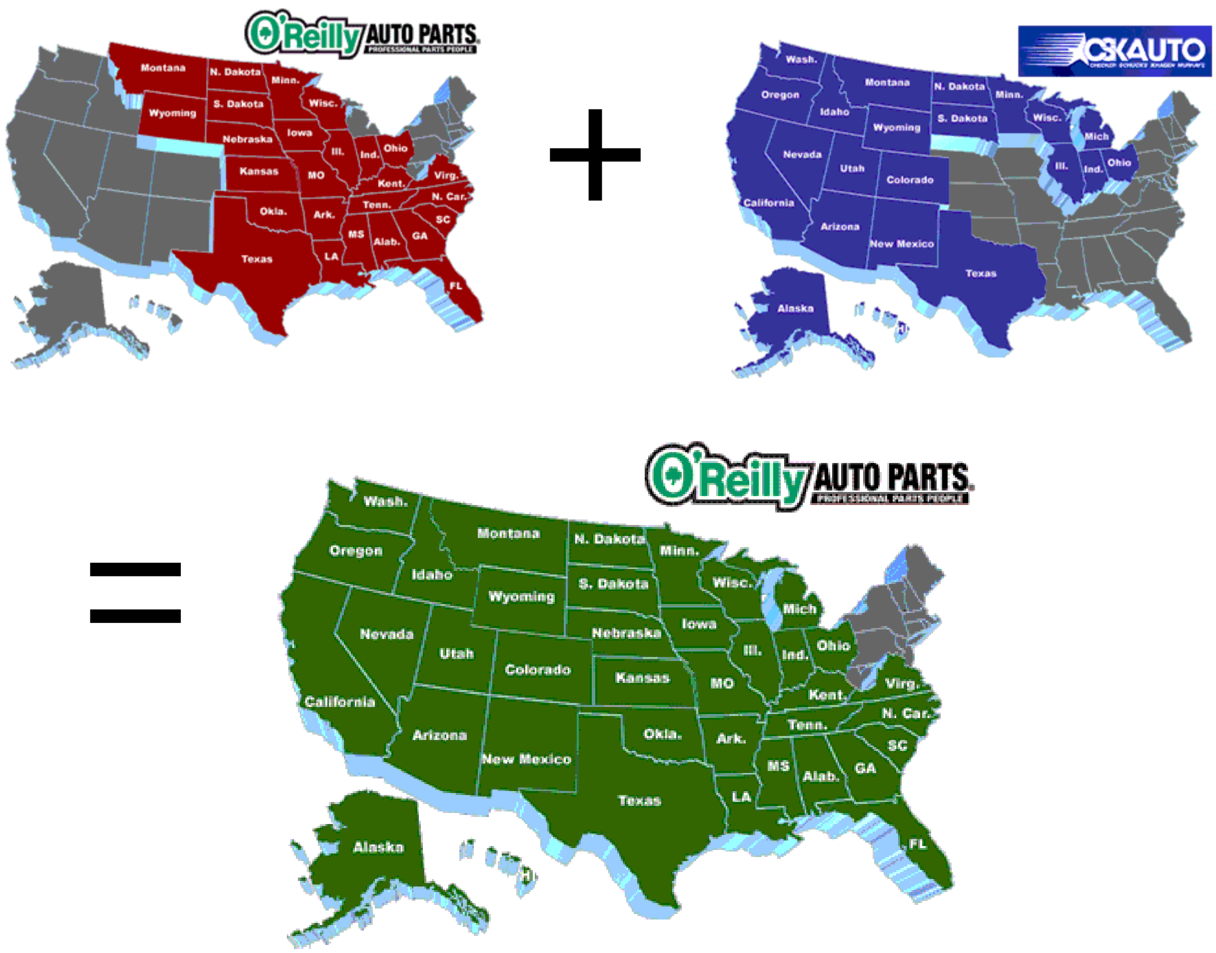
It is difficult to know how hard AMEX will be hurt by the recession. We do believe that the company's brand is intact and that in the next cycle, earnings should rebound. If it earns $4.25 and the P/E gets back to normal levels, this stock could reach $65, more than four times the current level.

O'Reilly Automotive

Four years ago, we acquired shares in O'Reilly Automotive, one of the most important retailers of auto parts in the US. We had paid around $20 and the company was earning $1.12 per share at that time. O'Reilly had grown by 20% a year since its IPO in 1993. Future prospects looked good to us. We had visited its headquarters in Springfield (Missouri) and were impressed by its top people. They built a strong culture and had a very long term horizon in their investment process.

In 2008, EPS reached $1.64. Even though it's 46% higher than in 2004, we believe that these earnings are not totally reflective of their true earning power. The store number has increased from 1200 to 3200 during those four years. The stock has been quite rewarding in this down market since it ended the year at $30.

Of the 2000 stores increase, a large part of it came from this year's acquisition of CSK Auto (1342 stores). It expanded the reach of O'Reilly to the whole country. And the price paid for CSK seems to us to be very reasonable. So the future of O'Reilly continues to look quite promising.



Fastenal

We are shareholders of Fastenal since 1998. So far, we have been rewarded to a large degree by this superb company from Winona (Minnesota). In the movie "*Other People's Money*", Lawrence Garfield (interpreted by Danny DeVito) likes businesses that are "*Dull but making a decent buck*!". At Giverny Capital, we share this admiration for such businesses. And Fastenal is making more than "decent" returns with its capital!

Fastenal started by selling fasteners but its CEO for many years, Robert Kierlin, diversified the company into many other lines of products as it expanded to around 2000 retail sites. My personal favorite line of products is the janitorial one.

We first purchased shares of Fastenal during the Asian crisis in October of 1998 at around $5 a share (adjusted for splits). In 1998, Fastenal earned $0.35 per share. In 2008, EPS reached $1.91, an increase of 450% in 10 years (18% annualized). The stock – as it should – has gone up by 500%.

The stock has been weak lately: the first few months of 2009 are difficult. But we do believe that in the next cycle, Fastenal will be able to again double sales and profits. And the stock should, at the very least, follow its underlying growth rate.

MTY Food

The Quebec based enterprise MTY Food had a good year in 2008. Its sales increased by 12% and EPS by 8%. MTY acquired two franchises: Tutti Frutti et Taco Time. The number of restaurants under the umbrella of MTY has crossed the 1000 level this year. The stock had a tough year as it went down from $12.6 to $7.3, a 42% drop. The company still has a great balance sheet. It shoud help to make other acquisitions in 2009 as the opportunities arise.

Pason Systems

Our Calgary oil services company, purchased four years ago, had a good year in 2008. Its US division is doing extremely well and helped the company earned record profits. EPS were up 25% in 2008 but 2009 looks much more difficult (the number of oil rigs are way down as of this writing). We admire Pason's CEO, Jim Hill, tremendously and we talk to him on a regular basis. We are optimistic about the long term prospects of this very impressive Canadian company.

5N Plus

5N Plus, a young and dynamic Quebec based company, is a World leader in metal purification. Their products are mostly used in photovoltaic cells for solar panels. For their last fiscal year (ending in May), revenues were up 41% and EPS 83%. After two quarters into 2009, revenues and profits are up 120%. The company has successfully completed its German plant and it's doing very well so far.

The stock was very volatile in the stock market. It started the year by going up from $8 to $13 and then went down the $4.6. The company – with some wisdom – issued more shares at $11 so it has a reserve of $1.2 per share in cash. So in fact, we're paying $3.4 for the company or around 10 times estimated profits for 2009. Such a low P/E for a fast growing company looks very attractive to us. Moreover, we know its founder and CEO very well and have great faith in his managerial skills.

Resmed

We purchased shares of Resmed in 2003, an Australian company that is the World leader in sleep disorder medical products. This segment is growing rapidly as more and more people are getting aware of the dangers of apnea. Resmed not only sells products, it helps the medical World and the population get more acquainted with the problem.

In 2008, sales were up 16% and EPS up 13%. Few companies had such a good performance in this economic environment. More importantly, it gained back some market shares from Respironics (now a division of the Dutch company Philips). The stock has over performed the indexes by going down only 29% (!). We believe that the company warrants its premium to the average company. So we are hanging on to ours shares even though they do not look as undervalued as some of our other holdings.

Knight Transportation

The trucking industry had to surf through a wave of problems in 2008: retail sales in constant descent, increase competition from railroads and high fuel prices (for a good part of the year). But that did not prevent Knight to continue to earn great returns: revenues were up 8% and EPS were down only 9%. Its efficiency ratio (the most important measure of competitive advantage) was maintained at 84%, more than 10% better than competitors. Its balance sheet is still without debt and with an excess cash level of $54 millions, even after having paid a dividend and repurchased shares.

This is why Knight Transportation was one of the few stocks to increase this year, ending up 9% compared to last year. When we first acquired shares of Knight in late 2003, we labeled it "an oasis in the desert" as it was a great company in a lousy industry. And it's in great drought that we recognize the best sources!

Walgreen's

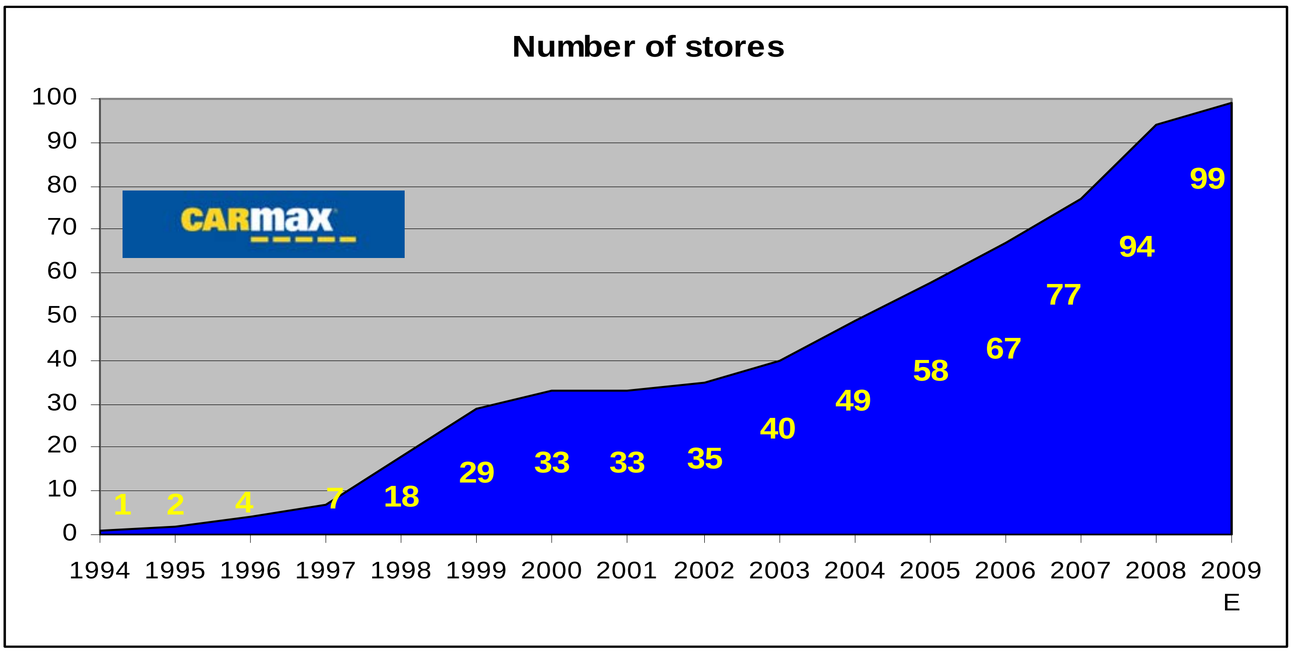
It was a tough year for Walgreen's, the leading pharmacy chain in the US. SSS went up but at a lower growth rate than the company had accustomed its shareholders. EPS were similar to those of 2007. The stock should have done well in the stock market because of its "defensive" status. But there were few of those in 2008 in Wall Street: the stock went down 34% to $25, doing as poorly as the index.

As always, what counts is the increase in intrinsic value not what the stock does in the short run. It seems to us that long term fundamentals are not as good as they used to be. The company has reduced its long term target of store openings and decided to focus on increasing margins. Although it might be the wisest choice, this is not good news. When we purchase the stock some 6 years ago, the company was growing at a 16-17% growth rate and had maintained that rate for the previous 30 years. Very very few companies had such a track record!

A look at the industry leads us to believe that competition has increased lately. And from a larger base, Walgreen's growth rate should be lower going forward (probably 7-10%). The stock looks incredibly cheap (at a P/E of 11x) and has discounted even worse growth perspectives that we envision. But we are reconsidering this investment as we are finding even better opportunities in other stocks.

Carmax

Carmax is the US largest retailer of used cars. Headquartered in Richmond (Virginia), it currently operates 99 used car superstores in 46 markets. In addition, Carmax offers financing to most of its clients (through its CAF division). Loans from clients with good credit scores are pooled and sold on the securitization market. When FICO scores are low, they are sent to Bank of America. Carmax has been growing since its founding some 15 years ago. It went from one store to 99 stores as revenues reached $8 billions in 2007.



It is hard to imagine a worst economic flood for the auto industry than the year 2008 (although it looks like 2009 is going for the record). Sales of cars (both new and used) have gone down by 25%, a decrease rarely seen since its entry into our civilisation. In addition, Carmax had to cope with a terrible securitization market for most of the year and had to accept much lower margins. They also had to increase reserves for delinquencies. So the financial arm lost money in 2008. So in two years, EPS went from $0.92 to $0.11.

We had purchased a starting participation in 2007. As bad news were coming out, we decided to wait to purchase more shares. That does not change our view that the long term fundamentals of Carmax are great. Few companies have so much growth potential. The used car market is highly fragmented and the consumer can gain better services (and less problems) by purchasing at Carmax instead of the local dealer. In just a few years, Carmax has built an impressive brand name that is without equivalent in the industry. With only 2% of market shares, it could grow by 15-20% per year for the next decade and still own less than 10% of the market.

So we believe that we should be patient with that investment and even perhaps considering increasing our holding at some point in the future.

Mohawk Industries

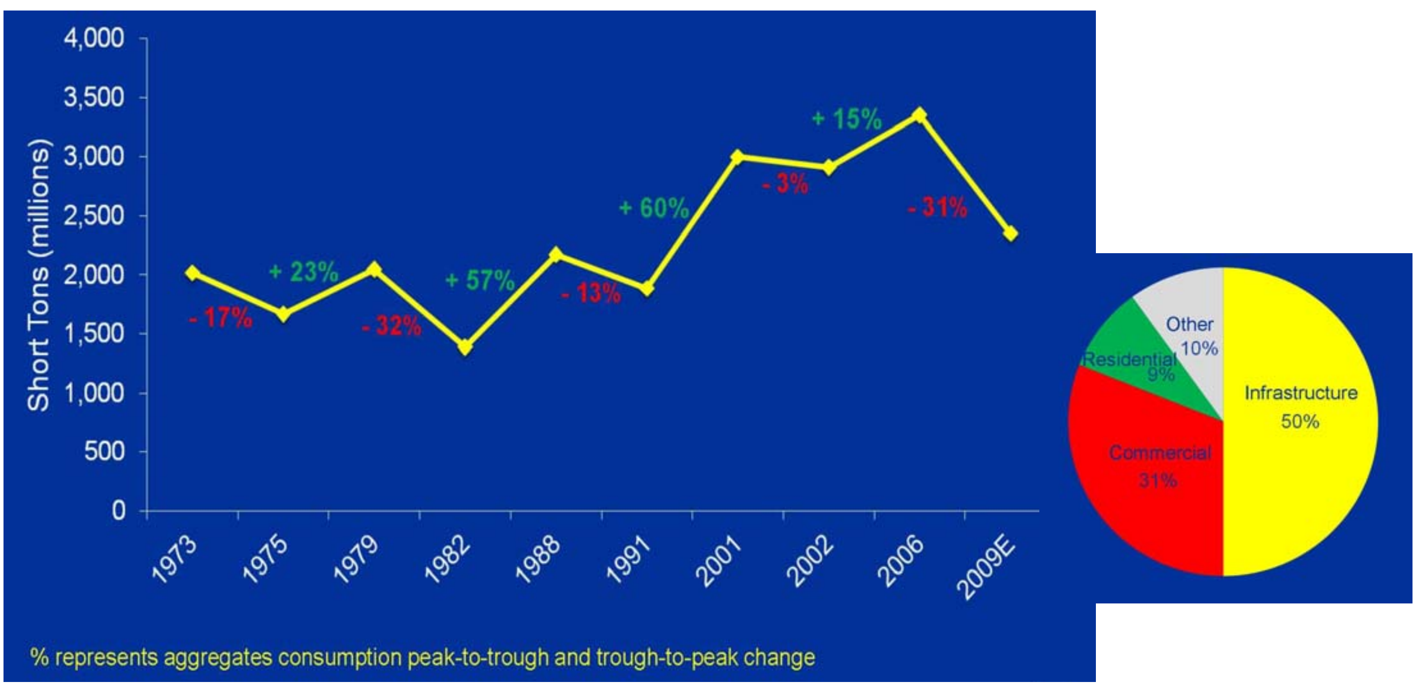
Mohawk Industries is one of the two main players in the flooring industry in the US. It is also an important player worldwide. The year 2008 was very difficult for the industry and for Mohawk. EPS went down 50%. Sales of carpets, tiles and hardwood floors we're down across all segments (commercial, residential and new home construction). Moreover, the increase in oil prices (until August) had a huge impact on gross margins (carpets are made from oil based products). Margins should improve later in 2009 as the company goes through its FIFO inventory. It is worth noting that its main US competitor, Shaw industries (a division of Berkshire Hathaway) had a similar drop in profits. So, it seems that Mohawk has not lost market shares. The other important ingredient is its CEO, Jeff Lorberbaum, who we admire greatly.

The stock had a volatile year. It fluctuated between $83 and $24, ending the year at $43. At its low, it traded at 3 times the earnings of the last cycle peak (2006). If in 5 years, the company returns to a more normal profitability level and trades at a P/E more in line with its historical norm, this stock could reach $120. So Mohawk stock looks to us as being quite undervalued.

<u>New purchases in 2008</u>

Martin Marietta Materials

We acquired shares of Martin Marietta Materials (MMM), the leading US aggregate producer. The company has strong competitive advantages and long life reserves (84 years). Because of the recession – including the drop in new home sales – aggregates consumption has its worst drop since 1982 as shown in the following chart. So we believe that there is a strong recovery potential.



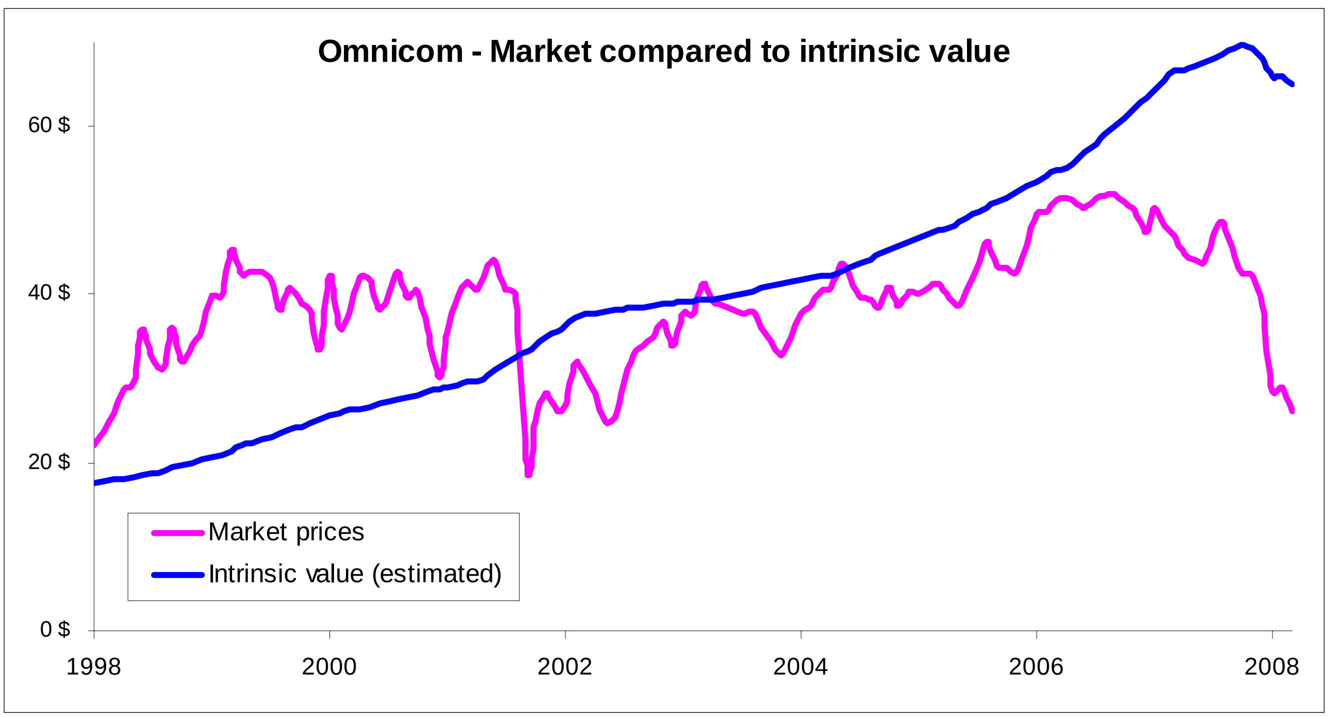
Moreover, according to our analysis, the mid and long term economics of this company are very promising. Around 50% of revenues come from infrastructure projects. This division should rebound in the next few quarters in light of the fact that the newly elected president Barack Obama has announced a major program of investments in that area. And, at some point, new home sales will go back up. So we believe that within the next 5 years or so, MMM earnings could more than double.

Omnicom

We have been following Omnicom since 1998. In fact, in 2006, the stock was in the "mistake *du jour*" section of our annual letter to partners. I explained that in 2002, the stock went from $49 to $18 on rumors of a financial scandal (that turned out to be unfunded). The stock had afterward rebounded to $53 in 2006. So I had lots of regrets to have stayed on the sideline four years earlier.

But in the stock market, we shall never lose patience. In 2008, the stock lost more than half its quoted value and was at $27 at year's end. The recession will have an impact on Omnicom's profitability but we believe that over the long term, its intrinsic value is intact.

It is interesting to note that in 2002, Omnicom realized EPS of $1.72 . In 2008, EPS reached $3.17. So the stock today is even more undervalued (at a P/E of 8x) than it was in 2002 at its low (P/E of 10x). Historically, Omnicom has traded at around 22 times earnings. So at its current level, we believe it is trading at a third of its underlying intrinsic value.



If you believe that decrease in stock value is bad for shareholders, we would tend to think otherwise. Since 2002, the company has bought back 60 millions of its own shares (or 16% of outstanding). It is way better for Omnicom to buy back its stock at 8 times earnings than at 16 times. So we think we will be rewarded from that investment in two ways: First by acquiring shares well bellow intrinsic value. Secondly, Omnicom increases shareholder's wealth by repurchasing its own shares at cheaper level.

Five years post-mortem : 2003

We try, on a regular basis, to do a post-mortem of our investment process when sufficient time has gone by. We believe that by studying our past decisions, we can learn from them.

In 2003, we had acquired shares of Factset Reseach, Expeditors International, Harley Davidson, Walgreen's, Fifth Third Bank, Resmed and bought back some First Data. Four of these companies were still in our portfolio at year's end (Factset, Expeditors, Walgreen's and Resmed).

Although we believe its brand to be solid, we sold Harley-Davidson a few months after our purchase. We were not comfortable with their finance division. Our fears were justified. Although it took a few years to materialize, the year 2008 was difficult for Harley. In addition to slower sales, the financial division is worrisome. And its stock went from a peak of $70 to $12 lately. This summer, I went to Milwaukee and visited the newly constructed Harley-Davidson museum. We can realize the strength of the company and of its brand. There are very few brands that people are ready to get tattooed on their body. Harley-Davidson is one of them!

First Data turned out ok. We sold our investment in 2005. The company was then split in two with the spin-off of Western Union. The other part was acquired by a private equity fund afterwards.

Finally, Fifth Third Bank was a poor investment. We sold our shares at around $40, two years after their purchase with a loss of 20%. The Cincinnati bank had a great history of outstanding returns for its shareholders. But sometimes, in capitalism, success creates its own anchor. When we look at today's price of $2 (I have to clean up my screen to be certain that there is not another digit in front of the "2"), we have no regrets that we sold our shares.

Mistakes *du jour*

> Success *is a lousy teacher. It seduces smart people into thinking they can't lose.*
>
> - Bill Gates

As we do every year, here are our three modals for "best" mistake of the year just passed. As usual, it is with a constructive attitude that we share them with our partners and go into detailed analysis. In the hope to always improve ourselves as investors.

Bronze Medal: First Cash Financial

We owned shares of First Cash Financial Services (FCFS) for a few months in 2007. We had purchased them at around $17 and sold them under $10. It was not a good transaction. FCFS had two divisions. The first one was a chain of pawn shops, in the US and in Mexico. This division is highly profitable and almost immune to recessions. But FCFS had a second division, much smaller, that sold used cars with "easy" payments. I was not a fan of that business but since it was a modest part of the profits, we decided to invest a small weight. As usual, we started with a small weight to slowly learn to know management a little better (there nothing like implication to learn about something).

In 2007, the car division turned out to be losing money. The stock fell in half on the news of the December quarter of that year. We believed that FCFS had to sell that division (even give it away, liabilities included). To my great disappointment, FCFS top management decided to keep the trouble division believing that they could solve its problems.

For a few days, I reflected on the situation. I believed that it is was a mistake to continue holding on to the car division. One important criteria when we acquire shares in a company is to have confidence in its top people. Once we are shareholders, if we do not agree with them, we are faced with a tough decision. Obviously, we have no chance on making them change their mind. We either have to accept their decisions or sell our participation. We decided to sell.

The car division continued to lose money in 2008 (and profits to increase in the pawn shops division). But after a few quarters into 2008, FCFS' management decided to depart from that business. The stock promptly rebounded to $17. It was hard to predict such a turnaround in a management decisions (ego sometimes block wisdom in many human beings in powerful positions). It was frustrating since FCFS did chose the path we believe was best.

Was it a mistake to sell? I don't think so. Our reasons were valid. Could we have been more patient with the management of the company? I believe the answer to that question is yes.

Silver Medal: Ritchie Brothers Auctioneers

Ten years ago, a fellow money manager recommended to me Ritchie Brothers Auctionneers (RBA), a Canadian company specialized in farm and industrial equipment auctions. A dull business if there is one! RBA gets a percentage on every transaction so their capital needs is quite low. The difficulty lies in the ability to built a strong reputation to attract a critical mass of buyers and sellers. Once that difficulty is surmounted, auctioneers can be a great business (we just have to think of the solidity of Christie's and Sotheby's).

I knew in 1998 that RBA a built a strong nice but I was worried that the farm and industrial equipment auctions would be a cyclical activity. So RBA's P/E of 15x seemed a little high at that time. During the recession of 2001-2002, the company did well and after that the stock continued to trade at high P/Es (sometimes in the high 20s). So far this year, RBA has held up fine.

So after 10 years of following from the stands – for a better price – we can look at the numbers since 1998: sales and earnings have increased three fold and the stock has quadrupled.

Gold Medal: Mastercard

In May 2006, Mastecard went public at $45 a share. I knew the company pretty well since we were shareholders of American Express since 1995 (although we have bought and sold the stock at a few occasions over the 14 year period). Mastercard is not as solid as Visa or AMEX but it is a good business that would do well as a newly independent entity. I knew that momentum was pretty good (because of their "priceless" ad campaign). And that margin expansion potential was high.

The stock looked a little high considering that the company earned $1.98 in 2005. But since I knew that margins could be improved, I should not have been too influenced by its high P/E.

I took the time to compare market shares, spending per card and profitabilites of all three most important card companies. I believed that AMEX had the best brand. But I also knew that Mastercard and Visa did not lend to consumers, as AMEX was. Mastercard and Visa were just transaction processors and that it was the banks that carried the loans on their books. The two companies just received a fee for their work. It is a pretty good economic model.

I considered reducing AMEX by half and acquire some shares of Mastercard. But I finally decided to keep all our shares of AMEX, believing the long term growth perspectives were better even if the sensibility to recessions was higher.

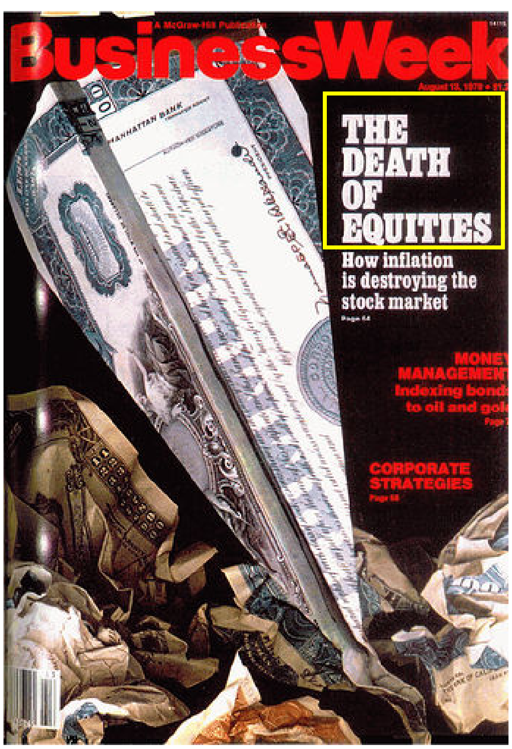
As noted above, today's recession has hurt AMEX a lot and the company had to increase its reserves for bad loans. Mastercard was immune to such charges. EPS in 2008 for Mastercard reached $9, a four and a half fold increase in three years. And the stock is up 200%.

Owning this stock in our portfolio would have been quite rewarding.

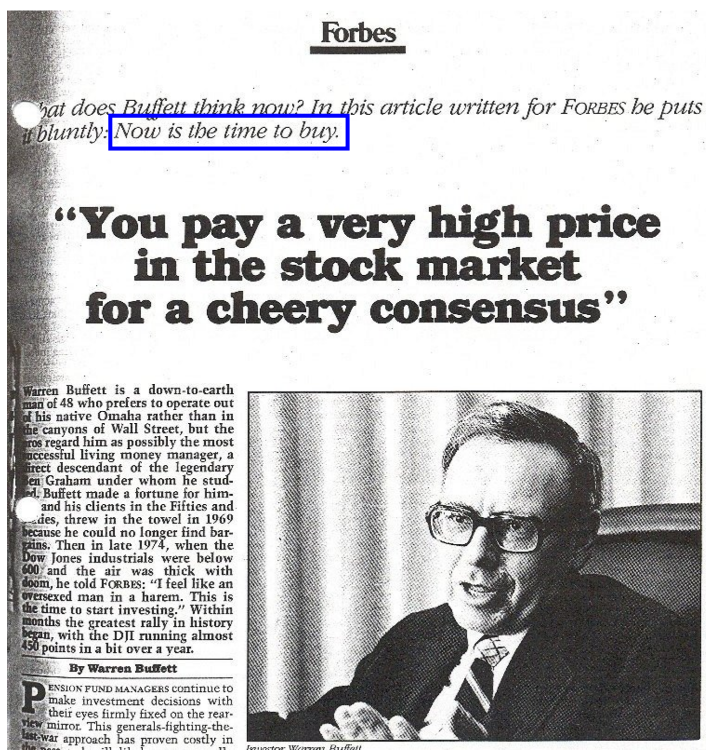
Conclusion : Warren Buffett recommends to buy stocks for the first time since 1979

By far, the best investor of all time is Warren Buffett. I have read everything I could find (past and present) about him. In only two instances in the past, Mr. Buffett had recommended to invest, with enthusiasm, in the stock market: in 1974 and 1979. Until this year.

In 1979, the stock market was depressed to a point that *Business Week* published its now famous edition entitled: "The Death of Equities". At about the same time, Warren Buffett published an article in *Forbes* entitled: "You pay a very high price in the stock market for a cheery consensus".



Source : Business Week (August 1979)


Forbes

...hat does Buffett think now? In this article written for FORBES he puts it bluntly: Now is the time to buy.

"You pay a very high price in the stock market for a cheery consensus"

Warren Buffett is a down-to-earth man of 48 who prefers to operate out of his native Omaha rather than in the canyons of Wall Street, but the pros regard him as possibly the most successful living money manager, a direct descendant of the legendary Ben Graham under whom he studied. Buffett made a fortune for him- and his clients in the Fifties and ...ies, threw in the towel in 1969 because he could no longer find bargains. Then in late 1974, when the Dow Jones industrials were below 600 and the air was thick with doom, he told FORBES: "I feel like an oversexed man in a harem. This is the time to start investing." Within months the greatest rally in history began, with the DJI running almost 450 points in a bit over a year.

By Warren Buffett

PENSION FUND MANAGERS continue to make investment decisions with their eyes firmly fixed on the rear-view mirror. This generals-fighting-the-last-war approach has proven costly in ...

Source : Forbes (August 1979)

In its 1979 article, Warren Buffett explained that it was not optimism but pessimism that was the friend of the true long term investor. That it is pessimism that creates the bargains in the stock market that lead to enrichment in the years to follow.

What has that market done in the following 10 years of these two articles (from 1979 to 1989)? A total return of 400% or 17% on an annual basis, one of the best decade in market's history!

Almost 30 years later, Warren Buffett wrote a similar article in the *New York Times* edition of October 17th 2008. He strongly urged investors that take advantage of the recession and the high level of fears that were (and still are) present in the stock market.

He was once again an aggressive buyer of stocks when others were selling!

To our partners

We are deeply aware of your vote of confidence in us and look forward to reward it in the years to come. It is imperative for us to not only select outstanding companies but also to have great stewardship in the managing of your capital. So we never let our emotions dictate our decisions, particularly during financial crisis.

We wish all of our partners a great year 2009.

François Rochon

François Rochon and the Giverny Capital team