Annual Letter to our Partners 2013

20th Anniversary of the Giverny portfolio

Gabor Szilasi
Giverny - 1998
Giverny Capital Collection

For the year ending December 31st 2013, our portfolio's return was 50.2% versus 38.9% for our benchmark. Both returns include a gain of approximately 8% due to fluctuations in the Canadian currency. So in 2013, we have outperformed our benchmark by 11.3%.

Since our inception on July 1st 1993, our compounded annual growth rate has been 15.5% versus 8.3% for our weighted benchmark, representing an annualized outperformance of 7.2% over this period. When we exclude the effect caused by the appreciating Canadian currency since our inception, which represents an annualized increase of 0.9% since 1993, our portfolio has returned 16.6% annually versus 9.3% 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 Gabor Szilasi entitled "Giverny".

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%	-0.8%	-2.0%	-17.7%	15.7%
2003	13.6%	14.0%	-0.4%	-17.7%	33.7%	34.1%	-0.5%
2004	1.6%	6.2%	-4.5%	-7.3%	8.3%	13.1%	-4.8%
2005	11.5%	3.6%	7.9%	-3.3%	14.5%	6.7%	7.8%
2006	3.5%	17.0%	-13.5%	0.2%	3.3%	16.8%	-13.5%
2007	-14.4%	-11.6%	-2.8%	-14.9%	-0.3%	2.2%	-2.5%
2008	-5.5%	-22.0%	16.5%	22.9%	-21.5%	-35.4%	13.9%
2009	11.8%	12.2%	-0.4%	-13.7%	27.7%	27.7%	0.1%
2010	16.1%	13.8%	2.3%	-5.3%	21.7%	19.3%	2.5%
2011	7.6%	-1.1%	8.7%	2.2%	5.5%	-2.9%	8.4%
2012	21.2%	12.5%	8.7%	-2.2%	23.4%	14.6%	8.8%
2013	50.2%	38.9%	11.3%	6.9%	42.2%	31.3%	10.9%
Total	**1825.9%**	**415.2%**	**1410.7%**	**-17.0%**	**2226.1%**	**519.0%**	**1707.1%**
Annualized	**15.5%**	**8.3%**	**7.2%**	**-0.9%**	**16.6%**	**9.3%**	**7.3%**

* 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: Refer to Appendix C 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 2013, it realized a return of 40.6% compared to 32.4% for our benchmark, the S&P 500. The Giverny US Portfolio therefore outperformed our benchmark by 8.2%

Since its inception in 1993, the Giverny US Portfolio has returned 1893.7%, or 15.7% on an annualized basis. During this same period, the S&P 500 has returned 512.7%, or 9.2% on an annualized basis. Our added value has therefore been 6.5% 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	4.7%	2.1%	2.6%
2012	22.3%	16.0%	6.3%
2013	40.6%	32.4%	8.2%
Total	**1893.7%**	**512.7%**	**1381.1%**
Annualized	**15.7%**	**9.2%**	**6.5%**

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

We outperformed the S&P 500 for a sixth consecutive year. No single stock alone was a factor for this outperformance and, when we looked to our performance attribution for 2013, we noted that seven 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 2013, the Giverny Canada Portfolio returned 49.4% versus 13.0% for the S&P/TSX, therefore outperforming the index by 36.4%.

Since 2007, the Giverny Canada Portfolio has returned 208.6%, or 17.5% on an annualized basis. During this same period, our benchmark had a gain of 29.3%, or a gain of 3.7% on an annualized basis. Our annual added value was therefore 13.7%.

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%
2011	13.5%	-8.7%	22.2%
2012	24.0%	7.2%	16.8%
2013	49.4%	13.0%	36.4%
Total	**208.6%**	**29.3%**	**179.3%**
Annualized	**17.5%**	**3.7%**	**13.7%**

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

Our primary Canadian holdings performed very well in 2013. The all-star in our portfolio was Valeant Pharmaceuticals, which rose 96%. Dollarama (+50%) and MTY Foods (+54%) also excelled.

For six out of the last seven 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.

2013: The year of the "triple play"

Legendary investor Peter Lynch always emphasized the importance of being patient: "Frequently, years of patience are rewarded in a single year". The year 2013 was such a year. We could qualify it with the baseball term: "triple play". Our 50% return includes three components:

- An earnings growth rate of 15% for our companies with an additional 1% from dividends
- An increase of the average Price to Earnings ratio (P/E) of our stocks from 14x to 17x
- A currency gain of 8% linked to the drop of the Canadian dollar from 0.99$ to 0.94$.

We believe our return for 2013 was justified. It reflects a return to a more normal valuation level for our holdings. We went through a period from 2006 to 2009 where we had to cope with a P/E compression for our stocks and a huge rise in the Canadian currency. As we stipulated in our annual letters during those years, we believed those events were temporary in nature and were not justified by our long term fundamental analysis.

Yet, it would be unrealistic to extrapolate our 2013 return into the future. In the the long run, the number one factor influencing a portfolio's return is the overall intrinsic value increase of the companies owned. But we believe that our stocks are still undervalued and that the Canadian dollar is still overpriced by 10 to 16%. So the next few years could also bring additional rewards to the intrinsic value of our holdings, but not at the same level as this year.

Since 1993, the cornerstone of our investment philosophy is based on Benjamin Graham's book "The Intelligent Investor", first published in 1949. In it, Graham wrote: "In the short term, the stock market reflects the irrationality and unpredictability of human investors. But in the long term, it reflects adequately the intrinsic value of companies".

Over the last two decades, we have been witnesses to strange market movements and numerous irrational behaviors from investors (the list would be too long to mention here). But in the end, the strangeness cleared up and common sense prevailed. If there is one thing that we have learned since 1993 is that market fads come and go but fundamental principles endure.

Twenty years of the Giverny Portfolio

I started to manage the Giverny portfolio in July 1993. So we celebrate our twenty year anniversary with this letter. Results over those two decades have been more than satisfactory. But most important, I've learned some valuable lessons which should be useful in enhancing portfolio values going forward. Last summer, I wrote in my Gazette column an article highlighting the ten most important lessons learned since 1993. You will find the article in Appendix A at the end of this letter.

I would like to emphasize the most important lesson of the last twenty years: <u>It is futile to try to predict the stock market over the short run</u>. All previous lessons are useless if you try to predict the stock market over the short run. I have heard people say hundreds of times that they were waiting to buy great companies because they had negative views on the short-term direction of the stock market. Owning great businesses, managed by great people and acquired at reasonable prices is the winning recipe. The rest is just noise.

The stock market and Bridge

Investing in the stock market has similarities with the game of bridge. As you probably know, a member of the Giverny Capital team, Nicolas L'Écuyer, is a great bridge player. He was Canadian champion six times. To succeed in bridge, you have to be able to combine logic and rationality. Another important point: in duplicate bridge, the points are never given in absolute terms but relative to what others have done with the same hand being played. As with the stock market, what counts is the result relative to the average.

Nicolas likes to say that two things are important in bridge: to have a plan to play the hand and always favor the play that has the best chance of success. The fact that a particular decision has worked or not at a particular time is irrelevant if the thought process was correct. In other words, if a play has a 75% chance to be the right one, do not blame yourself when it does not work (which will be one time out of four times). In addition, when playing in a bridge club where players of various levels of play are present, it is interesting to look at the results at the end of the evening. Very often, the best team plays for 60% and the worse one for 40%. The difference is not that large.

An analogy applies to the stock market: managing a portfolio of equities requires a specific plan (a philosophy of securities selection) and a decision-making process that favors the better odds. If we look at the history of the stock market in the long run, stocks have returned 10% per year compared to roughly 5% for bonds and 3% for treasury bills. So to be 100% invested in equities is the most favorable statistical approach. Some will tell you that a portfolio thus formed will be more volatile and more "risky". Obviously, it is true that an equity portfolio will fluctuate, sometimes widely as we saw in 2008-2009. But it is not really "risky" if its owner is patient and allows enough time for the odds to play out in their favor.

As important, we have to accept the 60-40 rule. To be wrong (or not totally right) 40% of the time can produce excellent results in arenas such as bridge and the stock market. In fact, we stipulated many years ago in our "Rule of three" that we have to accept that one year out of three, we will underperform the index and that one stock purchased out of three will not perform as expected. If one studies the table of the Giverny portfolio since 1994 (excluding the half-year of 1993), we observe that our portfolio has underperformed the S&P 500 six years out of twenty, the equivalent of 30% of the time. To be aware of this fact is vital so we can be psychologically prepared for the inevitable periods when we will have results that are worse than average. We have to accept from the start that it is impossible to be always the best in that field even if one is competent and loaded with motivation and efforts.

It is important to realize that our "Rule of three" is not linear and totally unpredictable. Some of our partners would love to know in advance the years we will underperform so that they can wait on the sidelines. In the long run, the stock market will eventually reflects the intrinsic values of the companies owned. But all temporal parameters are unknown. Few investors, professional or not, can do better than the average. In our opinion, one simple but crucial quality is needed: humility. Humility is needed to recognize that we can't predict the economy and the stock market (and why even try with politics?) Humility is needed to recognize that, even with our own stocks, we can't know in advance which ones will do well and when they are going to do well.

Nicolas would add that one key to succeed in bridge is to play often so odds can eventually win over luck. Persistence eventually trumps luck!

The Flavor of the Day for 2013

Many of the financial (and less financial) assets that we labelled "flavor of the day" in the last years have turned sour in 2013. Bonds lost value as interest rates increased. The price of gold is down 34% since its 2011 high. The Canadian Dollar has started to fall to a level closer to its Purchasing Power Parity or PPP (as evaluated by the OECD). Even housing prices in Canada show signs of getting back to more reasonable levels.

So where are we seeing popularity (and consequently danger)? Recently, we have observed the popularity of some new names in the technology field. A dozen or so years have passed since the tech bubble crash of 2000-2002. A new generation of young investors, and some older ones with "young memory", have become infatuated with outstanding companies with a great potential future but that trade at high P/Es in the stock market. Facebook and LinkedIn are good examples but we could also add Netflix and Tesla Motors, the terrific electrical car manufacturer.

These are all outstanding companies with great CEOs. But in the stock market, it does not guarantee outstanding investment results if one pays a too high price for them. With an average P/E of more than 100 times for these four stocks, we would advise prudence.

Here is a little table on the new "Fantastic Four"

Company	Quote[1]	EPS 2014	P/E 14
Facebook	68 $	1,25 $	55
Netflix	446 $	4,10 $	109
LinkedIn	204 $	1,58 $	129
Tesla Motors	245 $	1,90 $	129
Average			**105**

We could add a few words on Twitter, which came public last November. The stock quickly flew away (!) and now has a $30 billion dollar market value[1]. The company is not yet profitable so we could not include it in the preceding table. Analysts estimate that the company will have $1.2 billion in revenues

[1] As of February 28th 2014

in 2014. So theoretically, if the company had a 25% net margin level that would translate into $300 million dollars in profits. At its present level, the P/E would then be the equivalent of 100 times this hypothetical scenario. As for the four other securities mentioned, we would advise caution.

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 16% (15% 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 42% (without the effect of currency). As for the S&P 500, the underlying earnings growth of its companies was 7% (9% including dividends) and the total return of the index was 32%.

	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%	7%	16%	9%
2013	16%	42%	26%	9%	32%	23%
Total	**867%**	**903%**	**45%**	**259%**	**317%**	**58%**
Annualized	**13.4%**	**13.7%**	**0.3%**	**7.4%**	**8.3%**	**0.9%**

* 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 867%, or about a tenfold increase. Meanwhile, the value of their stocks has increased 903% (including dividends but without currency effects). On an annualized basis, our companies increased their intrinsic value by 13.4% and our stock returned 13.7% per year. The similarity between those two numbers is not a coincidence. During this same period, the companies comprising the S&P 500 increased their aggregated intrinsic value by 259% and saw their stock prices rise by 317%. 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 18 years, our portfolio has realized a return that is 5% higher than the S&P 500 primarily because 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: 2008

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.

The year 2008 was tumultuous, which is an understatement. We have never seen so much pessimism as in late 2008 and early 2009—to a point that many questioned the very survival of capitalism. Peter Lynch liked to say that the most important organ in the stock market is not the brain but the stomach. To have the right temperament toward stock quotes was vital during the 2008-09 crisis. We witnessed incredibly irrational behaviors on the part of many investors, even from seasoned investors.

At Giverny Capital, we did not panic. We stayed 100% invested in stocks and we made new purchases to the best of our capabilities. We also tried, with little success, to rally investors to our noble cause. I was interviewed in the Montreal newspaper "La Presse" on February 14th 2009 and I labelled the market environment as the "Opportunity of a generation" (in French, it is a little more poetic since it rhymes). We even set up a web site to encourage stock purchases and organized conferences (www.occasiongeneration.com). It was so popular that we had to cancel many conferences because of a lack of registration.

New buy in 2008: Omnicom

We bought shares of Omnicom in 2008 at $24. The big ad firm was on our radar for more than 15 years (yes, we are patient people). In 2008, we bought shares at approximately seven time normalized earnings, a level we believed to be at least a third of its intrinsic value. We held on to the stock for five years and sold it this year at $64 after it announced its merger with Publicis. We had a return of 167% for an investment that we believed had very low risk. In fact, we believe the stock is still undervalued today but we chose to invest our capital in another company that we believed to be even more undervalued.

Mistakes of 2008

In 2008-09, there were lots of great bargains. Many outstanding companies were trading at a third – even a fourth – of their fair value. Some of our own stocks like Carmax, Disney, American Express and Wells Fargo, went down to such attractive levels. We made additional share purchases but not to a level we should have. We would have shown fortitude if we had sold some our then more stable blue chips like Johnson & Johnson, Wal-Mart and Procter & Gamble to cash in on such opportunities. To sell a stock that trades at 66 cents on the dollar to buy a similar stock that trades at 33 cents on the dollar is an intelligent transaction. It is pointless to be too severe in castigating ourselves. But we could conclude that our lack of opportunism has cost us something like 10% of missed returns over the last few years.

Our total return since 2008

The good news, however, is that the Giverny Global portfolio had a total return of 141% since January of 2008 (*before* the start of the great bear market of 2008-2009), which compares to a total return of 54% for our benchmark.

Our Companies

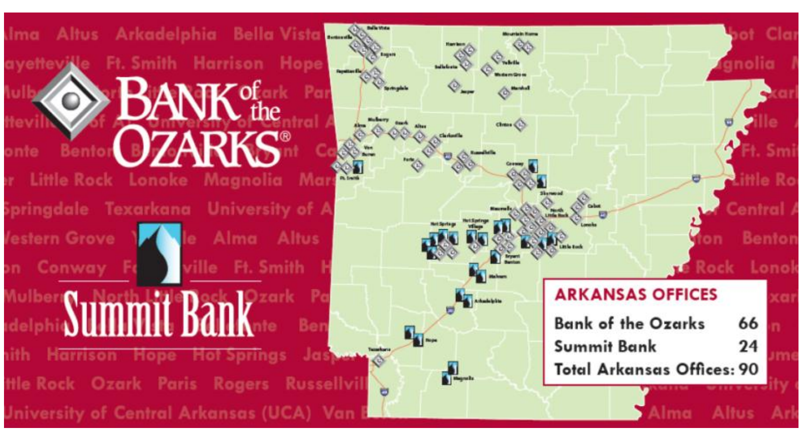
> "In my books, I've always placed the emphasis on the importance of the management team in selecting companies… and yet, I didn't do it enough"
>
> \- Philip A. Fisher

Bank of the Ozarks (OZRK, $57)

2013, yet again, was an exceptional year for Bank of the Ozarks, our bank from Little Rock, Arkansas. The company generated a 9% growth in EPS, reaching $2.41. Here are the highlights from 2013:

- The bank's efficiency ratio (a measure of its cost structure), was an impressive 46%.
- Return on Assets reached 2.04%
- Non-performing loans fell from .57% to .43%.
- The bank's balance sheet continues to strengthen with returns on equity of 13%.
- Ozarks completed its acquisition of First National Bank of Shelby, based in North Carolina.
- In December, Ozarks acquired Bancshares, a Houston-based bank.
- Deposits increased by 20% to $3.7 billion.
- Total assets grew by 18.5% to $4.8 billion.

The company also announced its acquisition of Summit Bancorp at the end of January 2014. This bank has $1.2 billion in assets and 24 branches in Arkansas. After this announcement, Bank of the Ozarks now operates 90 branches in this state (see map below). Given these acquisitions, Bank of the Ozarks now has $6.3 billion in assets.



Since our purchase in 2006, EPS has increased by 154%, or a 14% compounded annual return. Few banks can tout this kind of performance given the difficult economic context of the past years. For the third year in a row, Bank of the Ozarks has been named the best performing bank in the U.S. by *Bank Director* magazine. We remain optimistic about the company's prospect for continued growth.

Berkshire Hathaway (BRK.B, $119)

The company led by the legendary Warren Buffett had another excellent year in 2013. It's difficult to precisely measure the growth in the company's intrinsic value for the year, but we estimate it close to the 18% mark, which in line with their growth in book value.

The greatest asset for Berkshire is its float on insurance premiums which now tops $77 billion. This is the amount of funds set aside to pay for future insurance liabilities. Since the company has a profitable insurance business (with an underwriting ratio of less than 100%), this float is acquired for free. What could be better than having nearly $80 billion in interest-free dollars in the hands of the greatest investor in the history of capitalism? If Mr. Buffett can achieve a 10% return on this capital, this translates itself in $8 billion in annual pre-tax profit that is generated for shareholders. In our opinion, this business activity alone is worth roughly $80 billion, or $34 per share.

We continue to consider shares in Berkshire as undervalued by the market. Mr. Buffett's advanced age certainly plays into the equation. We believe that the company has become the strongest company in the world and is prepared to survive the genius who composed the symphony of capitalism which is Berkshire (though, like Mr. Buffett, we hope that this day is far into the future). We have no idea when this will happen but we see this stock someday trading at a price more representative of its intrinsic value.

Buffalo Wild Wings (BWLD, $147)

Buffalo Wild Wings (BWW) is a sports-oriented restaurant chain which primarily serves chicken wings, as its name reveals. We have been shareholders in the BWW for four years and have been handsomely rewarded for our ownership in this company. The company grew revenue by 22% in 2013 and its EPS climbed by 24%. In the beginning of 2014, the company surpassed 1000 restaurants (with 560 operating as franchises). We continue to see a bright outlook for this concept.

Cabela's (CAB, $67)

We bought shares in Cabela's during the year. This company operates a large chain of retail stores serving the hunting, fishing and outdoor apparel market. While it's been around for 50 years, Cabela's became a public company about 10 years ago. Jean-Philippe, an avid hunter and fisherman, and I have followed the company since.

The company recently adopted a more high-performing business model which grabbed our attention. By reducing the square footage of its new stores, Cabela's was able to significantly improve its return on equity. Profits per square foot are 62% higher in its newer stores relative to its older and larger ones. The company has gone ahead and put in place an ambitious expansion program to expand the number of smaller footprint stores. Cabela's only has a 3.6% market share and could double or triple this figure over the course of the next decade.

The Cabela's store in Louisville, Kentucky

Same-store sales increased almost 4% in 2013, while revenues grew by 16% to \$3.6 billion. EPS increased by 22% to \$3.32. We believe that Cabela's has an excellent brand and has a bright long-term future.

Carmax (KMX, \$47)

Carmax's fiscal year ends in February. We estimate that sales and EPS will grow by 15%. While the company operates 124 stores in the US, it only has roughly 3% of the used car market. Carmax is planning on opening between 10 and 15 stores annually within the coming years.

We have been shareholders since 2007, when we purchased the stock for \$21. The stock subsequently tumbled by 67% during the crisis (such things happen in the market). Yet, Carmax remained profitable during 2008 and 2009. Our patience was rewarded and the company generated earnings in 2013 that were more than twice that of 2007 (or an annualized growth rate of 18%). And the stock followed suit by rising in a commensurate manner to its EPS growth.

Disney (DIS, \$76)

Disney had an excellent 2013, with EPS climbing 16% and the stock appreciating by 50%. Bob Iger remains in our judgment one of the best CEOs in the US. We bought shares in Disney the very day Bob Iger was named CEO in September of 2005. Since his arrival at the helm of Disney, the company's stock has increased by 200%, or 150% more than the performance of the S&P 500 over the course of the same period. The difference to shareholders is an added value of \$70 billion (yes, I should repeat this one: 70 billion dollars). It's not even worth mentioning what a bargain Bob Iger has been for shareholders of Disney. We welcome the news from the company that Iger was going to postpone his retirement by 18 months. He will remain in his position until June 2016. Sigh of relief!

Dollarama (DOL-T, $88)

Four years ago, we were thrilled to see one of the company's we had always admired go public: Dollarama. The reason for this admiration is simple: we think that Larry Rossy, the company's founder and CEO, is one of the best businessmen in Canada. The stock has quadrupled since its IPO.

After its first three quarters of 2013 (the company's fiscal year ends on January 31st), revenues have risen by 14% and same-store sales has increased by 5%. EPS has climbed 22%. December was a bit difficult for the company due to inclement weather. The depreciation of the Canadian dollar could also have a minor impact on the company's gross margins for 2014. Dollarama now has more than 800 stores in Canada and is preparing for international expansion. We believe that the company's outlook is excellent and we are happy to continue owning our shares.

Fastenal (FAST, $47)

Fastenal had a more challenging year, with revenue and EPS only increasing by 6%. The good news is that most of Fastenal's growth was organic, since its store count only increased by 1%. After a few good years of solid growth, the number of new vending machines installed decreased relative to 2012.

We have been shareholders in Fastenal for more than 15 years and have been handsomely rewarded. In 2013, EPS was eight times higher than they were in 1998—equivalent to an annualized growth rate of 15%. We continue to admire the company's culture and management team.

Google (GOOG, $1121)

Google had a great 2013, with revenues climbing 19% and adjusted EPS rising by 12%. The company seems to have succeeded in stabilizing its margins and the transition from revenue derived from traditional Internet towards mobile seems to be occurring harmoniously.

The company dominates the search engine market and its mobile operating system, Android, continues to gain market share. Google continues to be a smaller weight in our portfolio as we would appreciate a better allocation of excess cash flows.

IBM (IBM, $188)

Although IBM's revenue slightly declined (using a constant currency) in 2013, the company's EPS grew by 12%. The company's hardware revenue continues to represent a smaller and smaller portion of its overall revenue—IBM announced the sale of its x86 server division to Lenovo at the beginning of 2014.

This company which dominates information services does a brilliant job at managing its capital. This is a primary reason why we are shareholders. On top of it, the stock is trading at roughly 10 times its estimated earnings for 2014 which seems to us as highly undervalued.

LKQ Corp (LKQ, $33)

We invested in LKQ in 2012. This Chicago-based company refurbishes used automotive parts. The company became the leader in its industry by offering very compelling prices relative to new parts (which pleases the insurance companies) along with an unrivaled distribution network. LKQ has diversified in Europe over the last years by making some acquisitions in the United Kingdom, Belgium, France and the Netherlands.

Revenues grew at an annualized rate of 22% from 2008 to 2013, from less than $2 billion to more than $5 billion. In 2013, EPS rose by 22% relative to last year and we see a bright future for the company's growth prospects.

M&T Bank (MTB, $116)

EPS at M&T Bank grew by 10% in 2013, to $8.66. The bank's return on asset reached 1.5% and its return on equity was 18%. The merger with Hudson City Bancorp, however, is taking a bit more time than anticipated. Once complete, we believe this acquisition will be highly beneficial to M&T.

Robert Wilmers has led M&T since 1983 and has done a phenomenal job and, despite being 79, we hope he'll remain as CEO of this Buffalo-based bank for years to come. I would also be remiss to not add that I often travel to Buffalo and I can say firsthand that M&T plays an outstanding role in its community.

Mohawk Industries (MHK, $149)

When we speak of phenomenal CEOs, we would have to include Jeffrey S. Lorberbaum of Mohawk in this same league. He has led this company, a leader in floor covering based in Georgia, with great skill and agility through the residential real estate crisis of 2006-2011. The company improved its balance sheet, made good acquisitions at compelling prices, and substantially improved its cost structure.

2013 was an exceptional year, with revenues rising 27% and adjusted EPS surging by 45% to $6.90. The acquisition of Marazzi, Pergo and Spano contributed significantly to this growth. We had to remain patient with Mohawk but we were finally rewarded, with the stock doubling since our first purchase more than six years ago.

MTY Food Group (MTY-T, $34)

MTY grew its adjusted EPS by 15% in 2013. The company also completed some important acquisitions, with Extreme Brandz the most significant. This company has roughly 235 Extreme Pita and more than 70 Mucho Burrito restaurants in Canada and the US. The 40 location in the US are the first foray by MTY on American soil. MTY begins its much-anticipated American expansion.

The Mucho Burrito at the *Bay Adelaide Centre* in Toronto

We have been shareholders in MTY for six years. From 2007 to 2013, adjusted EPS increased from \$.51 to \$1.50—a growth of nearly 200%. We are great admirers of Stanley Ma, the company's CEO, and we continue to see a bright future for the company.

O'Reilly Automotive (ORLY, \$129)

O'Reilly had another excellent year in 2013, with revenues climbing 8%, same-store sales rising by 4% and EPS increasing by 27%. O'Reilly's surge in EPS was amplified by the fact that the company bought back approximately 10% of its shares outstanding in 2013.

Since our purchase in the summer of 2004, EPS has quintupled (equivalent to a 21% annualized growth rate) and the stock has gone up six fold. It's difficult to not be highly satisfied from this investment.

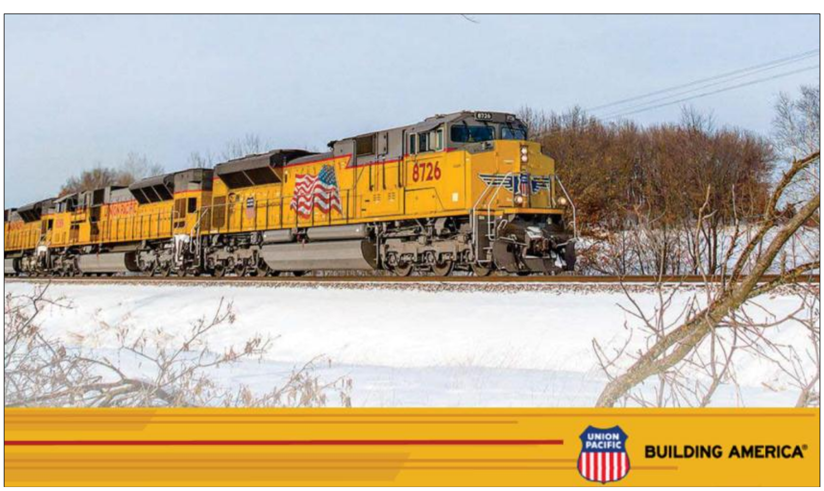
Precision Castparts (PCP, \$269)

Precision Castparts manufactures complex metal composite parts sold primarily to the aerospace industry. The company is a leader in this market and benefits from highly durable competitive advantages which enable it to generate net margins of 18%. This is an exceptional level for an industrial company.

2013 was an excellent year, with EPS rising by 26%. We estimate that 2014 revenues will be \$11 billion and that net income will come in at \$2 billion (or roughly \$14 per share). We would like for the stock to have a more compelling P/E multiple which is the reason why we don't have a greater allocation to PCP in our portfolios!

Union Pacific (UNP, \$168)

Union Pacific had an excellent year. EPS rose by 14% in 2013 and we anticipate a similar growth for 2014. The most important factor for shareholders of Union Pacific is the company's capacity to increase its prices. The company increased its prices by 3.75% in 2013—surpassing inflation and exceeding the company's rise in its own costs (of less than 1%). The company's operating cost ratio decreased from 67.8% in 2012 to 66.1%, with company aiming for 65% in the near term. The company also increased its dividend by 19% and bought back \$2 billion of its own shares. So everything is rolling along (!) for our railroad company based out of Omaha.



Valeant Pharmaceuticals (VRX, $117)

It was another year of solid growth for our Laval-based pharmaceutical. The company completed many acquisitions, with the purchase of Bausch & Lomb the most significant. Valeant has complex accounting but we believe that adjusted EPS will be $6.24 in 2013 compared to $4.51 for the prior year (a 38% increase). 2014 also looks promising, with a growth rate estimated to surpass 30%. The stock has nearly tripled since our purchase two years ago.

The pharmaceutical industry is not easy to predict and analyze. The reason behind this investment is simple: we greatly admire Valeant's CEO, Michael Pearson.

Visa (V, $222)

Visa had another exceptional year. Revenues increased by 13% and EPS climbed by 21% (this EPS growth is magnified by the company buying back 5% of its shares). Our purchase of Visa three years ago, after a sharp decline in the stock, has proven to be very rewarding with the stock tripling since.

Wells Fargo (WFC, $45)

Wells Fargo had another very solid year. EPS rose by 16% to $3.89—a record level. We estimate that the adjusted EPS for Wells Fargo, while compensating for the amortization of intangible assets, reached $4.08. Chargeoffs related to non-performing loans also significantly decreased. The bank's return on asset was 1.51% and its return on equity was 13.9%. The company increased its dividend by 31% in 2013.

We estimate adjusted EPS of $4.45 for 2014 and continue to consider this stock as highly undervalued.

The Podium of Errors

> "There's no way that you can live an adequate life without many mistakes.
> In fact, one trick in life is to get so you can handle mistakes"
>
> \- Charlie Munger, Vice-Chairman of Berkshire Hathaway

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 them on our statements.

Bronze Medal: Tripadvisor

As you can imagine, I spend a great deal of the year on the road visiting companies, attending conferences and meeting partners. Having had all sorts of hotel experiences over the course of the past decades, I really like to be able to choose hotels which can make my travels more enjoyable. I discovered the website Tripadvisor a few years ago and became a loyal fan. To paraphrase an American Express advertising, I never leave home without vetting out my destination on Tripadvisor ahead of time. The company also owns another very useful site called webseatguru.com which helps you choose the best seat on any commercial flight.

Tripadvisor went public at the end of 2011 and I was very impressed with the company's financial performance after reading the prospectus. Unfortunately, the stock rapidly climbed to $45 and was trading at 30 times its earnings. Then, in the fall of 2012, the stock tumbled by 33% to $30 and I seriously thought about buying it. The P/E seemed reasonable (20x) for a company with a dominant brand that was growing at 20% a year. Yet, as often the case, I decided to wait for an even better price. And the stock surged by 180% in the following year and is now trading at $84. It's too bad that I didn't convert my admiration into profits as it would have paid for a few five star hotels…for both you and me.

Silver Medal: Buffalo Wild Wings

You are likely surprised to find Buffalo Wild Wings in this section about errors as we have quadrupled our money since becoming shareholders. Difficult to ask for more? Well, it could have been better.

In the middle of 2012, the company had a disappointed quarter due to a substantial increase in the price of chicken wings that weakened gross margins. True to its typical myopia, Wall Street punished the stock which dropped by 24% thereafter.

We had a 2% weight on this stock in our portfolio at that moment. We thought about doubling our holding, believing that these margin problems would be temporary. I decided to go to Minneapolis to meet the executive team at BWW to look into this. I was (yet again) highly impressed by their vision and game plan for the company. I came back convinced that we should not only keep our shares but that we should add to our position. But I didn't act on this conviction and when the stock started to climb, I waited on the sidelines. The stock doubled over the next 15 months. If we had had twice the weight in our portfolio, we would have been even more rewarded this year.

Gold Medal: Church & Dwight

Church & Dwight was first known for its Arm & Hammer brand, the baking soda often placed in our refrigerators to capture odors. About 15 years ago, the company decided to develop an ambitious growth plan by developing new products for Arm & Hammer and also by acquiring new brands. In 2001, the company purchased Carter-Wallace which has many brands including Trojan (the famous condoms), Nair (to remove superfluous body hair) and First Response (the pregnancy test).

As soon as 2003, I could observe the success of this strategy. In only five years, EPS increased from $.26 to $.62 and the stock was trading at $11 (or a P/E of 19x). I hoped that the stock would drop to a more interesting level which never really happened. In 2013, the company generated $2.89 in EPS, meaning that the company grew at an annualized rate of 17% over the course of the last decade. The stock is now trading at $61, a gain of 455% in 10 years (19% annually). And the P/E increased rather than decreased.

This was a great error because I understood the nature of the company's product and brands (allow me to make a juvenile joke by mentioning that *Trojan is an ideal repeat business*). Additionally, after following the company closely for five years, I also realized by 2003 that the company was led by a brilliant team dedicated to serving and creating wealth for its shareholders. I don't have any excuses to even mention and this error is certainly in the gold camp.

Conclusion: the Missing Gene Hypothesis!

We've repeated on numerous occasions throughout the years the importance of having a good attitude towards market fluctuations in order to realize returns that are above the average. We like to repeatedly cite the wise words of the great money manager John Templeton: "It is impossible to produce superior performance unless you do something different from the majority." This something different, in our opinion, is to be able to buy stocks without being affected by the opinions and behaviors of other investors.

Over the course of the last 20 years, we have noticed how few market participants actually achieve this. Warren Buffett even said a few years ago that the capacity to have a good attitude towards stock prices might be an innate trait not acquired with experience (or good arguments). This statement made us think about another way to look at things.

Clearly, the capacity to do better than average is not just linked to intelligence, work or financial resources (if this were the case, all the great financial institutions would achieve it). We came to the conclusion that those rare investors who are able to do better than average over a long period of time might have something that others do not have.

Actually, it's the contrary; they are actually missing something that is present in others: the hypothetical "tribal gene". Like animals, our genetic code was developed over hundreds of thousands of years, with the primary objective being survival. As humans, we learned early (more than 200,000 years ago) that living in a tribal unit offered protection. Following the tribe became a survival instinct well-entrenched in the core of our being. This unconscious instinct is extremely powerful, primarily in moments of crisis or when our survival is in jeopardy. So, when stocks tumble and those around you sell in a panic, it's almost impossible for someone with an intact genetic code to resist the tendency to follow the tribe towards a safe haven (in this case, towards the liquidity of cash).

From our empirical observations, it seems that some members of our species are immune to this call of the herd. They can go left when the rest of the tribe goes towards the right. Their attitude isn't influenced by the behavior of the tribe. Their genetic code seems to not have the "tribal gene". It's difficult to evaluate what percentage of humans have this particularity but it's a minority. And it's probably those who eventually become creators (artists, scientists, writers, entrepreneurs, etc), as the act of creation requires the capacity to make something new and to forge a new path different from others. To create is to go where there was nothing before. Creating is the antonym of following.

Such a theory, which is of course impossible to prove, probably sounds arrogant despite that not being our intent. We are simply on a quest for learning.

Subjectively, we believe that our team at Giverny Capital doesn't have this tribal gene. This line of thinking enables us to answer the question of why we didn't panic during the crisis of 2008-09 and remained optimistic while nearly all others sought refuge.

Many decades ago, Warren Buffett told a group of students: "To succeed in the market, be fearful when others are greedy and greedy when others are fearful." This simple phrase captures the essence of success in the market.

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 the 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 well above average.

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 (and have developed a taste for it), 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 2014 to all our partners.

François Rochon and the Giverny Capital team

APPENDIX A

The Gazette

Published on July 9th 2013

Twenty years of the Giverny Portfolio

By François Rochon

I started to manage the Giverny Portfolio in July 1993 (and have thoroughly measured results since). The results over twenty years are very satisfactory. More importantly, I have learned lots of lessons that should be useful going forward. Here are the top 10 things I have learned since 1993:

10- Investing in the stock market is not a game.

Investing in the stock market is about acquiring partial ownership in companies. It is not a game. Those who approach the market as if it were a casino end up with the results of gamblers.

9- Beating the market is harder than most people think

The vast majority of investors don't come close to beating the market. Even professional managers, as a whole, don't beat the market because they are the market. But some investors are able to do it. In my experience, it requires a total devotion to the art of investing in addition to the right temperament toward market fluctuations.

8- Short-term results can be caused by luck as much as by skill

Most great investors I know have, on average, underperformed the market one year out of three. Results over a few years don't mean much. But over the long term, chance evens out and sound investment principles prevail. So patience is a key quality to investment success.

7- The more an industry changes, the riskier it is to invest in

I am astonished to see that many leading tech companies of the nineties don't exist anymore (or have lost 80% of their values). Industries that change quickly can be good for customers but bad for shareholders. It applies to technology stocks as well as stocks in some medical fields or government regulated sectors. On the other hand, a company like Coca-Cola will still exists in 50 years!

6- Beware of IPOs

Initial Public Offerings are usually popular at the end of a bull market. When you hear about new exciting IPOs, raise your shields! Although some IPOs do very well (I did buy Dollarama when it came public a few years back), the majority do poorly. The main reason is that the price set is rarely advantageous to the buyer.

5- Most people are wrong most of the time

I don't have much scientific data to explain this one. But my observations over the years have led me to believe that, in the stock market, most people are wrong most of the time. And the irony is that most people think they know more than the others!

4- Price and value are not the same thing

Price is what you pay, value is what you get. I have seen over the years many stocks sell at half what they were worth. And I've seen overvalued stocks by the bucket. A great business is not always a great stock. Although it is a mistake to solely focus on price, it is an important factor.

3- Look for a company with a competitive advantage

It is a ferociously competitive business world out there. Companies that do better than average - over many years - have a competitive advantage. Look for such advantages.

2- One key ingredient is the management

A great business model is one key ingredient. A great management team is the other one. Most of my big winners were linked to the fact that the management of the company was outstanding.

1- It is futile to try to predict the stock market over the short run

All the previous lessons are useless if you try to predict the stock market over the short run. I have heard people say hundreds of times that they are waiting to buy great companies because they had some views on the short-term direction of the stock market. Owning great businesses, managed by great people and acquired at reasonable prices is the winning recipe.

APPENDIX B

Investment philosophy

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

In 2013, 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 C

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 2013 :

  - 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.