Giverny Capital Inc.

Annual Letter to our Partners

2010

Barry Allikas
Fly-over, 2010
Giverny Capital Collection

For the year ending December 31st 2010, our portfolio's return was 16.1% versus 13.8% for our benchmark. Our return, including a loss of approximately 5% due to fluctuations in the Canadian currency, therefore outperformed our benchmark by 2.3%.

Since our inception, on July 1st 1993, our annual compounded rate of return has been 13.9% versus 7.1% for our weighed benchmark, or an annualized outperformance of 6.8% over this period. When we exclude the effect caused by the appreciating Canadian currency since our inception, which represents an annualized increase of 1.4%, our portfolio has returned 15.5% annually versus 8.5% for our benchmark. Our long-term (and ambitious) objective is to maintain an annual return that is 5% higher than our benchmark.

The Artwork on Our Letter

We have illustrated the cover of our letter with a copy of an artwork from our corporate collection since 2004. We chose the work of a Quebec artist, Barry Allikas, entitled "Fly-over". This work seemed fitting of the year 2010—a year when the companies in our portfolio continued to fly over much of the ambient doom and gloom and, as a group, generated record profits.

The Giverny Portfolio (in Canadian dollars): Returns Since July 1st 1993

Return *	Giverny	Index **	+ / -	$ US/Can	S&P 500	+ / -	Giverny ***	Indices ***	+ / -
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	**37.8%**	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	**-2.8%**	-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%**	-3.3%	1.5%	**10.0%**	**14.5%**	6.7%	7.8%
2006	**3.5%**	17.0%	**-13.5%**	0.2%	15.7%	**-12.1%**	**3.3%**	16.8%	-13.5%
2007	**-14.4%**	-11.6%	**-2.8%**	-14.9%	-10.0%	**-4.2%**	**-0.3%**	2.2%	-2.5%
2008	**-5.5%**	-22.0%	**16.5%**	22.9%	-22.2%	**16.7%**	**-21.5%**	-35.4%	13.9%
2009	**11.8%**	12.2%	**-0.4%**	-13.7%	9.6%	**2.2%**	**27.7%**	27.7%	0.1%
2010	**16.1%**	13.8%	**2.3%**	-5.3%	9.0%	**7./%**	**21.7%**	19.3%	2.5%
Total	**878.4%**	**232.8%**	**645.6%**	**-22.4%**	**205.3%**	**673.2%**	**1149.6%**	**320.5%**	**829.2%**
Annualized	**13.9%**	**7.1%**	**6.8%**	**-1.4%**	**6.6%**	**7.3%**	**15.5%**	**8.6%**	**7.0%**

* Green section: all returns are adjusted to Canadian dollars
** Index is a hybrid index (S&P/TSX, S&P 500, MSCI EAFE, Russell 2000) which reflects the weight of the underlying assets
*** Estimated without the effect of currency

Note: Canadian dollar returns audited by PricewaterhouseCoopers. See "notes on the returns" in the appendix.

The Giverny US Portfolio

We have been publishing the returns of the Giverny US Portfolio, which is entirely denominated in US dollars, since 2003. The Giverny US Portfolio corresponds to the American portion of the Giverny Portfolio. In 2010, the Giverny US Portfolio realized a return of 21.9% compared to 15.1% for our benchmark, the S&P 500. This return and our benchmark are all in US dollars and include dividends paid during the year.

Since its inception in 1993, the Giverny US Portfolio has returned 1002.0%, or 14.7% on an annualized basis. During this same period, the S&P 500 has returned 290.7%, or 8.1% on an annualized basis. Our added value has therefore been 6.6% annually.

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%	37.6%	17.2%
1996	27.0%	23.0%	4.1%
1997	32.9%	33.4%	-0.4%
1998	11.0%	28.6%	-17.6%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-9.1%	20.4%
2001	8.1%	-11.9%	20.0%
2002	-4.4%	-22.1%	17.7%
2003	31.6%	28.7%	2.9%
2004	9.3%	10.9%	-1.6%
2005	12.5%	4.9%	7.5%
2006	3.3%	15.8%	-12.4%
2007	-1.7%	5.5%	-7.2%
2008	-24.3%	-37.0%	12.7%
2009	28.7%	26.5%	2.3%
2010	21.9%	15.1%	6.9%
Total	1002.0%	290.7%	711.4%
Annualized	14.7%	8.1%	6.6%

Note: Returns audited by PricewaterhouseCoopers
S&P 500 returns provided by Standard & Poors. See “notes on the returns” in the appendix.

We outperformed the S&P 500 for a third consecutive year and the smaller companies in our portfolio led the way in 2010: Fastenal, Resmed, Bank of the Ozarks and O’Reilly Automotive. It is now the larger companies in our portfolio that seem undervalued—and therefore with the greater potential for future appreciation.

We believe that American blue chips, relative to other stocks, are now trading at the kinds of compelling valuations that we have not seen in decades. If you take a moment to reread our 1998 letter (available on our website), you will see how these valuations are the exact opposite of what occurred 12 years ago when large capitalization companies were much more expensive (and, of course, much more popular). The average P/E ratio for companies in this category have dwindled from 33x at that time to 11x currently.

Giverny Canada Portfolio

We introduced a portfolio that is 100% focused on Canadian equities in 2007. This corresponds closely to the Canadian portion of the Giverny Portfolio. In 2010, the Giverny Canada Portfolio returned 26.7% versus 17.6% for our benchmark (a blend of the S&P 500 and the TSX). Since 2007, the Giverny Canada Portfolio has returned 46.6%, or 10.0% on an annualized basis. During this same period, our benchmark had a gain of 15.3%, or a gain of 3.6% on an annualized basis. Our annual added value is therefore 6.4%.

Year	Giverny Canada	S&P/TSX	+/-
2007	19.7%	9.8%	9.9%
2008	-24.6%	-32.9%	8.3%
2009	28.2%	33.1%	-4.9%
2010	26.7%	17.6%	9.1%
Total	46.6%	15.3%	31.2%
Annualized	10.0%	3.6%	6.4%

Note: Returns audited by PricewaterhouseCoopers. See "notes on the returns" in the appendix.

Our Canadian stocks performed very well in 2010 and we have outperformed the TSX for three out of four years. The largest holding in our Canadian portfolio is MTY Food Group which rose approximately 50% for the year.

2010: A Year in Review

We finished our 2009 letter with the following sentence: "Despite a satisfactory year in 2009 as far as our returns, we believe that we are only at the beginning of a bull market that will last for years to come." The bull market began to take hold in 2010 as Western economies began to recover. GDP growth in North America for 2010 likely neared 2.6%, which is about 1% less than historical averages but still a clear sign that the recession is behind us.

It seems that the apocalyptic scenarios and predictions of another Great Depression have not materialized, and the civilization of free enterprise survived another financial crisis! Like is often the case, solid companies endured while weak ones were restructured or simply disappeared.

Plenty of problems remain, however. Canadian consumers remain overly indebted (their debt/revenue ratio reached a record of 150%), Western governments continued to stretch their borrowing capacities (in North America and Europe), and global competition has never been more intense. If this wasn't enough, governments are also interfering more and more with the business models of those rare enterprises that have succeeded at building wide competitive moats. For example, Visa/Mastercard, Google, and many medical products companies, were all subject to more governmental scrutiny in 2010. While these actions have generally been good for the popularity of politicians in the eyes of their electorate (something so ephemeral), this may not turn out to be ideal for neither the long-term wellbeing of a country nor for human progress. Allowing excellence to bear the fruits of its labor is the only way to encourage future excellence.

But our opinion, regardless whether it is justified, is secondary to our role as stewards of your capital—we are required to face life as it is. Humility, realism, and reason, provide bearing to navigate the difficult waters of the business world. And an unwavering confidence in human potential in the long term stands as a lighthouse guiding us towards our destination in the investing world—particularly when the storms are raging.

The loss of an investing legend: Roy Neuberger (1903-2010)

On December 24th, Roy Neuberger died at the age of 107. Mr. Neuberger was a Wall Street pioneer. He started his career in 1929, just a few months before the Crash. The stroke of genius of his youth was to sell short shares of one of the crowd's favorite stocks of this era: RCA (radio was the new technology of the time). Due to this transaction, he only lost 15% of his capital during the Crash and went on to cofound an investment management firm that became a titan in this industry: Neuberger Berman—which today has $180 billion under management.

Even well beyond the age of 100, Mr. Neuberger remained deeply passionate about the market. During the midst of the financial storm (in March 2009), he called Jeff Bolton—a Neuberger Berman executive—to his office. He told him: "Listen young man [Mr. Bolton was only 69], if you don't find a way to invest my cash, I'm going to find someone else to do it." Jeff Bolton, due to Mr. Neuberger, massively bought into the market at the bottom.

I was deeply struck by the first of two books written by Mr. Neuberger: "So Far, So Good: The First 94 Years". Although the market highs and lows are often described as bull markets or bear markets, Mr. Neuberger—with his unique sense of humor, liked to say that the market was most often a sheep market. According to him, most investors follow the crowd while as the same time attempting to predict the direction of the crowd.

Having lived through an incredible number of investing fads (like bowling alley companies in the 1950s) for a period of 80 years, he liked to say that it was wise to study the past and to become your own historian.


Bloomberg News
Mr. Neuberger in 2003

But my fondness of Mr. Neuberger also exists on another level. Aside from his passion for the market, he also had a great passion for art. He decided at age 25 that he wanted to become rich on Wall Street so that he could use his fortune to purchase works of art. He had the clairvoyance, for example, to purchase one of the earliest works by Jackson Pollock, as well as an extraordinary painting by Edward Hopper (Barber Shop, 1931). He was also a major patron of numerous burgeoning artists such as Milton Avery. In 1974, he opened his own museum at SUNY-Purchase with the help of the then governor of New York, Nelson Rockefeller (another great philanthropist). Art within the workspace was always an integral part of the culture at Neuberger Berman—something that continues to this day.

Owner's Earnings

We do not evaluate the quality of an investment based on short-term stock quotations, but instead, take the perspective of ownership in the companies in which we invest. As such, we analyze the growth in earnings for our companies and study their long-term prospect (see the appendix for a review of our investment philosophy).

Each year, we present to you a chart indicating the growth in the intrinsic value of the companies in our portfolio using a method created by Warren Buffett: owner's earnings. This enables us to estimate the intrinsic value of our companies by adding the growth in earnings per share and the average dividend yield of our portfolio.

In 2010, the aggregated intrinsic value of the companies in our portfolio rose 22%. The stock market value of our portfolio also rose 22% (without the effect of currency fluctuation)—in line with the growth in intrinsic value of the underlying companies. You will note that this is only the third year (out of 15) when the two experienced a similar annual performance. Market performance and corporate performance are rarely synchronized over the course of a calendar year. But as more time goes by, the synchronization between the two begins to affirm itself.

	Giverny			S&P 500		
Year * **	**Value ***	**Market ****	**Difference**	**Value ***	**Market ****	**Difference**
1996	14%	29%	15%	13%	23%	10%
1997	17%	35%	18%	11%	33%	22%
1998	11%	12%	1%	-1%	29%	30%
1999	16%	12%	-4%	17%	21%	4%
2000	19%	10%	-9%	9%	-9%	-18%
2001	-9%	10%	19%	-18%	-12%	6%
2002	19%	-2%	-21%	11%	-22%	-33%
2003	31%	34%	3%	15%	29%	14%
2004	21%	8%	-12%	21%	11%	-10%
2005	14%	15%	0%	13%	5%	-8%
2006	14%	3%	-11%	15%	16%	1%
2007	10%	0%	-10%	-4%	5%	9%
2008	-3%	-22%	-19%	-30%	-37%	-7%
2009	0%	28%	28%	3%	26%	23%
2010	22%	22%	0%	45%	15%	-30%
Total	493%	440%	-53%	162%	167%	5%
Annualized	13%	12%	-1%	7%	7%	0%

* Estimated growth in earnings plus dividend yield
** Market performance, inclusive of dividends
******* Results estimated without currency effects

For 2010, the growth in owner's earnings for the S&P 500 was higher than that of our portfolio companies. One must bear in mind that the profits of the S&P 500 had fallen much further during

2007-08. If we do a quick calculation of the profit growth at our companies since 2007, we can see that it has considerably outpaced the growth of the companies included in the S&P 500.

	Giverny			S&P 500		
Recession	**Value**	**Bourse**	**+/-**	**Value**	**Bourse**	**+/-**
2007-2010	**30%**	**22%**	**-8%**	**0%**	**-3%**	**-3%**

Since the beginning of 2007, our companies have grown their owner's earnings by 30% while the S&P 500 experience 0% growth in its owner's earnings. The value of our companies on the stock market rose 22% (without currency effect) while the value of the S&P 500 lost 3%. The businesses that make up our portfolio, in aggregate, not only made it through the recession but were also able to increase their market share and increase their profitability.

When we look at it from a longer term perspective (since 1996), our companies have increased their intrinsic value by 493% according to our estimates—a factor of nearly 6 times—while the market value of these companies increased by 440% (without the effect of currency). During this same period, the companies in the S&P 500 saw their intrinsic values rise by 162% while their market values rose by 167%. Despite the economic highs and lows, in the long term, the market prices of companies approximately follow the growth in owner's earnings of its underlying business.

Our stock holdings have outperformed the S&P 500 by 5% annually for the simple reason that the underlying companies in our portfolio have increased their intrinsic value at a rate that is 5% greater than the average. It is in this manner—rather than by speculating on the market—that we anticipate continuing to meet our objective of adding value to your (and our) capital.

The flavor of the day for 2010: Gold

We've discussed the current popularity of gold on a few occasions over the course of the last years. We recently echoed a commentary from Warren Buffett on this topic. Gold seems a tenacious relic from another era—from a time when indefinite and successive warfare would make it impossible to have an effective currency without the mutual reference point of a precious metal.

Until very recently, for example, Canadian coins represented their fair value in silver. The five cents coins were twice as small as dimes (though during the 1920s, nickel was used to make the five cents coins larger since too many people were losing them).

Today, there exists a stability in our financial systems (especially when compared to prior centuries) and the need for currency to have their equivalent value in a precious metal is obsolete. The price of most commodities (wheat, copper, nickel, steel, etc) generally follows inflation rates. Actually, historical commodity prices (as represented by the CRB index) have failed to keep up with inflation by about 1% annually. The reason is simple: human ingenuity has made the extraction of these products more and more efficient.

At its current high of $1400 an ounce, gold prices are 74 times higher than they were 100 years ago—an annual return of 4.3% versus for 3.3% for inflation. So gold has slightly outperformed inflation over this period (though if we used gold prices from 5 years ago, we would have a return equal to inflation). It is worth noting that stocks have returned 1,300,000% over the same 100 years—approximately 200 times better than the performance of gold. An unequivocal truth stems from taking an historical perspective: in the long term, gold has not been a better investment than stocks and barely outperforms Treasuries. Once inflation is taken into consideration, the source of wealth creation has been stocks.

There is a certain logic to all of this. The activity of lending money to governments does not create wealth. Owning a few kilograms of a yellow metal in a safe doesn't either. Businesses create products that meet the needs of consumers, new technological tools that improve our lives, new medicines that allow us to live longer, and services that help us better manage our activities. And we must admit that the capacity of businesses to develop new ways of entertaining us seems without limit. To own an economic participation in these businesses is an authentic source of wealth creation. And the long-term performance numbers adequately illustrate this.

But this doesn't prevent people from speculating on gold these days. The most often invoked reason behind the rise of gold prices is the loss of confidence in our capitalist system. No one knows the future (regardless of what "they" say) but, historically, betting against the progress of humanity and the improvement of our standard of living as always been a losing proposition. The desire to progress and build a better life for ourselves is bound within the genes of a human being. I believe that those who speculate on gold will eventually lose capital—or as a better outcome, hold on to an asset that will standstill for several years. Nothing gets built in the long term with pessimism.

I would be remiss to not share with you a quote from Charlie Munger, Warren Buffett's longtime partner:

> "I don't have the slightest interest in gold. I like to understand what works and what doesn't in human systems. To me that's not optional; that's a moral obligation. If you're capable of understanding the world, you have a moral obligation to become rational. And I don't see how you become rational hoarding gold."

The American and Canadian markets

This discussion on gold would not be complete without mentioning the Canadian stock market. In late 2010, about 14% of the TSX was comprised of gold stocks. This almost suggests that one in seven jobs in Canada is linked to gold extraction! Canada only produces three million ounces of gold annually, so at $1400 an ounces, this equals about $4.2 billion in annual revenue—or about 0.3% of Canadian Gross Domestic Product (GDP). Now it is true that large gold companies carry out the majority of their extraction activities outside of Canada, but the disparity between the economic weight and the value assigned by the stock market to these activities remains fascinating.

If we look at the Canadian stock market at its current level, it is 158% of its GDP (based on a currency constant with purchasing power parity). For the US market, the figure would be 103% which is much more in line with historical levels. One should note that approximately 25% of Canadian GDP is exported (three quarters of that going to the US), though this is also the case for American companies which export about a quarter of their revenue.

This disparity between Canadian and US markets is partly due to an overvaluation of the Canadian dollar by about 20% (the OECD estimates the fair value of purchasing power parity of the loonie to be $ 0.82). The other source of disparity is linked to the slightly higher P/E ratios for the Canadian market.

As always, we remain agnostic vis-à-vis fluctuations in the markets, the economy and currency levels. Our work, however, is to compare the relative valuations of the securities we can acquire. From this perspective, we believe that in the years to come, the 55% disparity between the two stock markets will diminish and that the Canadian market is at risk of underperforming its American counterpart.

This doesn't prevent us from finding terrific Canadian companies. In the last years, in fact, we have acquired three young and exceptional Quebec companies: MTY Food Group, Dollarama and 5N Plus (see the next section for more details).

Our companies

"To open a shop is easy, to keep it open is an art"

- Chinese proverb

Our companies, as a group, had an excellent year in 2010. While many of our companies reached record profits, even more important is the fact that many of them continued to widen their competitive moats relative to their competitors.

Wells Fargo (WFC, $31)

Wells Fargo had an excellent year, with adjusted earnings per share (EPS) of $2.54—an increase of 45% compared to 2009. Its balance sheet continued to improve with its equity ratio rising from 6.5% to 8.3% over the year. EPS for 2010 was actually better than EPS from 2006, before the crisis began. Assets have grown from $482 billion to $1,227 billion in four years (an increase of 155%). This growth was achieved by issuing an additional 55% of its shares outstanding (following the acquisition of Wachovia). Thereby, assets per share rose 64% during the worst period of the US banking sector since the Great Depression.

Return on assets (ROA) was 1.09% in 2010, compared for 1.76% in 2006. The earning power of Wells Fargo is therefore far from its peak. Our estimate is that in 2015, Wells Fargo could have assets of $1,800 billion and have an ROA of 1.5%. This would result in an EPS of $5.25—so shares in Wells Fargo seem bright with potential. We took advantage of the stock dropping to $23 last fall (for no reason) and increased our holding.

Bank of the Ozarks (OZRK, $43)

Our small bank from Little Rock (Arkansas) avoided, this year again, the slump that marred much of the US banking industry. Even better, Bank of the Ozarks benefited from the misfortunes of competitors and was able to be very active on the acquisition front during 2010. Why open new branches and raise new assets at great marketing costs when it's possible to acquire those of competitors at a fraction of the price? With the help of the Federal Deposit Insurance Corporation (FDIC), Bank of the Ozarks was able to get its hands on five struggling banks in a year. Here is a list of acquisitions with their respective asset bases:

- Unity National Bank of Cartersville (Georgia) in March ($295m)
- Woodlands Bank of Bluffton (South Carolina) in July ($390m)
- Horizon Bank of Bradenton (Florida) in September ($170m)

- Chestatee State Bank of Dawsonville (Georgia) in December ($240m)
- Oglethorpe Bank of Brunswick (Georgia) in January 2011 ($210m)

In short, Bank of the Ozarks was able to increase its asset base by $1.3 billion, an increase of 47% of its assets. Already in 2010, EPS blasted ahead from $2.18 to $3.75. Although certain components of this current level of profitability are not recurring in nature, we anticipate that the earning power per share for 2011 will be more than $3. The stock, therefore, still seems to us to be trading at a reasonable valuation.

M&T Bank (MTB, $87)

Like Wells Fargo and Bank of the Ozarks, M&T Bank has excellent year in 2010, with EPS rising 65% to $5.84. Charges related to bad debts dropped from 1.01% in 2009 to .67% in 2010, and ROA rose from .71% to 1.17%. Return on equity reached 19%.

M&T also made a significant acquisition towards the end of the year: Wilmington Trust. Wilmington Trust is the dominant bank in Delaware, with 23% of the market. This bank has $10 billion in assets—enabling M&T to increase its asset base by 15%. M&T paid $350 million for Wilmington Trust and assumed $330 million in loans from the government under the TARP program. This acquisition cost corresponds to only 7% of the market capitalization of M&T Bank.

M&T Bank is a truly exceptional bank. The bank has been profitable for 138 quarters in a row and, since Robert Wilmers took the helm in 1983, EPS has grown at an annual rate of 15% (for a total compounded growth of 4300%). During the crisis, M&T was the only bank in the S&P 500 to neither reduce its dividend nor issue equity.

Omnicom (OMC, $46)

The global economic recovery helped Omnicom improve its profitability in 2010. Revenues climbed 7% and EPS rose by 8%. We estimate that Omnicom will reach its pre-crisis profitability level in 2011. The stock has risen 80% since our purchase in 2008 but still trades at only 14 times its profit anticipated for 2011. This seems a reasonable ratio for a company that has strong returns on equity, offers a vital service for other businesses, dominates its industry and has a strong presence in numerous countries.

Berkshire Hathaway (BRK.B, $80)

Berkshire Hathaway and its legendary president, Warren Buffett, continued to reap the fruits of its investments from 2008-2009. All in all, Mr. Buffett invested more than $50 billion during the crisis, half in equity/debt instruments and the other half for the acquisition of Burlington Northern Santa Fe (see our 2009 Annual Letter). His investments in Goldman Sachs, GE and Swiss Re created very considerable wealth for Berkshire shareholders. BNSF had an outstanding year and it’s already apparent that Mr. Buffett proved highly opportunistic in his acquisition from the year before.

Shares in Berkshire rose approximately 20% in 2010. Still, when looking at the company from a longer term perspective, the stock has failed to follow the growth in intrinsic value of the underlying company. According to our estimates, we consider the intrinsic value of Berkshire to be 30% higher than what it was before the crisis—meaning approximately $130 to $140 per share. We therefore continue to have a significant allocation of our portfolios to this company.

Microsoft (MSFT, $28)

Microsoft had an excellent 2010, with the migration towards Windows 7 leading the way. The company has already sold 300 million licenses for this operating system and Windows 7 is now installed on about 20% of PCs. On the entertainment front, the company's new gadget for its Xbox console, the Kinect sensor, has been a great success: the company sold no less than 8 million of them in 60 days! Always looking to work for the benefit of our partners, I tried the Kinect during the holidays (watching me waddle in front of the television, I couldn't help to think that the process of fundamental research has evolved over the years).

For the last twelve months ending in December, EPS at Microsoft rose by 25%. This growth in intrinsic value has yet to be reflected in the company's stock price, with its price finishing the year right around where it started. From another perspective, however, the company continued to benefit from the undervaluation of its shares by buying back some of its own shares. During the last quarter alone, Microsoft bought back $5 billion of its own shares. This stock seems a bargain to us.

Resmed (RMD, $35)

It's been six years since we first acquired shares in an exceptional Australian company: Resmed. The company is the global leader in medical equipment for sleep disorders (sleep apnea, etc). Resmed has tripled its profitability since we first acquired it and, in 2010, its EPS grew by 26%. The company is highly profitable, with net income of roughly $220 million on $1.8 billion in assets (with $600 million of those assets being in cash with no debt on its balance sheet). Resmed's stock price has followed its growth in earnings since 2004—climbing 200%.

Despite its rapid growth, problems with sleep apnea remain largely unknown, with a small percentage of those suffering from it actually being diagnosed. The company continues to work to increase awareness of this medical condition.

5N Plus (VNP-T, $7)

5N Plus, a young and dynamic Quebec company, is one of the worldwide leaders in the purification of metals needed to build photovoltaic solar panels. Its primary product is cadmium telluride used by companies like First Solar. Solar panels based on CdTe are gaining market share since they are more economical to manufacture than those based on silicon.

5N Plus experienced a difficult first half of the year with profits declining. The company's renewal contract with First Solar—its largest client— lowered margins but increased future volume commitments from First Solar. 5N Plus, however, did post very positive numbers for its latest quarter with a return to high growth and a rapid increase in its backlog.

Solar energy is not an easy industry to analyze and forecast. Still, we consider 5N Plus to possess durable competitive advantages and, more importantly, to be led by a CEO we greatly admire and trust.

O'Reilly Automotive (ORLY, $60)

O'Reilly had a fabulous 2010. EPS increased 35% due to improved same-store sales (+8.8%) and a successful integration of its CSK Auto acquisition from late 2007. This increase in EPS is not cyclical in nature, with 2010 EPS roughly doubling from 2006 EPS. We first bought shares in O'Reilly in the summer of 2004. Since then, EPS has tripled and the stock price has followed suit (though not necessarily in a linear fashion), as depicted by this stock chart:

O'Reilly Auto 2004-2010 (Source: Bigcharts.com)

American Express (AXP, $43)

After two difficult years, Amex has returned to growth and profitability in 2010. Revenues increased by 13% and EPS reached $ 3.41—121% higher than in 2009 and higher than the 2007 EPS of $3.37 (the year before the start of the financial crisis).

Amex is the only company issuing fully integrated credit cards, meaning that they assume all of the following roles: banker, transaction provider, and card issuer. Its competitors are not only Visa and MasterCard but also banks like JP Morgan and Bank of America. On the banking side, Amex gained market share during the crisis. In 2010, the growth in transactions at Amex was 15%, versus 5% and 3% for JPM and BoA, respectively. The rate of bad loans in 2010 was also much lower than its competitors (approximately 5% versus 8% for JPM and BoA).

The company reiterated its goal to grow EPS by 12-15% annually. Although the crisis marked a "pause" in this noble and ambitious goal, we are confident that Amex will continue to grow its intrinsic value at a rate greater than the average. With this in mind, the current P/E ratio of Amex stock (12x) vis-à-vis the P/E of the S&P 500 (14x) seems unjustified.

Astral Media (ACM.A-T, $42)

Revenues at Astral Media rose 6% in 2010 while EPS rose by 12%. This growth in EPS for 2010 comes after 5% growth in 2009 and 10% growth in 2008. The television division experienced another year of robust growth with profits rising 12%, while radio (-4%) and outdoor advertising (-1%) were more stagnant. Astral is a high quality Quebec company with stable growth rates and, to this day, has more or less, been sheltered from economic cycles. It seems to us that this solid business deserves a higher P/E than its current P/E of 12x.

China Fire & Security Group (CFSG, $7)

It was a difficult year for CFSG. This young Chinese company (founded in 1995) dominates a niche market: fire prevention and detection systems used in industrial settings. Steel production in China, the primary market for CFSG's products, slowed in 2010—thus impacting the company's sales. We were used to CFSG growing at 40% annually. But EPS were down by 40% for 2010, at $0.52, though everything had been indicating a potential 50% growth at the beginning of the year (they had an impressive backlog). The stock therefore dropped by half.

It seems premature to us to conclude that the company's problems are permanent rather than temporary but we continue to follow the situation closely.

Mohawk Industries (MHK, $57)

Mohawk sells floor covering products (carpets, tiles, hardwood floors, etc). The company has remained profitable despite the severe impact of the recession on this industry. There was a 38% improvement in the level of profitability in 2010 versus 2009 (measured by adjusted earnings).

Though currently depressed, we believe that a turnaround is near for the residential construction industry. The good news is that there are a million new households created each year in the United States and buying a home there has rarely been so affordable. We anticipate that in a normalized environment, Mohawk should earn $8 in EPS—meaning that the current stock has excellent potential for appreciation.

Fastenal (FAST, $60)

Fastenal had an exceptional year, with sales growing 18% and EPS rising by 45%. The company opened 127 new stores (an increase of 5.4%) and continued to benefit from the recession by widening its competitive moat relative to competitors. Revenue has risen from $2.1 billion to $2.3 billion since the end of 2007—Fastenal has increased its revenue by 10% during the recession. As for EPS, they grew 16% in three years.

2011 is off to a good start, with 19% annual sales growth in January with 11% growth in employees. Fastenal is truly a well-oiled machine.

We bought Fastenal 12 years ago (during the Asian crisis) and the stock has gone up tenfold since then. We continue to believe, however, that the company has many great years of growth in its future and we are holding on to our shares.

Knight Transportation (KNX, $19)

Our trucking company based in Phoenix (AZ) had a strong year. Revenues climbed 12% while EPS rose 20%. Knight continued to take market share within an industry that was devastated by the recession (2000 companies disappeared!) The company's operating cost ratio decreased from 85.7% to 84.5% and Knight's cost structure is about 10% less than the average for the industry (in other words, profit margins are twice the industry average).

The company rewarded us at the end of the year with a special dividend of $0.75 (a yield of about 4% at the time). Since the company's stock seems appropriately valued by the market, we have reduced the weight of this holding in our portfolio during the last couple of years. Knight once commanded a much greater allocation in our portfolio but we continue to believe that the company is exceptionally solid.

Medtronic (MDT, $37)

Medtronic, one of the largest medical manufacturing equipment companies in the world, experienced flat sales in 2010. EPS rose 8% which is acceptable but not spectacular. The CEO, William Hawkins, also announced that he would leave the company next spring and it is too early to know his successor's game plan for revitalizing growth. He will have to juggle, among many other things, the health care reform in the US.

This multinational company is an industry leader and its stock seems extremely undervalued by the market, trading at about 11 times earnings.

Carmax (KMX, $32)

Carmax broke all profitability records in 2010. This company, which primarily sells used cars, grew EPS by 43%. The crisis of 2008-09 was particularly harsh for the auto industry, but Carmax emerged stronger and is now 80% more profitable than before the recession!

We were not rewarded immediately though we acquired this stock in 2007 at about $21. During its low of November 2008, Carmax was trading at $7. But our patience has paid off and we believe that Carmax has a very bright future. Still, we should have bought more stock during that low had we had foresight in addition to patience.

MTY Food Group (MTY-T, $14)

MTY Food has been our largest Canadian investment for a few years already. The company has become the Canadian leader in restaurant franchises (with over 1700)—mainly located in food courts. MTY has achieved excellent growth in its number of restaurants, revenues and earnings. The company's EPS (adjusted for the amortization of intangible assets) reached $0.91 which is an increase of 23% from 2009 and 78% from 2007 (when we became shareholders). The company became listed on the Toronto Stock Exchange during the spring and also announced the acquisition of Valentine in August. Lastly, MTY acquired a food factory at the end of the year to become more vertically integrated.

During the year, we also met again with Stanley Ma, the CEO of MTY Food. We remained confident after our meeting that MTY remains in good hands and continues to have excellent growth prospects.

<u>Sales of 2010</u>

We sold our shares in Martin Marietta and Morningstar during the year. We deemed each of these stocks to be less undervalued than others and decided to sell them. We continue to believe that these two companies are excellent businesses.

Nitori

We sold our shares in Nitori in early 2011. We initially bought this superb Japanese retailer in June of 2007 at around ¥6000. One of our reasons for our purchase was the weakness of the Yen—we believed the Yen to be undervalued by about 20% at the time, partly due to the "carry trade" where Japanese bonds were sold short in large quantities.[1] Since Nitori was buying most of its inventory from China (where the currency is tied to the US dollar) and then reselling it within Japan, an increase in the value of the yen would have had a very positive impact on the company's gross margins. Nitori also seemed well managed and had strong sales growth (around 15-17% annually).

We sold for two reasons. The most important was that sales growth had slowed during its latest quarters, to around 10% annually. This was a very acceptable rate but not the strong growth of prior years. Profits had grown even more rapidly, thanks to an increasing in margins from an appreciation of the Yen. The level of the Yen (and therefore the company's margins) now seemed difficult to sustain going forward—meaning that we anticipated EPS growth to dip below 10%.

The second reason for selling was due to the higher level of the Yen relative to the US dollar. The Yen had gained 50% in three and half years against the US dollar. Even relative to the strong Canadian dollar, the Yen rose by 33%. We locked in a 65% gain on our Nitori holding from 2007 and, due to the high level of both the company's stock and the Yen, we were confident that prospects for future returns were better elsewhere.

New investments for 2010

Dollarama (DOL-T, $29)

We discussed our purchase of Dollarama in our letter from the first quarter of 2010. We have always been admirers of its founder, Larry Rossy, and we were very disappointed when the company agreed to be acquired by a private equity fund (Bain Capital) in 2004 instead of having an initial public offering (IPO). The company then resurfaced on our radar screen when it announced an IPO in late 2009.

Dollarama is, by a wide margin, the leader in "dollar stores" (though many items are more expensive) in Canada, with over 620 stores across the country. Despite its dominance, we anticipate that there is still significant growth potential for this company. The penetration rate of dollar stores in Canada, for example, is about half of the rate of the US.

In its first year as a public company, sales at Dollarama jumped 14% and same store sales grew by 8%. EPS came in at $1.65. Based on its current price, the stock trades at about 15 times expected 2011 profits—this seems very reasonable.

Visa (V, $71)

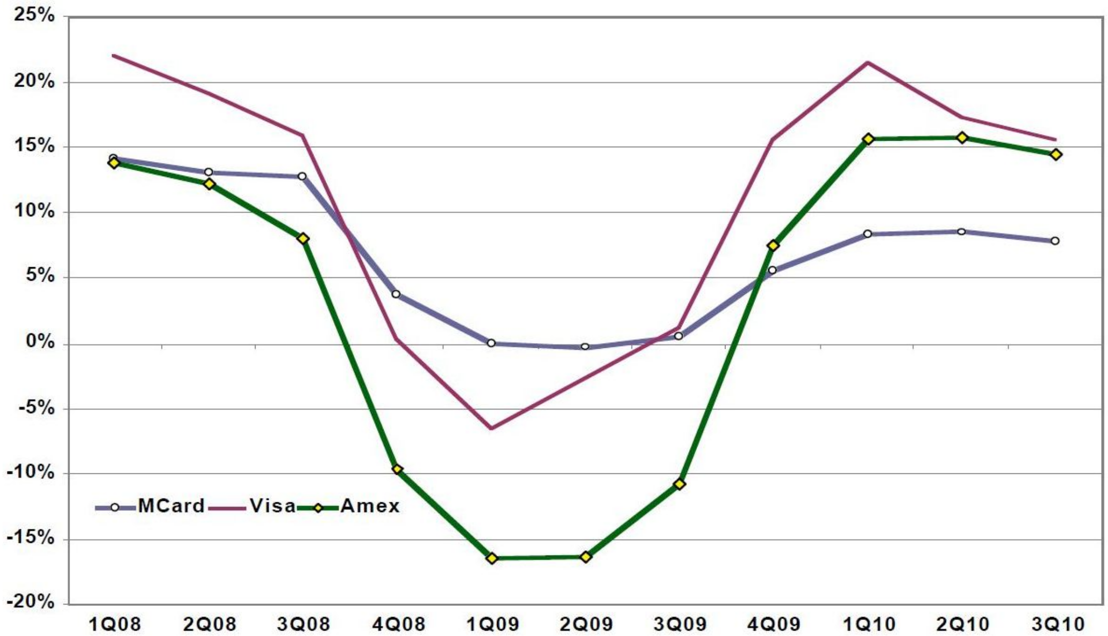
We like companies in the credit card industry, dominated by Amex, Visa and MasterCard. Our interest is nothing new: we first purchased shares of American Express in 1995. In 2006, MasterCard had its IPO and were able to see firsthand the remarkable profitability of these companies (a triopoly is just a little less than a duopoly).

It's been 30 years since an excellent book was published on investment: The Money Masters (by John

[1] Financial transaction that exploits interest rate differentials between different currencies. The idea behind the *carry trade* is to borrow (and/or by selling short) in a currency from a country where interest rates are low and to invest these borrowed funds in another currency where interest rates are high.

Train). Warren Buffett, then totally unknown, was interviewed. Something he said always stuck in my mind: "The best types of businesses to be acquired are those which have the equivalent of a royalty on the growth of others." We believe that this applies to credit card companies.

Visa finally became a public company in 2008 and we were determined to follow this company closely. Shares shot up from $60 to $90 while EPS was only $2.47. We unfortunately couldn't say that this was an attractive P/E ratio. Two years later, however, the situation was different. The company had shown great resilience during the crisis (see chart below) and EPS reached $4.22 in 2010—an increase of 72% in two years. Meanwhile, the stock had dropped from a high of $97 to $70 during the second half of 2010.



Growth rates of the three credit card companies 2008-2010 (Source : Argus Research)

Visa is the leader in terms of both market share and technological innovation (nothing against MasterCard and Amex). Visa's balance sheet is immaculate, with no debt and $3.5 billion in cash ($5 per share). So, we are paying $66 for about $5 in estimated EPS for 2011—about 13 times profits. The company is taking advantage of its stock valuation by buying back some of its own shares.

A company like Visa, however, doesn't see the value of its shares drop by 25% for no reason. The American senator, Dick Durbin, proposed a legislative amendment regarding transaction fees charged for debit cards. He is spearheading this movement (as though the banks won't be able to find other fees to strike back). In my humble opinion, Mr. Durbin would have another opinion towards all of this if he came to Canada to see if the higher regulatory environment here ever helped lower banking fees for consumers...

Regardless, it is therefore highly likely that the profits for Visa in 2012 will be 10% lower than what we initially anticipated. So, instead of earning almost $6 per share, we have lowered our estimate to $5.40. A P/E of 20x for this business seems totally justified in our opinion, even given the political risk, and we view this stock as undervalued at its current price.

Five-year Post-mortem: 2005

Like we do every year, we go through a five-year port-mortem analysis. We believe that studying our decisions in a systematic manner, and with some hindsight, enables us to learn from both our achievements and our errors. In 2005, we had acquired shares in two extremely high quality American companies: Wal-Mart and Disney.

Wal-Mart (WMT, $54)

We acquired shares in Wal-Mart in March of 2005 for about $50, which was equivalent to 18 times its profit at the time (the same P/E as the market back then). We had anticipated annual EPS growth of 12% which meant that the stock deserved its valuation—even a premium to the S&P.

From 2005 to 2010, EPS grew at 9% annually (including 11% in 2010). This compares favorably to the 2% annually earned by the S&P 500 over the same period. The company has outperformed the vast majority of businesses during very difficult economic times. But this 9% growth translated itself into only 2% growth in the company's stock value. The P/E is lower today than it was in 2005—it now has a discount of 12% relative to the market.

This has not been a very rewarding investment since, including dividends, our total annual return has been approximately 4%. In hindsight, we should have been more conservative with our growth expectations and/or allowed ourselves to have a greater margin of safety at the time of purchase.

But we must look ahead. If the company continues to grow at annual rates of 9% and adds a dividend of 2%, we're talking about an annual return of 11% in the intrinsic value of the company. And if the P/E ratio rises, at last, to a more reasonable level, then we could have a return in line with our objectives. For example, if by 2015, the P/E rises from 13x to 17x, the return on the stock would be around 16% annually from today onward.

Disney (DIS, $38)

Disney grew its EPS by 19% this year to $2.28 ($2.07 for the fiscal year ending in September). This is a record profit for Disney and represents a 71% increase (11% annualized) since we became shareholders again in September 2005—the day when Bob Iger became CEO. There are few leaders we admire as much.

Disney had several blockbusters in 2010. "Toy Story 3" broke sales records at the box office for animated films and "Alice in Wonderland" crossed the billion dollar mark at the box office.

"Alice in Wonderland" was a remake of an animated film from 1951 which was, at that time, a huge success for Disney. The modern version of the Tim Burton remake of this film was a great cinematographic achievement for Disney and, once again, the company greatly benefited from this film. Disney's business model is truly extraordinary. A movie like "Alice in Wonderland" is a little like having a giant oil well and pumping out all of its content… and then finding this well again 60 years later and pumping out even more oil, without any additional maintenance or extraction costs. The stars at Disney, like Mickey Mouse and Alice, are also immortal—without the need for capital and especially WITHOUT AN AGENT.

Few people know that "Alice in Wonderland" wasn't the second version of this film for Disney, but its third. At the age of 20, in 1922, Walt Disney had launched his first animated film business: Laugh-O-Gram Studio. In 1923, he went on to create a film based on the Lewis Carroll classic, but the company went bankrupt during that year and the production of this film was halted.

But Disney was a difficult man to discourage. He started a new animation studio and created his first star: "Oswalt the Lucky Rabbit" in 1927. His distributor in New York decided to continue the Oswalt series without Disney, taking with him the character and much of Disney's staff. Returning from New York on the train, back to square one, Disney drafted out a new character—a mouse. Disney's initial idea was to call the mouse "Mortimer" until his wife said: "why not Mickey?"

In 2006, the Walt Disney Company acquired all the rights to the character of Oswalt, then property of NBC Universal. No less than 78 years after Disney had created him.

Walt Disney was not only a fearless visionary but also a man with unmatched tenacity. Without the latter, we would have never heard of the former.

Mistake "du jour"

"Only those who are asleep make no mistakes"

- Ingvar Kamprad (founder of IKEA)

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2010. It is with a constructive attitude, in order to always become better investors, that we provide this detailed analysis. As is often the case with stocks, errors from omission (non-purchases) are often more costly than errors from commission (purchases). This year's list gave me shivers.

Bronze Medal: Coach

We bought a small amount of stock in Coach, the famous maker of luxury handbags, three years ago. It is not quite Louis Vuitton or Dolce & Gabbana but still a very solid brand. Coach is also very popular in Asia where the company has experienced rapid growth.

In 2007, while I was in Omaha for the Berkshire Hathaway shareholder meeting, I asked my girlfriend what I could bring back for her as a souvenir (I had in mind a pink Warren Buffett t-shirt or a box of

See's Candies). She answered, with enthusiasm, that she wanted a small bag from Coach (I had told her that I had visited a store as part of my research process). This is when I realized how many women held this brand in high regard.

Upon reading their annual report, I realized that Coach had impressive growth rates, along with exceptional profitability and a shareholder-friendly management team.

The company had belonged to Sara Lee for a number of years. In a restructuring of its finances in 2000, Sara Lee decided to distribute its ownership in Coach to its shareholders. As is often the case, this enabled the newly-independent Coach to considerably improve its profitability. In 2007, the stock had dropped from $51 to $35 and the company was trading at 15 times its profits, while companies such as Burberry, PPR (owner of Gucci) and LVMH (Louis Vuitton), were all trading at 20 times their earnings. Given the strength of these brands, such valuations were justified. But I would have preferred a better valuation so I only bought a small position in Coach, thinking that I might have a better valuation down the road…

And I had my chance. During the financial crisis, at its low, the stock had tumbled to $12. The company had $800 million in cash—equivalent to $2.50 per share. The stock market was effectively assigning a valuation of $9.50 per share for the business—and the company was still earning around $2 per share. We could buy one of the world greatest brands for five times its profit!!! But, worried that the recession would further hit the luxury goods industry, I passed on my chance. Even worse, when the stock bounced off its lows, I sold our few shares.

Today, the stock is trading at $54. Given that the Coach should earn $3 per share this year and that it has $3 per share in cash, the current valuation is still reasonable. Imagine it at $12.

Silver Medal: Google

Google went public in 2004 at $85 a share. We were naturally skeptical at the company's ability to continue dominating the search business on the Internet—a universe which historically evolved so quickly with market leaders changing just as quickly. Further, the stock was trading at about 50 times its profits at the time. We were, however, very impressed by the Shareholder Manual that that had been written by the company (inspired by the one written by Warren Buffett for Berkshire Hathaway). Google was definitely on our radar screen.

In 2005, when the stock was trading at $280, I was interviewed by La Presse and asked about Google. I actually described the company as a "Miracle of Capitalism" (difficult to have been more enthusiastic!) But I was not consistent in carrying out this admiration for Google into actually buying shares in the company. The stock continued to climb, reaching $700 in 2007.

During the big dip of 2008-09, the stock dropped to less than $300. At the time, the stock was trading at 15 times its profits. We decided to slowly begin buying shares in Google. The stock then quickly bounced back to $600.

The rise in the price of Google is totally justified. The company has become almost immovable in its leading position in the web search market (its moat is as big as it comes). YouTube is a worldwide success and its Smartphone operating system, Android, is a blockbuster. The company's EPS has grown from $1.50 in 2004 to more than $25 in 2010. Moreover, the company has accumulated $33 billion in cash in just a few years.

During the summer of 2010, the stock fell to $450 for no apparent reason—corresponding to a P/E of 15x. Jean-Philippe Bouchard, Vice-President at Giverny Capital, pleaded with me to wake up and buy shares in this unique business. But I wanted an even better prices and I decided to wait. The stock almost immediately bounced back to $600.

Gold Medal: Intuitive Surgical

About five years ago, my longtime friend Bernard Mooney talked to me about a company making revolutionary medical products: Intuitive Surgical (IS). IS had invented a robotic surgery system called "Da Vinci". This robotic system converted the movements of a surgeon into micro movements by the robotic tools inside a patient. In a few years, revenues at IS surged from $100 million to $1 billion. The beauty of the system is that the company earns more revenue from specialized accessories than from the robot itself (similar to Gillette with its razor blades). In fact, each surgery costs about $2000 in accessories. The company has little competition and its products have quickly become very popular with surgeons in a number of different specialties (such as prostate surgeries and hysterectomies).

Such innovative companies, with outstanding profitability and excellent growth prospects, seldom trade at bargain prices. Despite this, I followed this business closely. During the crisis of 2008-09, the stock dropped from a high of $350 in 2008 to a low of $85 at the beginning of 2009. The company had no debt and roughly $13 per share in cash, and had earnings per share in excess of $5. So, it was possible to buy one of the most promising businesses in the universe of stocks that we follow for about 14 times its profits. I bought a small starting position and waited for a better price (are you started to see a trend?)

After a quarter of lower profits, growth has come back with a vengeance. In 2010, revenues grew by 60% relative to 2008. EPS has climbed from $5 to almost $9 in two years. And the stock has quadrupled, reaching $345.

We should have bought shares in this company: we had front row seats and fully understood its business and the strengths of its model.

What is the lesson from our 2008-2009 errors?

Of course, many other stocks aside from Google and Intuitive Surgical were just as undervalued during the bottom of March 2009. We were fully invested since there was no shortage of bargains. In order to buy Google, we would have had to sell another stock—most likely one that was also undervalued.

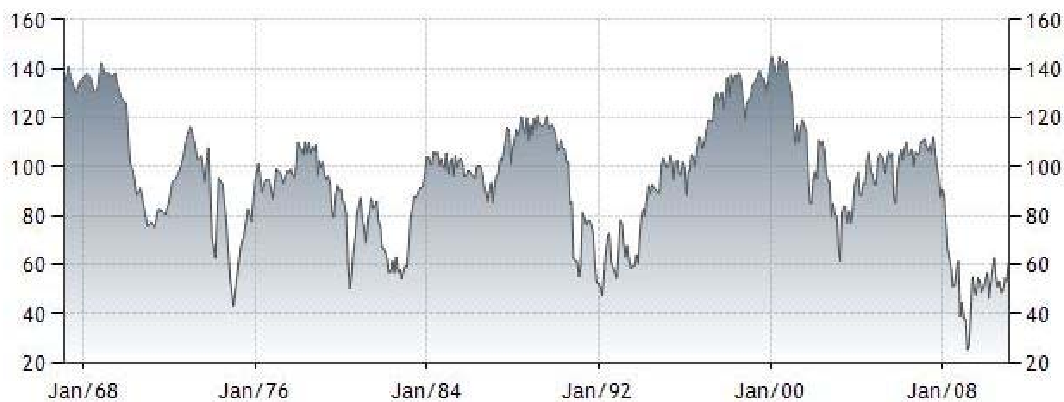
We did, however, have more conservative holdings in our portfolio, such as Wal-Mart, Procter & Gamble and Johnson & Johnson, that had not decline as much as the market. Relative to other stocks, these holdings were less undervalued and should have been sold. We would have certainly added several percentage points of performance to our returns for 2009 and 2010.

The conclusion: one should not hesitate to sell stocks trading at 60 cents to the dollar to buy stocks trading a 40 cents to the dollar!

Conclusion: the wall of fear

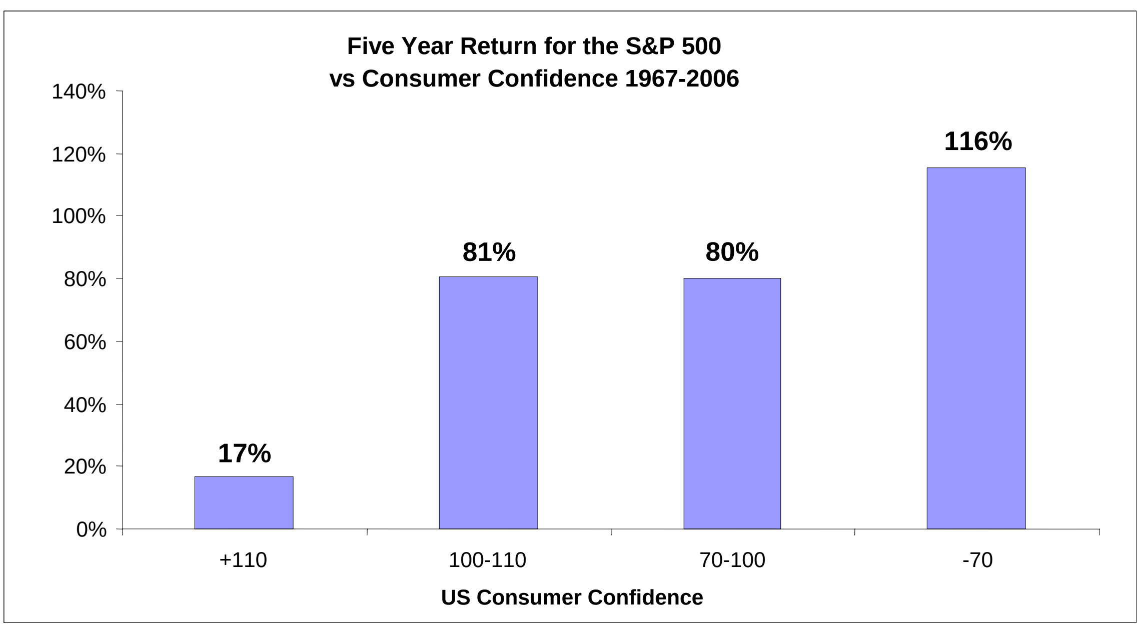
During my most recent interview with La Presse newspaper, I spoke about the “wall of fear” when referring to the continuous rise of the market. The ambient pessimism is still very high these days: people were highly distressed by the crisis and remain skeptical.

One way to measure the pulse of the population is to follow the level of consumer confidence in the US. If I were a macroeconomic strategist and wanted to receive only one piece of economic data per year in order to predict the market in the short or medium term, this would be it! It’s no doubt simplistic, but when consumers are pessimistic, the market is low and there are numerous opportunities to create wealth. When consumers are optimistic, the market is high and a pause is likely to come.



US consumer confidence from 1967 to 2010 (Source: TradingEconomics.com and Conference Board)

A normalized confidence level is 100. The level at the end of the year was 53. This level remains quite low despite that it was higher than the level from the beginning of 2009. In fact, the level is still as low as it was during the recessions of 1974, 1982 and 1992.



Five years forward total return of the S&P 500 depending of the level of US consumer confidence (1967-2006)

Historically, when the level of consumer confidence was high (such as during 1999-2000), the return of the S&P 500 during the following five years ends up being quite modest. And when the level of consumer confidence was low, the return of the S&P 500 during the following five years was high. The more the population is pessimistic, the greater the potential for stocks in the medium term. As indicated in the chart above, when the level of consumer confidence dropped below 70, the return for the S&P 500 in the following five years was 116% (or 17% on annualized basis).

So, we still see great potential for the market for the years to come, especially in more undervalued sectors of the market. Even more importantly, however, is that the companies in our portfolio are in excellent financial health and trade at compelling valuation.

We also want you to know that we are fully aware and grateful for your vote of confidence. It is imperative for us to not only select outstanding companies for our portfolios, but to also remain outstanding stewards of your capital.

We wish a great 2011 to all our partners.

François Rochon

François Rochon and the Giverny Capital team

APPENDIX 1

Investment philosophy

In 2010, we saw a large increase in the number of Giverny Capital partners (the term we use for a client). With all these new comers, it is imperative that we write again (and again) about our investment philosophy.

Here the key points:

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

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

But there is one important point: Owning a few undervalued securities (around 20) over many years doesn't yield linear returns. To stare at a freshly planted tree does not make it grow faster. Our approach is to judge the quality of an investment over a minimum **five years period.**

So patience – ours AND those of the partners – becomes the key ingredient for success.

Real patience is neither easy nor that common. That is why many investors pray in those words: "Dear God, could you gratify me with patience? And if it is at all possible, RIGHT NOW"

The Rule of Three

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

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

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

APPENDIX 2

Notes on the returns of the Giverny portfolios

- The Giverny portfolio is a private family group of accounts managed by François Rochon since 1993. The returns of the period from 1993 to 1999 were realized before registration of Giverny Capital Inc. at the AMF in June of 2000.
- The returns indicated include trading commissions, dividends and other income but do not include management fees.
- The Giverny portfolio serves as a model for Giverny Capital's clients. But returns from one client to the other can vary depending on a multitude of factors, as for example the timing of their arrival.
- Past results do not guarantee future results.
- The index benchmark group is selected at the beginning of the year and tends to be a good reflection of the asset composition of the portfolio. In 2010 :

    - Giverny Global Portfolio: TSX 14% Russell 2000 39% S&P 500 39% MSCI EAFE 8%
    - Giverny US Portfolio : S&P 500 100%
    - Giverny Canada Portfolio : S&P / TSX 100%

- The returns are audited by Price Waterhouse Coopers (PWC) at the end of each year for each portfolio. PWC has audited all yearly results since 1993.
- The PWC data are those given by the fiduciary TD Waterhouse.
- The returns calculated by PWC are in compliance with ***generally accepted accounting norms in Canada.***
- The PWC report is available upon request.