Giverny Capital Inc.

Annual Letter to our Partners 2012

Lynne Cohen
Untitled (smiling couch) - 2011
Giverny Capital Collection

For the year ending December 31st 2012, our portfolio's return was 21.5% versus 12.5% for our benchmark. Our return, including a loss of approximately 2% due to fluctuations in the Canadian currency, therefore outperformed our benchmark by 9.0%.

Since our inception, on July 1st 1993, our compounded annual growth rate has been 14.0% versus 7.0% for our weighted benchmark, representing an annualized outperformance of 7.0% over this period. When we exclude the effect caused by the appreciating Canadian currency since our inception, which represents an annualized increase of 1.3% since 1993, our portfolio has returned 15.4% annually versus 8.3% 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

Since 2004, we have illustrated the cover of our letter with a copy of an artwork from our corporate collection. This year we selected a photographic artwork by Lynne Cohen entitled "Untitled (smiling couch)".

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

Return *	Giverny	Index **	+ / -	$ US/Can	Giverny ***	Index ***	+ / -
1993 (Q3-Q4)	37.0%	9.5%	27.6%	3.3%	34.4%	7.4%	27.0%
1994	16.5%	3.7%	12.7%	6.0%	12.0%	-0.3%	12.3%
1995	41.2%	24.0%	17.2%	-2.7%	43.8%	26.3%	17.5%
1996	28.0%	22.8%	5.2%	0.3%	27.7%	22.5%	5.2%
1997	37.8%	28.6%	9.2%	4.3%	33.4%	24.5%	8.9%
1998	20.6%	18.8%	1.8%	7.1%	14.5%	12.8%	1.7%
1999	15.1%	16.3%	-1.2%	-5.7%	20.6%	21.9%	-1.3%
2000	13.4%	3.2%	10.2%	3.9%	9.7%	-0.2%	9.9%
2001	15.1%	-0.4%	15.5%	6.2%	9.4%	-5.3%	14.7%
2002	-2.8%	-18.3%	15.6%	-0.9%	-2.0%	-17.7%	15.7%
2003	13.6%	14.0%	-0.4%	-17.8%	33.9%	34.3%	-0.5%
2004	1.6%	6.2%	-4.5%	-7.3%	8.3%	13.1%	-4.8%
2005	11.5%	3.6%	7.9%	-3.2%	14.5%	6.7%	7.8%
2006	3.5%	17.3%	-13.8%	0.2%	3.3%	17.1%	-13.8%
2007	-14.4%	-11.9%	-2.5%	-14.9%	-0.3%	2.4%	-2.7%
2008	-5.5%	-22.4%	16.9%	22.9%	-21.5%	-35.6%	13.9%
2009	11.8%	12.8%	-1.0%	-13.7%	27.7%	28.2%	-0.5%
2010	16.1%	13.9%	2.2%	-5.4%	21.7%	19.5%	2.2%
2011	7.8%	-1.0%	8.8%	2.3%	5.8%	-2.8%	8.6%
2012	21.5%	12.5%	9.0%	-2.2%	23.7%	14.6%	9.1%
Total	**1182.2%**	**270.8%**	**911.4%**	**-22.4%**	**1536.1%**	**371.5%**	**1164.6%**
Annualized	**14.0%**	**7.0%**	**7.0%**	**-1.3%**	**15.4%**	**8.3%**	**7.1%**

* 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: Please refer to Appendix B for disclosure statements on the Giverny portfolios and their corresponding indices.

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 2012, the Giverny US Portfolio realized a return of 22.8% compared to 16.0% for our benchmark, the S&P 500. The Giverny US Portfolio therefore outperformed our benchmark by 6.8%

Since its inception in 1993, the Giverny US Portfolio has returned 1318.7%, or 14.6% on an annualized basis. During this same period, the S&P 500 has returned 362.8%, or 8.2% on an annualized basis. Our added value has therefore been 6.4% 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%
2011	4.9%	2.1%	2.8%
2012	22.8%	16.0%	6.8%
Total	**1318.7%**	**362.8%**	**955.9%**
Annualized	**14.6%**	**8.2%**	**6.4%**

Note: Please refer to Appendix B for disclosure statements on the Giverny portfolios and their corresponding indices.

We outperformed the S&P 500 for a fifth consecutive year. No single stock was a factor to this outperformance and, when we looked to our performance attribution for 2012, we noted that nine out of our top ten holdings outperformed the S&P 500.

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 2012, the Giverny Canada Portfolio returned 24.2% versus 7.2% for the S&P/TSX, therefore outperforming the index by 17.0%.

Since 2007, the Giverny Canada Portfolio has returned 106.6%, or 12.9% on an annualized basis. During this same period, our benchmark had a gain of 14.4%, or a gain of 2.3% on an annualized basis. Our annual added value was therefore 10.6%.

Year	Giverny Canada	S&P/TSX	+/-
2007	19.7%	9.8%	9.9%
2008	-24.6%	-33.0%	8.4%
2009	28.2%	35.1%	-6.9%
2010	26.7%	17.6%	9.1%
2011	13.5%	-8.7%	22.2%
2012	24.2%	7.2%	17.0%
Total	**106.6%**	**14.4%**	**92.2%**
Annualized	**12.9%**	**2.3%**	**10.6%**

Note: Please refer to Appendix B for disclosure statements on the Giverny portfolios and their corresponding indices.

Our primary Canadian holdings performed very well in 2012. The all-star in our portfolio was MTY Foods, which rose 45%. Dollarama (+33%) and Valeant Pharmaceuticals (+28%) also performed well.

For five out of the last six years, the Giverny Canada Portfolio outperformed the TSX. It is also worth repeating that our Canadian portfolio is very concentrated and has little correlation to the TSX. So the relative performance, whether positive or negative, will therefore often be high.

2012: A Year in Review

Our portfolio companies, despite slowing Western and to some extent Eastern economies, continued to grow their profits and intrinsic values at a very satisfying pace. The market also adequately reflected this wealth creation in the case of the majority of our companies. We thought that 2012 was the "year of the stock picker" (in market astrology) and many investors who favor a diligent and rational method for selecting holdings for their portfolios were rewarded.

In the US, the residential real estate market has finally begun to show signs of a rebound, after six years of misery. And, despite a deep rooted skepticism from many people, the S&P 500 posted a total return of 16% for the year. The old adage about the market climbing a wall of fear (even a fiscal wall) never seems to have been more true.

The situation is different in Canada as companies linked to natural resources had a difficult year. Furthermore, the Canadian real estate market is showing signs that it is beginning to run out of steam. The S&P/TSX index only climbed 7% in 2012 and is still 13% lower than what it was in April 2011.

The economic situation in China plays an increasingly important role in the global arena. Yet, it is difficult to get a clear idea of the exact situation. Despite excellent GDP growth announced by the government, stock market investors in China have not been rewarded: in 2012, the Shanghai Stock Exchange (SSE Composite) was flat and it is still down 63% from its October 2007 high.

Looking towards Europe, several countries are mired in problems that will likely take years to resolve. In the case of some of these countries, the problems seem more cultural rather than economic. Moreover, the use of a common currency further complicates the situation. Yet, this does not prevent us from admiring several European companies located in countries such as the United Kingdom, Sweden, Denmark, Italy, etc. Quality has no nationality.

An Energy Revolution in the US

Media outlets are quick to present us with one crisis after another, along with constant economic and political worries. With the help of the Internet and many television stations, bad news circles the planet in no time. With the right twist, plain old bad news begins to look more and more like an imminent catastrophe and for many investors, the perfect reason to sell their stocks! Good news, on the other hand, remains largely unnoticed since it seems to represent a less valuable source for ratings and clicks.

One piece of good news, which could have major consequences for several decades to come, is what we could call the American energy revolution. Five years ago, when oil was selling for $140 a barrel, a significant problem in the US was its trade deficit in global energy markets. The country's high energy demand couldn't be met by domestic supply which resulted in massive energy imports. The problem was also exacerbated by China's growing demand for energy resources. But the economic crisis of 2008-2009 reset the supply and demand equation. New oil reserves in the US have also been developed to the point where for each barrel produced between 2007 and 2009, there was 1.6 barrels of new reserves added. Oil prices collapsed to $40 in 2008 and have recently bounced back to $91—still quite a bit lower from its high just a few years prior.

Meanwhile, as supply and demand for oil has found a new equilibrium on a global level, new discoveries of oil and gas reserves in the American west (and the ability to extract it from shale), has the potential to completely change the energy balance in the US. In 2012, the US produced 6.4 million barrels of crude oil, an increase of 760,000 barrels from the prior year (a 14% increase). And the estimates predict an additional 25% increase within the next two years. As for natural gas, the amount of new reserves is simply astronomical. The International Energy Agency, in a report released last November, now predicts that the US will be energy independent by 2035.

So the US seems destined to significantly change the dynamics of its trade balance for energy. A decrease in its trade deficit (relative to GDP) will likely be the most important consequence. This should bolster the value of the US dollar and foster continued growth in states like Wyoming, North Dakota, and Montana.

Despite the optimistic tone of this section, none of this changes the fact that the energy industry is – to us – difficult to predict. The fact that it has changed so much since 2007 (and we did not foresee it) serves as evidence. This simply means that companies that operate in the energy industry are difficult for us to evaluate. We are quite disciplined in sticking within the boundaries of our circle of competence. On the other hand, we believe that we can indirectly benefit from this US energy boom through our investments in companies such as Union Pacific and Burlington Northern Santa Fe (now a part of Berkshire Hathaway).

Owner's Earnings

At Giverny Capital, we do not evaluate the quality of an investment by the short-term fluctuations in its stock price. Our wiring is such that we consider ourselves <u>owners</u> of the companies in which we invest. Consequently, we study the growth in earnings of our companies and their long-term outlook.

Since 1996, we have presented a chart depicting the growth in the intrinsic value of our companies using a measurement developed by Warren Buffett: "owner's earnings". We arrive at our estimate of the increase in intrinsic value of our companies by adding the growth in earnings per share (EPS) and the average dividend yield of the portfolio. This analysis is not exactly precise but, we believe, approximately correct. In the non-scientific world of the stock market, and as Keynes would have said: "It is better to be roughly right than precisely wrong."

This year, the intrinsic value of our companies, as a whole, rose by 19% (18% from the growth in earnings and 1% from the average dividend). Despite changes to our portfolio during the year, we consider this growth in earnings to appropriately reflect economic reality. The stocks of our companies rose approximately 23% (without the effect of currency). As for the S&P 500, the underlying earnings growth of its companies was 5% (8% including dividends) and the total return of the index was 16%.

	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%
2011	17%	6%	-11%	17%	2%	-15%
2012	19%	23%	4%	8%	16%	8%
Total	**726%**	**606%**	**-120%**	**229%**	**216%**	**-13%**
Annualized	**13.2%**	**12.2%**	**-1.0%**	**7.3%**	**7.0%**	**-0.3%**

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

Since 1996, our companies have increased their intrinsic value by 726%, or about an eightfold increase. Meanwhile, the value of their stocks has increased 606% (including dividends but without currency effects). During this same period, the companies comprising the S&P 500 increased their aggregated intrinsic value by 229% and saw their stock prices rise by 216%. Market performance and corporate performance are rarely synchronized over the course of a calendar year. But as more time passes, the synchronization between the two inevitably begins to reveal itself.

Over 17 years, our portfolio has realized a return that is 5% higher than the S&P 500 for the simple reason that the underlying companies in our portfolio have increased their intrinsic value at a rate that is 5% higher than the average. This is how we plan on continuing to reach our performance objectives in the future, rather than trying to speculate on the highs and lows of the market or trying to read the tea leaves of economic or political trends.

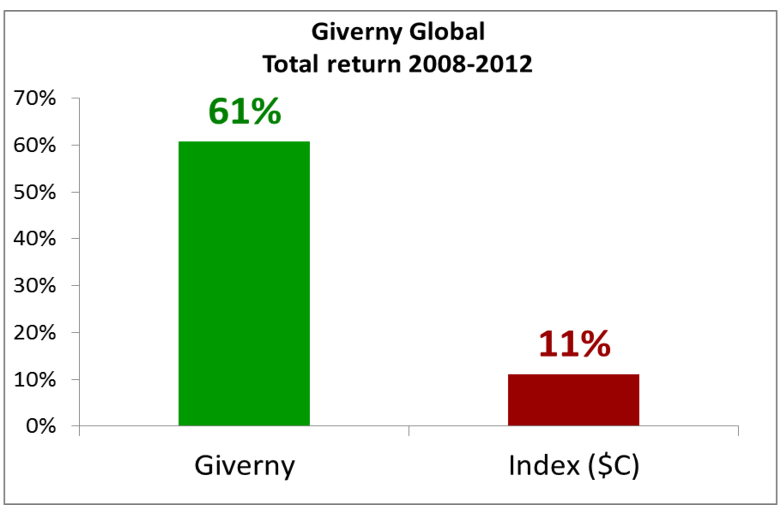
Five-year Post-mortem: 2007

Like we do every year, we go through a five-year post-mortem analysis. We believe that studying our decisions in a systematic manner, and with the benefit of hindsight, enables us to learn from both our achievements and our errors.

2007 was a very difficult year for our investment style. The soaring Canadian dollar weighed heavily on our portfolio returns that year. Furthermore, our holdings underperformed the index (it was difficult to outperform that year if you didn't own companies focused on natural resources). We wrote in our 2007 letter that the headwinds facings our companies seemed temporary in nature and that the next five years should bode well for our portfolios.

We added the following to the end of our 2007 letter: *"If there is a recession in 2008, we are ready. Historically, recessions in North America have been temporary. Our businesses have good balance sheets and they will profit from slowdowns by taking market share from weaker competitors or by making acquisitions at good prices."*

There was quite a recession in 2008-2009 and, as we had hoped, our companies weathered the storm and—in many cases—benefited by making advantageous acquisitions at bargain prices. Our portfolio has performed well since the beginning of 2008: the Giverny Global Portfolio has had a total return of 61% while its benchmark returned 11% (in Canadian dollars).



Note: Please refer to Appendix B for disclosure statements on the Giverny portfolios and their corresponding indices.

The Flavor of the Day for 2012

Each year, we select our "flavor of the day" for the year. In other words, we look for what is (too) popular and will eventually yield little financial reward. In the last three Annual Letters, we named bonds, Canadian real estate and gold as posing risks to fellow investors. While we remain confident that these asset classes will disappoint many, we don't see any other segments of the market that seem to suffer from exaggerated popularity these days.

A New Book on Benjamin Graham

We had a nice surprise this year: a new book on the father of value investing, Benjamin Graham. Joe Carlen's "The Einstein of Money" is an exceptional biography of Warren Buffett's mentor. I am convinced that all fans of value investing will find this book a fascinating read.

Our Companies

"Quality is never an accident; it is always the result of intelligent effort."

- John Ruskin

American Express (AXP, $58)

Amex had an excellent year: revenues climbed 5% and earnings per share (EPS) increased 8% to $4.40. The company also repurchased $4 billion worth of its own shares during the year. We consider American Express an exceptionally high quality international business. The stock also seems reasonably priced, trading at 12 times the company's estimated earnings for 2013.

Bank of the Ozarks (OZRK, $34)

2012 was yet another exceptional year for Bank of the Ozarks. Our bank, based in Little Rock, had EPS of $2.21. The profits from last year had a number of non-recurring items, making them more difficult to interpret comparatively. What is significant for 2012, however, is the bank posting a solid return on assets of 2.04% and an efficiency ratio (a measure of the bank's cost structure) of 46.6%. Its balance sheet also remains strong: the bank increased its equity to assets ratio from 10% to 12%.

We consider Ozarks to be one of the best banks in the US. Since 2006, EPS have risen from $0.95 to $2.21, an annualized increase of 15%. Very few banks can brag about having that kind of performance within the difficult economic climate of the last few years.

Berkshire Hathaway (BRK.B, $90)

The company led by the legendary Warren Buffett had an excellent 2012. The uptick in residential construction helped many of Berkshire's holding companies. We remain confident that Wall Street is still nearsighted about the intrinsic value of Berkshire and its long term potential. That's good news for us (since we're regular buyers) and we were happy to see the company continue to buy back its own shares at very compelling prices.

Buffalo Wild Wings (BWLD, $73)

Buffalo Wild Wings (BWW) is a chain of sports-oriented restaurants which, as its name suggests, specializes in selling chicken wings. We have been shareholders for three years and the company is growing very quickly, with the number of restaurants increasing from 493 at the end of 2007 to 891 at the end of 2012. The company is aiming for 1700 restaurants within a few years.

Revenues for 2011 grew by 33% but EPS rose by only 12%. Rising prices of chicken wings gnawed away at the company's margins. We are confident that BWW's long-term business model is sound and that margins should stabilize despite year to year fluctuations.

Carmax (KMX, $38)

The fiscal year at Carmax ends on the last day of February. For fiscal 2012-2013, we are anticipating sales and EPS growth of 10% and 7%, respectively. The company now has 117 stores in the US but still only has 3% of the used car market (and only 6% share in existing markets). The company is also launching smaller concept retail stores.

Carmax is planning on opening 10 to 15 units per year for the foreseeable future and aims to reach 160 stores in three years.

Disney (DIS, $50)

Disney had another excellent year in 2012. Earnings rose by 17% and the company's stock price rose by 32%. The film "Wreck-It Ralph" was a blockbuster, becoming the 75th film by Disney to gross more than $100 million. But the biggest news of the year was Disney's acquisition of *Lucas Film*, the famed studio started by George Lucas, the creator of the Star Wars empire. Disney plans to launch "Star Wars Episode 7" in 2015. This seems like a terrific acquisition for Disney and, vice versa, we think that George Lucas couldn't have found a better home to ensure the perpetuity of his work.

Bob Iger and George Lucas (Source: Disney)

We bought our first shares in Disney in September 2005 (the day that Bob Iger was named CEO). Since then, EPS has climbed 135% (an annualized growth rate of 13%) and the stock has risen from $24 to $50 (or 108%).

Dollarama (DOL-T, $59)

Three years ago, we were thrilled by the IPO of a company we had long admired: Dollarama. The reason our admiration is simple: for us the company's founder and CEO, Larry Rossy, is one of the best businessmen in Canada. We bought shares immediately and the stock has done very well, tripling in value since.

In 2012, Dollarama introduced two new fixed price levels for its goods: $2.50 and $3.00. This enabled the company to vastly expand its product offering.

The company's performance in 2012 exceeded our expectation. After the first three quarters of 2012 (the company's fiscal year ends January 31st), revenues increased 14%, same-store sales increased 7%, and EPS surged 33%. The company also increased its dividend and started buying back shares.

With EPS possibly reaching $3.50 in 2013, the stock seems reasonably valued at the current level.

Fastenal (FAST, $47)

Fastenal had another good year in 2012. Revenues rose by 13% and EPS climbed by 17%. One of the primary areas of growth for the company has come from the installation of vending machines at client sites. The number of vending machines has increased from 7,453 at the end of 2011 to 21,095 at the end of 2012.

The other factor to the company's growth in recent years has been significant productivity improvements at its existing stores. During the last quarter of 2012, sales per store reached $83,098, compared to $78,781 per store for the same quarter in 2011. The company's operating margins have increased from 20.2% to 20.9%.

We bought Fastenal in 1998 and it has been a very rewarding investment, even if the stock seemed on many occasions richly valued (trading at 30 times its earnings). For the last ten years, the annualized growth rate of Fastenal's earnings has been a whopping 19%. It may not be the latest technological craze of the day, but Fastenal sure knows how to sell nuts and bolts while delivering top notch customer service!

Google (GOOG, $707)

Google had a good year in 2012. Revenues rose 34% and EPS (according to our estimate) increased by 8%. The company continues its dominance of the search engine market, while its mobile operating system, Android, is rapidly taking market share from other competitors.

Google is a small position in our portfolio because we believe that the company could be a better allocator of excess cash flows (such as IBM, for example). Aside from this, we consider Google an exceptional company.

IBM (IBM, $192)

IBM had flat revenues in 2012 (without currency effect). EPS still rose by 10% for the year. This dominant information services company does a brilliant job at managing its capital, which is the primary reason why we are shareholders. It's so rare!

LKQ Corp (LKQ, $21)

LKQ is a new purchase. The company is the North American leader in the manufacturing and distribution of refurbished auto parts. The acronym for the company's name stands for "Like Kind and Quality", referring to the high quality of its recycled products.

Before buying shares in LKQ, I wanted to meet with the CEO at their offices in Chicago. His assistant explained to me that he was seldom at the headquarters and that he preferred being on-site at the company's other locations. I was curious to know more and eventually met the management team at a conference in New York. I was impressed with its quality and the growth outlook for this business, along with the prospect of industry consolidation, which made a compelling case to own shares in this company. The company has also just expanded overseas with a significant acquisition in the UK.

LKQ is growing very quickly: from 2007 to 2012, revenues rose from $1.1 billion to $4.1 billion. EPS has climbed from $0.27 to $0.84 (a 25% compounded annual growth rate). We estimate EPS for 2013 to come in around $1.05.

M&T Bank (MTB, $99)

M&T Bank had a phenomenal year. Net interest revenues rose 9% and reserves for bad debt dropped by 24%. Return on assets rose from 1.26% to 1.40% and its efficiency ratio dropped to 56%. EPS climbed by 20% to $7.88—a record level for our Buffalo-based bank.

M&T also completed another significant acquisition: Hudson City Bancorp. HCB has branches in New Jersey, Connecticut, Long Island, and regions north of New York City. This bank has a good track record, but had a very difficult year in 2011. We think the integration of HCB within M&T should go smoothly as M&T has done a great job at this for 30 years.

M&T Bank was rated one of the best banks for 2012 by Money Magazine

We bought shares for the second time in M&T Bank in 2009 for about $38 and the stock has performed well since. We had previously been shareholders between 1998 and 2007 for one single reason: we had deep admiration for the bank's CEO, Robert Wilmers. In 2007, Mr. Wilmers decided to retire and we sold. During the crisis of 2008, he decided to return to take back the helm at M&T Bank so we decided to buy again. Mr. Wilmers is now 78 and we hope he can stay another decade at M&T Bank.

MTY Food Group (MTY-T, $22)

MTY Food is an operator and franchisor of multiple quick service restaurant concepts. We have been shareholders in this superb Montreal-based company since 2007. MTY grew rapidly in 2012, with revenues rising 31% while EPS climbed 33%. The company acquired the "Mr. Souvlaki" chain in 2012 and also began signing international development agreements in places such as the UK, Lebanon, the UAE, and Saudi Arabia.

We continue to deeply admire the company's CEO, Stanley Ma, and remain confident in the company's future prospects.

Omnicom (OMC, $50)

Omnicom, one of the largest advertising firms in the world, saw revenues rise by 3% in 2012. EPS increased by 9%, with the company increasing its dividend and actively buying back roughly 5% of its shares. Omnicom remains a very stable player in this industry and its stock valuation is attractive.

O'Reilly Automotive (ORLY, $89)

O'Reilly had an excellent year, with revenue climbing 7% and net income increasing 15%. EPS surged 25% due to the company aggressively buying back its own shares. By returning excess cash flows to shareholders through its share buyback, the company was able to greatly improve its return on equity. The company's ROE topped 20% for the first time in its history.

Since our purchase in the summer for 2004, the total growth in earnings has been 324%, or 20% annually, and the stock has quadrupled. Who says that "buy and hold" no longer works?

Resmed (RMD, $42)

After a difficult 2011, Resmed had an exceptional 2012. This leader in medical equipment used for sleep disorders saw its revenues rise by 10% and its EPS surge by 34%. Since 2008, Resmed has maintained a revenue growth rate in excess of 14% annually. Since our first purchase in 2004, EPS has grown by 367% (or 21% annually).

We decreased our position in this company in 2011 when the company's founder, Peter Farrell, retired and the company was looking for a successor. To this day, the company has proved us wrong on this decision by continuing to grow its profits at admirable rates of return.

Union Pacific (UNP, $126)

At the end of 2009, Berkshire Hathaway acquired Burlington Northern Santa Fe (BNSF). This allowed us to exchange parts of our existing shares in BNSF for additional shares in Berkshire. But we still like the industry fundamentals for railroad companies.

Last summer, we met with the CEO of a very successful Los Angeles based business. This brilliant businessman had had dinner the night before with the CEO of BNSF, Matthew Rose, and he further convinced us of the outstanding economics of the rail industry. He explained how Union Pacific and BNSF became dominant in the western part of the US to the point where there is now a quasi-duopoly in this region. With the energy boom in this area, in particular with shale oil, these two companies are benefiting from an increase in rail cargo. So we decided to buy shares in Union Pacific after returning from California. We see a bright future for the company.

Valeant Pharmaceuticals (VRX, $60)

Valeant is a bit different from the typical business we are drawn to at Giverny Capital. Based in the Montreal region, Valeant has become a sizable pharmaceutical company on a global level. However its accounting isn't simple and the company has a vast array of different products.

The reason we decided to invest in Valeant is our admiration for its CEO, Michael Pearson. The company's results for 2012 were impressive. Sales reached $3.6 billion—double the sales from three years ago. EPS followed suit, rising 57% to $4.14.

The most important acquisition of the year for Valeant was Medicis Corp, a leader in dermatological drugs. In 2008, Valeant was in 11th place in the dermatology segment in the US. With the Medicis acquisition, Valeant is now in first place, with more than twice the revenue than its closest competitor.

Visa (V, $152)

Visa had a terrific year in 2012: operating revenues increased 15% and EPS rose 24%. Visa returned the majority of its profit back to shareholders, with dividends and share buybacks to the tune of $3 billion. It's difficult to ask for more.

We bought Visa two years ago, when the stock fell by 25%. The Durbin reforms from the US congress and the potential impact on transaction fees for debit cards was a great worry on Wall Street. But, as we had thought, the impact of these reforms turned out to be modest and the stock has doubled since.

Wells Fargo (WFC, $34)

Wells Fargo continued to improve its profitability in 2012: the bank's return on asset rose from 1.25% to 1.41% while its return on equity reached 13%. EPS increased by 19% to $3.36. The company also increased its dividend by 83% and bought back 120 million of its shares—equivalent to a non-taxable dividend of $3.9 billion.

We expect EPS of $3.75 for 2013. We think that Wells Fargo is one of the best large banks in the US and its stock is still trading well below its intrinsic value.

The Podium of Errors

"Mistakes are the usual bridge between inexperience and wisdom."

- Phyllis Theroux

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2012 (or from past years). It is with a constructive attitude, in order to always improve as 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)… even if we don't see those on our statements.

Bronze Medal: JP Morgan

Here is a recent error with opportunity costs that were quick to materialize. We've followed JP Morgan for some time and are fans of its CEO, James Dimon. This summer, the bank announced an unexpected loss of a couple of billion dollars. JP Morgan found itself at the center of an exaggerated media frenzy that is oh-so-typical of our era. The stock quickly tumbled from $44 to $32—this represented a decrease of $40 billion in the bank's market valuation and seemed out of line with a loss realistically assessed in the $4-5 billion range.

The stock seemed undervalued to us before the drop, so imagine afterwards: at $32, the PE ratio for JP Morgan was now seven. Given that JP Morgan is one of the top banks in the US and it was now possible to buy shares at prices that had an earnings yield of more than 15%.

I even went ahead and enthusiastically recommended the stock on television and in the Montreal Gazette newspaper. But with our own money, I stayed on the sidelines. It was difficult to choose which of our other holdings to sell and I thought that we already had a large exposure to financial services in our current portfolio. But such an opportunity is rare and these excuses are regrettable.

Wall Street's worry quickly ebbed and the stock went back to trading at its levels from last Spring. As I write this paragraph, the stock is trading at $48. We therefore missed out on a 50% rise. And the stock is still trading an only 9 times the estimated earnings for 2013. When a stock rises by 50% in just a few months and is still attractively priced, there isn't much more that needs to be said about how deeply discounted this stock was when it was at its low.

Silver Medal: Lumber Liquidators

The sale of Lumber Liquidators (LL) in 2011 was one of the worst mistakes in recent years. We bought shares in the company in 2010, after visiting the company in Toano, Virginia. This is probably one of the most out-of-the-way places we've visited in our noble goal to realize good returns on our capital. We were very impressed by this company which sells hardwood floors and other flooring products directly to customers. LL has a low cost structure and is able to offer more value to its customers than if they made their purchase at a retailer such as Lowe's of Home Depot. LL has been growing very quickly but in 2010, the company implemented a new IT system that affected it profitability. The stock dropped in price as a result of this and we jumped at the chance to become shareholders at around $25.

In 2011, the company continued to have some difficulties and same-store sales fell significantly (by 7% in the second quarter). EPS were flat for a second consecutive year, while operating margins fell from 8.9% in 2009 to 7.4% in 2011. Further, the CEO decided to leave his post. We were surprised by this news and decided to sell since the original investment thesis no longer seemed valid.

The company has, just opposite to our errant prognosticating, turned itself around. Sales rose 17% in 2012 and EPS surged from $0.94 to $1.61, while operating margins reached 9.5%. And as for its share price? Since our sale at around $17, the stock has more than tripled, to $60 (as of February 2013). Analysts expect more than $2 in EPS this year (twice the level of 2010). While the stock is hardly a bargain (now trading at 30 times estimated profits), we have stomped on our pride and continue to follow the company closely. But I have to admit that this goes to show that I showed a flagrant lack of patience on this one.

Gold Medal: Stericycle

About a decade ago, a fellow portfolio manager spoke to me, with great enthusiasm, about a company called Stericycle. The company is a leader in the collection of medical waste and thereby absolutely being my kind of business: unexciting, tending not to attract competition, and not affected by technological change. While the business isn't exciting, its financial results most definitely are. Over ten years, annual revenues have increased from $400 million to nearly $2 billion. EPS has risen from $0.55 to $3.30 this year, with an annualized growth rate of 20%. The stock has risen from $16 to $92.

You might have noticed − given your usual perceptiveness − that the stock's P/E ratio was 29 times in 2002 and is still 28 times at the current moment. The stock has always traded at lofty P/E ratios. I have therefore made an error that I have, unfortunately, made many times: avoiding a high quality enterprise due to a valuation that seemed higher than what I would have liked to pay. I waited in vain for a better price… for a decade. It's very difficult to find a company that can maintain an annual growth rate of more than 20% over a long period of time. When we find one and we have confidence that the future outlook is promising, refusing to pay a slight premium relative to average companies often becomes a very costly mistake. It was an error of almost 500% in this case.

Conclusion: The Current Potential for Stocks

In recent years, we have regularly emphasized our enthusiasm for the stock market and, even more specifically, for our businesses. We don't have a crystal ball, but we know that the potential for the appreciation of stocks is inversely proportional to the valuation assessment reflected by the market. From this perspective, the news is good: the S&P 500 is trading at only 13-14 times the earnings estimate for 2013.

The other ingredient, which is often associated with low valuations, is the pessimism of the financial community. On this level, we could not ask for better news. Since 2008, investors have been fleeing the stock market. Indeed, over the last five years, they sold half a trillion ($500 billion) worth of equities and injected a trillion dollars into bond funds.

Furthermore, the consumer confidence index in the United States (my favorite contrarian indicator) ended the year at 67 (normal is 100) and even dropped to 59 in January. This level is usually found during a recession.

This tendency towards pessimism for stock is not limited to individual investors. Many institutional investors have also reduced their allocation to equity markets, in favor of bonds and "alternative" investments (real estate, private equity, commodities, etc.) For example, the endowment funds at the top American universities (those with more than a billion under management) have reduced their exposure to equities to 27% from 45% ten years ago, while their exposure to "alternatives" is now 61%.

We believe that equities will be the best asset class in the coming years for the simple reason that it seems to be the most undervalued.

To Our Partners

Using rationality, along with our unwavering optimism, we trust that the companies we own are exceptional, led by top-notch people, and destined for a great future. They should continue to prudently navigate the often troubled waters of the global economy. Furthermore, the valuation assigned by the market to these outstanding companies is very similar to the valuation of an average company in S&P 500, despite the fact that our companies have better growth prospects than average. Therefore we consider the appreciation potential for our portfolio, both in absolute and relative terms, to be excellent.

We also want you to know that we are fully aware of and grateful for your votes 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 certainly like to achieve good returns, but it must not come at the cost of taking undue risk. Our philosophy to favor companies with solid balance sheets and dominant business models, along with purchasing these companies at reasonable valuations, is central to the risk management of our portfolios.

We wish a great 2013 to all our partners.

François Rochon

François Rochon and the Giverny Capital team

APPENDIX A

Investment philosophy

Note: This section is repeated from prior annual letters and is aimed at new partners.

In 2012, we saw a large increase in the number of Giverny Capital partners (the term we use for our clients). With all these newcomers, it is imperative that we write again (and again) about our investment philosophy.

Here are 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 high (and sustainable) margins and high returns on equity, good long term prospects and are managed by brilliant, honest, dedicated and altruistic people.
- Once a company has been selected for its exceptional qualities, a realistic valuation of its intrinsic value has to be approximately assessed.
- The stock market is dominated by participants that perceive stocks as casino chips. With that knowledge, we can then sometimes buy great businesses well below their intrinsic values.
- 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.

Experience and common sense teach us that an investment philosophy based on buying shares in companies that are undervalued, and holding these companies for several years, will not generate linear returns. Some years, our portfolio will have a return that is below average. This is a certainty that we must accept.

Another important point: the significant volatility of the market is often perceived negatively by many investors. It's actually the contrary. When we see stock prices as *"what other people believe the company is worth"* rather than the real value (at least in the short term), these fluctuations become our allies in our noble quest for creating wealth. Instead of fearing them, we can profit from them by acquiring superb businesses at attractive prices. The more that markets (the "other" participants) are irrational, the more likely we are to reach our ambitious performance objectives.

Benjamin Graham liked to say that the irrationality of the market was an extraordinary advantage to the intelligent investor. The person, however, who becomes affected by short-term market fluctuations (less than 5 years) and who take decisions based on them transforms this advantage into a disadvantage. His or her own perception of stock quotes becomes their own worst enemy. Our approach at Giverny Capital is to judge the quality of an investment over a long period of time.

So patience – ours AND that of our partners – becomes the keystone for success.

APPENDIX B

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 Giverny portfolios serve as a model for Giverny Capital's clients, but returns from one client to the other can vary depending on a multitude of factors, such as the timing of the opening and funding of a client's account.
- Past results do not guarantee future results.
- The Giverny Canada and Giverny US portfolios are parts of the Giverny Global portfolio.
- The returns indicated include trading commissions, dividends (including foreign withholding income taxes) and other income but do not include management fees.
- 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 2012 :

    - Giverny Global Portfolio: TSX 18% Russell 2000 40% S&P 500 40% MSCI EAFE 2%
    - Giverny US Portfolio : S&P 500 100%
    - Giverny Canada Portfolio : S&P/TSX 100%

- The returns for the S&P 500 (in $USD) are provided by Standard & Poors.
- The returns for the various indices used for comparable purposes are deemed reliable by Giverny Capital. It should be noted that currency effects and the impact of dividends on the returns for indices are estimated. Despite its best effort, Giverny Capital cannot guarantee that this information is accurate and complete at all times.
- The custodian of our client portfolio is TD Waterhouse in Canada and TD Ameritrade Institutional in the US.
- The financial statements of the three portfolios are audited by PricewaterhouseCoopers (PwC) at the end of each year. The PwC data are those provided by our custodian TD Waterhouse. The PwC reports are available upon request.
- For more information, please see the "returns" section of our website.