Annual Letter to our Partners 2018

Gabor Szilasi
Monet's garden in Giverny; the water garden in summer, Giverny, 1998
Giverny Capital Collection

Historical Summary

It has been more than 25 years since I discovered the writings of Warren Buffett, Benjamin Graham, John Templeton, Philip Fisher and Peter Lynch. I then decided to begin managing a family portfolio based on an investment approach synthesized from these great money managers. By the end of 1998, after five years of satisfactory results, I decided to launch an investment management firm offering asset management services aligned with my own investment philosophy. Giverny Capital Inc. came into existence.

In 2002, Giverny hired its first employee: Jean-Philippe Bouchard (JP for those who know him well). A few years later, JP became a partner and participates actively in the investment selection process for the Giverny portfolio. In 2005, two new persons joined the firm who eventually became partners: Nicolas L'Écuyer and Karine Primeau. Finally, in 2009, we launched a US office in Princeton, New Jersey. The director of our Princeton office, Patrick Léger, shares in the culture and long-term time horizon inherent to Giverny.

We are Partners!

From the very first days of Giverny, the cornerstone of our portfolio management philosophy was to manage client portfolios in the same way that I was managing my own money. Thus, the family portfolio I've managed since 1993 (the "Rochon Global Portfolio") serves as a model for our client accounts. It is crucial to me that clients of Giverny and its portfolio managers are in the same boat! That is why we call our clients "partners".

The Purpose of our Annual Letter

The primary objective of this annual letter is to discuss the results of our portfolio companies over the course of the prior year. But even more important, our goal is to explain in detail the long-term investment philosophy behind the selection process for the companies in our portfolio. Our wish is for our partners to fully understand the nature of our investment process since long-term portfolio returns are the fruits of this philosophy. Over the short term, the stock market is irrational and unpredictable (though some may think otherwise). Over the long term, however, the market adequately reflects the intrinsic value of companies. If the stock selection process is sound and rational, investment returns will eventually follow. Through this letter, we provide you with the information required to understand this process. You will hopefully notice that we are transparent and comprehensive in our discussion. The reason for this is very simple: we treat you the way we would want to be treated if our roles were reversed.

The Artwork on Our 2018 Letter

Since 2004, we have illustrated the cover of our letters with a copy of an artwork from our corporate collection. This year we selected an artwork by the Quebec artist Gabor Szilasi. It is a photography taken at Giverny in 1998.

For the year ending December 31st 2018, the return for the Rochon Global Portfolio was -0.6% versus -1.4% for our benchmark, which represents a relative outperformance of 0.8%. The return of the Rochon Global Portfolio and the one of our benchmark include a gain of approximately 6.7% due to fluctuations in the Canadian currency.

Since its inception on July 1st 1993, our compounded annual growth rate has been 15.1% versus 8.8% for our weighted benchmark, representing an annualized outperformance of 6.3% over this period. It's worth noting that the effect of the fluctuations in the value of the US Dollar has been nearly nonexistent on our returns. Over 25 years, the US currency has appreciated by 6.5% relative to the Canadian Dollar, which corresponds to an effect of 0.2% on our annualized returns. Our long-term (and ambitious) objective is to maintain an annual return 5% higher than our benchmark.

The Rochon Global Portfolio: Returns since July 1st 1993

Year *	Rochon	Index **	+ / -	$ US/Can ***
1993 (Q3-Q4)	**37.0%**	9.5%	**27.6%**	3.3%
1994	**16.5%**	3.7%	**12.7%**	6.0%
1995	**41.2%**	24.0%	**17.2%**	-2.7%
1996	**28.0%**	22.8%	**5.2%**	0.3%
1997	**37.8%**	28.6%	**9.2%**	4.3%
1998	**20.6%**	18.8%	**1.8%**	7.1%
1999	**15.1%**	16.3%	**-1.2%**	-5.7%
2000	**13.4%**	3.2%	**10.2%**	3.9%
2001	**15.1%**	-0.4%	**15.5%**	6.2%
2002	**-2.8%**	-18.3%	**15.6%**	-0.8%
2003	**13.6%**	14.0%	**-0.4%**	-17.7%
2004	**1.6%**	6.2%	**-4.5%**	-7.3%
2005	**11.5%**	3.6%	**7.9%**	-3.3%
2006	**3.5%**	17.0%	**-13.5%**	0.2%
2007	**-14.4%**	-11.6%	**-2.8%**	-14.9%
2008	**-5.5%**	-22.0%	**16.5%**	22.9%
2009	**11.8%**	12.2%	**-0.4%**	-13.7%
2010	**16.1%**	13.8%	**2.3%**	-5.3%
2011	**7.6%**	-1.1%	**8.7%**	2.2%
2012	**21.2%**	12.5%	**8.7%**	-2.2%
2013	**50.2%**	38.9%	**11.3%**	6.9%
2014	**28.1%**	17.8%	**10.2%**	9.1%
2015	**20.2%**	13.4%	**6.8%**	19.3%
2016	**7.3%**	14.3%	**-7.0%**	-3.0%
2017	**13.1%**	10.3%	**2.9%**	-6.6%
2018	**-0.6%**	-1.4%	**0.8%**	8.7%
Total	**3477.1%**	**755.2%**	**2722.0%**	**6.5%**
Annualized	**15.1%**	**8.8%**	**6.3%**	**0.2%**

* All returns are adjusted to Canadian dollars
** Index is a hybrid index (S&P/TSX, S&P 500, Russell 2000) which reflects the weight of the underlying assets at the beginning of the year.
*** Variation of the US dollar compared to the Canadian dollar

Refer to Appendix B for disclosure statements on the Rochon portfolios.

The Rochon US Portfolio

We have been publishing the returns of the Rochon US Portfolio, which is entirely denominated in US dollars, since 2003. The Rochon US Portfolio corresponds to the American portion of the Rochon Global Portfolio. In 2018, it realized a return of -8.3% compared to -4.4% for our benchmark, the S&P 500. The Rochon US Portfolio therefore underperformed the S&P 500 by 3.9%.

Since its inception in 1993, the Rochon US Portfolio has returned 2724%, or 14.0% on an annualized basis. During this same period, the S&P 500 has returned 821%, or 9.1% on an annualized basis. Our added value has therefore been 4.9% annually.

Year	Rochon 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%
2014	18.0%	13.7%	4.3%
2015	1.7%	1.4%	0.4%
2016	7.5%	12.0%	-4.5%
2017	19.7%	21.8%	-2.1%
2018	-8.3%	-4.4%	-3.9%
Total	**2724.2%**	**821.0%**	**1903.2%**
Annualized	**14.0%**	**9.1%**	**4.9%**

Refer to Appendix B for disclosure statements on the Rochon portfolios.

After eight years of consecutive outperformance (a statistical event unlikely to reoccur), the Rochon US Portfolio underperformed the S&P 500 for the third year in a row. Once again this year, a few of the all-star stocks in the S&P 500 contributed in an outsized manner to the performance of the index. Relative to the Russell 2000 (an index composed of smaller cap companies), the S&P 500 was up 6.6%

in 2018. In fact, over the last five years, the S&P 500 has achieved an annual return of 8.5% vs. 4.4% for the Russell 2000.

Over a long period of time, the returns of the S&P 500 and Russell 2000 tend to be similar. Since 1993, the S&P 500 generated annual returns of 9.1% versus 8.7% for the Russell 2000. The stock market tends to accurately reflect the intrinsic value of companies, whether large or small.

We accept in advance that we will sometimes underperform the S&P 500 in the short term when our style and/or our companies are out of favor (and sometimes for no reason). While it is not always easy, we try to remain impervious to short-term results, both in good and not-so-good times.

Rochon Canada Portfolio

We introduced a portfolio that is 100% focused on Canadian equities in 2007. This corresponds approximately to the Canadian portion of the Rochon Global Portfolio. In 2018, the Rochon Canada Portfolio returned -7.6% versus -8.9% for the S&P/TSX, therefore outperforming its index by 1.3%.

Since 2007, the Rochon Canada Portfolio has returned 462%, or 15.5% on an annualized basis. During this same period, our benchmark had a gain of 58%, or 3.9% on an annualized basis. Our annual added value was therefore 11.6%.

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%
2014	20.3%	10.6%	9.7%
2015	16.0%	-8.3%	24.3%
2016	11.0%	21.1%	-10.1%
2017	27.4%	9.1%	18.3%
2018	-7.6%	-8.9%	1.3%
Total	**462.4%**	**57.7%**	**404.6%**
Annualized	**15.5%**	**3.9%**	**11.6%**

Refer to Appendix B for disclosure statements on the Rochon portfolios.

The holding that contributed most significantly to our loss in 2018 was Dollarama. Despite its sharp decline in 2018, we have had a cumulative gain of more than 700% on this stock since our initial purchase in 2010. We will go in more detail regarding Dollarama in our "company" section below.

Over 12 years, the performance of our Canadian securities has been significantly higher than that of the S&P/TSX. A concentrated portfolio can drastically exceed the performance of an index but the risks inherent to high concentration is not appropriate for a portfolio that is to be managed prudently. In fact, we consider that a portfolio of about 20 securities is the right balance between having a minimum diversification level to reduce company-specific risk while also having few enough companies to improve the odds of beating the market indices. Since this portfolio represents only a portion (approximately 15%) of the Rochon Global Portfolio, our diversification requirements are met.

2018

The year unfolded in two parts. Over the first two quarters, the US market did very well and reflected a sharp increase in corporate profits bolstered by a significant drop in corporate tax rates. The rest of the world, however, did not have the same experience and had marked stagnation in places such as Canada, Europe and Asia.

Then in the fall, the sentiment of US investors turned 180 degrees and the S&P 500 and the Russell 2000 fell by 20% and 27%, respectively, from their high of September to their low of December 24th. The sharp decline in December resulted in a bear market (a drop of more than 20%) which was the fifth since my debut in 1993, some 25 years ago.

We've been around the block!

We've known for a long time that the stock market, in the short term, behaves like a manic-depressive entity. No medicine can cure it or even stabilize it. The market is a network of millions of emotional human beings interacting with each other (imagine millions of people trying to predict what the other millions of people will do and vice versa).

Increased transaction efficiency and near instantaneous access to information has dramatically changed the way in which the investors approach the market since 1993, just before the large-scale implementation of the Internet. But what has not changed is human nature. When it comes to money, humans over and over flip flop from fear to greed like wind vanes armed with cell phones.

Here are the 2018 returns for different indices around the world and annualized over 5 years:

Return (in $US)	2018	2018 $Can	5 year
Russell 2000	-11.0%	-3.2%	4.4%
S&P 500	-4.4%	4.0%	8.5%
MSCI EAFE	-13.8%	-6.3%	0.5%
MSCI Europe	-14.9%	-7.5%	-0.6%
MSCI China + HK + Taiwan	-22.4%	-15.6%	2.9%
MSCI AC Asia	-13.7%	-6.2%	3.6%
Average	**-13.4%**	**-5.8%**	**3.2%**
S&P/TSX (in $Can)	-8.9%	-8.9%	4.1%

With a fall of 4% for 2018, the S&P 500 was the index that performed best among the main indices of the World. Furthermore, over the past three years, the S&P 500's returns have been extremely polarized, with software and internet-related stocks increasing by about 60% while those related to more traditional industries increasing by about 20%. In other words, if you had been underweighted the software and internet segments over the last few years, it would have been very difficult to achieve the S&P 500's performance.

Some of the companies in these sectors are clearly exceptional and have drastically changed the world we live in just a few years. On the other hand, one must bear in mind that all companies have an intrinsic value and that it can be risky to pay too much for even the best of companies.

A few words about big American banks

Many companies have slowly increased their debt levels during this economic cycle. The reason is very simple—the very low cost of capital (low interest rates). This prevailing appetite for debt is also very present in the world of private equity, as they have a business model which requires significant leverage.

We believe that it is not the big American banks that are financing the current level of leveraged loans. If we go back 25 years, about 30% of leveraged loans were owned by US banks and 40% by institutional investors. Recently, this ratio is about 5% for US banks and more than 85% for institutional investors (Source: S&P, Goldman Sachs).

Most major US banks, still scalded by the 2008 financial crisis, are stronger than ever and their stock market valuations seem very attractive to us. That's why we own shares in four US banks at the time of writing this letter.

Outlook for 2019

The prospects for earnings growth could certainly be much lower in 2019 than in 2018. We believe that US companies could increase their earnings per share (EPS) by an average of about 4% this year.

Even in the event of a more pronounced slowdown, the growth of corporate profits will eventually pick up again. Over the long run, stocks remain the best asset class to own for the simple reason that corporate profits are always growing (albeit not linearly).

If the stock market continues to behave like a manic-depressive entity in the short term (as 2018 so eloquently demonstrated), it nonetheless still always accurately reflects the intrinsic value of companies over the long term. Is this not a good premise for investing our savings?

The popularity of index funds

> *"….The idea behind buying an index fund is that the average manager - by definition - gets an average performance. But because of the management fees and transaction costs, their collective result can only be lower than the indices (which incur only little expense)... Many investors have concluded that investing in an index fund is statistically the best option for someone who cannot distinguish a good investment from another or a good manager from another... Thus, in recent years, capital has gradually shifted from active management to passive management. The side effect of this is that money moves to the largest companies that have the most weight in the index (the S&P 500). This movement of capital has had the effect of pushing the S&P 500 higher, which has the effect of making active management look even worse, which has the effect of transferring even more money from active to passive strategies. Some managers see the threat of not owning the largest stocks for their performance and they therefore make sure to have these securities with at*

least the weight of the S&P 500 in their portfolios (which has the effect of driving up these few securities once again). As one well-known manager said: "Many have capitulated". "

Do you think this is a good summary for 2018? And yet, I wrote these words 20 years ago for the 1998 annual letter. I then explained in detail the significant difference in valuation between large cap stocks (bought massively by index funds) and all others. I then added these sentences:

"...In the long run, the stock market reflects the intrinsic value of companies - large and small - and this imbalance between larger companies and smaller ones should be rectified on its own in the future.... In the stock exchange, as in life, common sense ends up triumphing even if it can test the patience of the wise man..."

What happened in the two decades that followed this text?

From 1999 to 2018, the S&P 500 achieved an annual return of 5.6%, while the Russell 2000 achieved an annual return of 7.4%. So, as I predicted, the S&P 500 returned to normal and smaller cap stocks did better than larger ones (a total return of 317% for the Russell 2000 vs. 197% for the S&P 500).

In 1998, many managers (and their clients) threw in the towel and resorted to index funds. Many observers argued that it was almost impossible to beat the S&P 500 over a long period. From this perspective, what was the performance of the Rochon Global Portfolio for the same period of 20 years? Here is a summary table:

Return in $Can	S&P 500	Russell 2000	S&P / TSX	**Rochon Global**	**Added value**
1999-2018	5.0%	6.8%	6.6%	**10.6%**	**4.6%**

Refer to Appendix B for disclosure statements on the Rochon portfolios.

You will note that the Canadian dollar appreciated from 1998 to 2018 and had the effect of reducing the annual return of US indices by 0.6% when presented in Canadian currency. The Rochon Global Portfolio results are calculated in Canadian dollars. As you can see, our annual return of 10.6% outperformed the S&P 500 by 5.6% annually, the Russell 2000 by 3.8% annually and the TSX by 4.0% on the same basis. This gives a weighted annual added value of 4.6% by combining the three indices (with 43% / 43% / 14% of respective weight).

As in 1998, I do not want to denigrate an investment approach based on indexing. For the vast majority of investors, this is a winning solution since most managers (amateurs and professionals) do not outperform the indices over the long term.

On the other hand, I have observed some investors generate returns that were much higher than the indices over the long term (such as Ben Graham, Peter Lynch, Lou Simpson, Warren Buffett, Charlie Munger, Bill Ruane, John Neff, Philip Carret, John Templeton, etc.) So I took the time to study the source of their outperformance and they all had one thing in common: they considered buying a stock as the purchase of a business and were all trying to buy these businesses at a meaningful discount to their intrinsic values.

I adopted this approach right from the start in 1993 and we have been validated (and rewarded) by this value investing philosophy so far.

A great quote from Ben Graham from 1958

I read Ben Graham's *The Intelligent Investor* late in 1992—this was the book that converted a young Warren Buffett in 1949 to value investing. For Buffett, this was the starting point for his immense success as an investor. I also read at the time the appendices of the book (the fourth revised edition) which includes a transcription of a speech by Ben Graham of 1958 entitled *The New Speculation in Common Stocks*. I found this text arid and of little interest at the time.

Although I've been reading *The Intelligent Investor* on a regular basis over the years, I never reread the 1958 speech, until I came across a Latin quote from Ben Graham and searched far and wide for its origin. I finally found the quote and its context in this speech from 1958. In my rereading, and also now armed with 25 years of new perspectives, I realized the profound nature of this quote and the highly nuanced writing ability of Ben Graham (a trait that seems extremely rare in the clouds of the social cyberworld of the 21st century).

This famous quote comes from Ovid's Metamorphoses (a classical author from 2000 years ago). Phaeton was the son of the sun god Phoebus—the god flying across the sky in his solar chariot. One day, Phaeton asked his father for permission to drive the famous chariot himself. Phoebus warned him to stay well in the middle of his trajectory—too low and he would ignite the Earth and too high he would ignite the heavens. Phaeton showed little prudence and lost control of his horses and crashed down to Earth in a fiery hell, nearly setting the World on fire.

Peter Paul Rubens, The fall of Phaeton (c 1636)
Musées royaux des Beaux-Arts de Belgique, Bruxelles / photo : F. Maes (MRBAB)

The words of caution which Phoebus spoke to Phaeton were:

medius tutissimus ibis
you will go safer in the middle road

As we mark the 25th anniversary of the beginning of the Rochon Global Portfolio and the 20th anniversary of the founding of Giverny Capital, I think it is worth reconsidering these words of wisdom that have survived since Roman times. Consciously or not, I realize that we have consistently followed the middle road in investing and assimilated the teachings of Ben Graham. At Giverny Capital, we have an approach that could be summarized as follows:

- We have an open mind but at the same time an independence of thought. We try to maintain a balance between humility and confidence in our judgment.
- We like to invest in companies that are growing quickly but not too quickly (knowing the dangers of growing too fast or falling prey to shifting trends).
- We understand the economic benefits of using some debt, but we stay away from companies that use it too aggressively.
- We can invest in companies related to new technologies but not in their very beginnings (we want to make sure that the business model is sound and sustainable).
- We are willing to pay a higher P/E multiple than when we began investing but there is a limit we are not ready to cross.
- We are patient but also know that there is a difference between being patient and stubborn.

We have very ambitious long-term performance targets that have been achieved so far. But we have always wanted to reach them without taking on inappropriate level of risk. We want to be good stewards of our capital and that of our partners. To constantly keep in mind the wisdom of Phoebus is the equivalent of having a lighthouse illuminating the path to enrichment in the stock market while also remaining cautious.

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 EPS and the average dividend yield of the portfolio. We believe that analysis is not exactly precise but approximately correct. In the non-scientific world of the stock market, we believe in the old saying: "It is better to be roughly right than precisely wrong."

This year, the intrinsic value of our companies, as a whole, rose by about 22% (21% from the growth in earnings and 1% from the average dividend). Despite some of the changes to our portfolio during the year, we consider the estimate of the EPS growth at our companies during 2018 to adequately reflect their economic reality.

The market performance of the Rochon Global portfolio in 2018 was a decline of roughly 7% (estimated without currency effects). Our stocks therefore realized a price performance that was far less than their underlying economic performance.

In fact, in 23 years of tracking owner earnings, this is the most significant disparity between the estimated increase in intrinsic value and the stock market value we have experienced. There are two possibilities that present themselves: either our securities were overvalued at the beginning of 2018 (and therefore already factored in the rise in the upcoming growth of their intrinsic value) or that our securities at the end of the year were more undervalued than in beginning of the year. We believe the latter to be the case.

The companies in the S&P 500 also saw strong growth, with growth in the order of 21% (about 23% when we add the dividend). The S&P 500 had a total performance of -4% (in $USD).

	Rochon Global Portfolio			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%
2014	13%	19%	6%	9%	14%	5%
2015	11%	4%	-7%	1%	1%	0%
2016	9%	10%	1%	3%	12%	9%
2017	14%	20%	7%	14%	22%	8%
2018	22%	-7%	-29%	23%	-4%	-27%
Total	1723%	1424%	-298%	474%	524%	50%
Annualized	13.5%	12.6%	-0.9%	7.9%	8.3%	0.4%

* Estimated growth in earnings plus dividend yield
** Market performance, inclusive of dividends (refer to Appendix B for disclosure statements on our returns)
*** Results estimated without currency effects

Since 1996, our companies have grown their value by about 1723% and their stocks have achieved a total return of approximately 1424%. On an annualized basis, we achieved an intrinsic performance of 13.5% versus 12.6% for their stock market performance (dividend included in both cases). The correlation between the two figures over a long period is not accidental since the stock market always reflects the fair value of companies over the long term.

Our stocks have outperformed the S&P 500 by 4.3% annually over the last 23 years for the simple reason that our companies grew their intrinsic values at a rate that was around 5% greater than that of the companies that make up the S&P 500.

Five-year Post-mortem: 2013

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.

We made few changes to the portfolio in 2013, but here are a few remarks from reviewing the annual letter from that year.

- In 2013, we acquired shares in Cabela's, a chain of outdoor, hunting and fishing stores. It was a disappointing investment. In 2013, we wrote that the "the company recently adopted a more high-performing business model which grabbed our attention." But in the end, the financial performance of these retail stores did not live up to our expectations and we resigned ourselves to selling our investment at a loss.
- In 2013, we invested in Precision Castparts. We liked the management of the company and the significant competitive advantages of its products. Berkshire Hathaway acquired the business in 2015 and this investment proved very rewarding over a relatively short period.
- In 2013, I gave a gold medal to the mistake of not buying shares in Church & Dwight. I explained that I had studied the stock in 2003 and that it had risen by 455% during those ten years. The growth rate of this company slowed afterwards but, during the five years that followed, the stock returned 93% versus 34% for the S&P 500 (gross of dividends).

Frutarom Acquisition

We purchased shares in the Israeli company Frutarom in 2017. This company specializes in the manufacturing of essences and flavors with a focus on natural-based flavors. It is an industry that we have always appreciated because of its great stability. Moreover, Frutarom had an exceptional track record, maintaining a growth rate of more than 20% over the last decade.

During the year, Frutarom was acquired by the American company International Flavors & Fragrances, a leader in this sector. We achieved a gain of about 45% over a period of just over a year.

<u>Our Companies</u>

" Trees with deep roots are those that grow higher "

- Frédéric Mistral (Les îles d'or)

Section for Giverny Capital's partners only

The Podium of Errors

"How do you become better tomorrow? By improving yourself, the world is made better. Forget your mistakes, but remember what they taught you."

- Benjamin Franklin

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2018 (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: Lululemon

I've followed the Canadian company Lululemon since its IPO in 2007. I admire the quality of their products, their marketing strategies and the loyalty of their customers. Lululemon addresses, among others, the yoga clothing market. I'm not a fan of this activity (I prefer to go to museums to recharge my battery) but I can see that Lululemon is dominant in this market segment. The stock has often commanded a high P/E so I followed its performance from afar.

The company had issues with some of its products a few years ago and also made management changes. In 2017, the issues seemed to have been addressed and the prospects for growth and profitability had greatly improved. The stock market did not reflect, in our opinion, these better prospects. So we decided to become shareholders in early 2018.

But the day we were about to buy, the CEO resigned for "lack of leadership". So I opted to wait to see who the new appointee would be. Meanwhile, financial results came out and were very strong. The share price then climbed quickly and I decided to wait for a better price. At the time of writing this, the stock is 88% higher.

Silver Medal: Boyd Group

We starting paying attention to the Canadian company Boyd Group in July 2011 when the stock was trading for around $14. Boyd Group has a network of 575 body shops. Its collision repair centers are located in Canada and the United States mainly under the respective names of Boyd and Gerber. Boyd's beautiful track record and attractive growth prospects caught our attention.

We were also attracted by the inherent characteristics of the industry in which Boyd operated. It's a highly fragmented industry with many small independent local players which created an opportunity for consolidation for a company like Boyd. The stock then traded at a reasonable multiple, about 14-15 times the estimated profits for 2011. At about the same time, we were also studying LKQ, a distributor of refurbished body parts. LKQ seemed to have greater competitive advantages than Boyd. So we eventually decided to invest in LKQ in 2012.

We also chose to pass on Boyd because we found it odd that the company was structured as a corporate income trust (a patently simplistic excuse). From 2012 to 2018, LKQ increased its EPS by 17% annually but the stock did not follow suit (rightly or wrongly, the P/E decreased). As for Boyd, EPS has grown by 32% annually and the stock is now trading around $125—it has appreciated by nine times.

Gold Medal: Bright Horizons Family

We discovered Bright Horizons Family about fifteen years ago. The company operates private daycare facilities within companies. It responds to a vital need of our era. Bright Horizons had strong growth (in the 25% range) and seemed to have strong competitive advantages. Because of its high valuation (often trading at 25 to 30 times earnings), we never became shareholders. In early 2008, the company was privatized by a private equity fund at about three times the price I had considered investing five years prior.

But we must always keep our eyes open: the company went public again in 2013. Unfortunately, the company had a lot of debt at the time. The stock was issued at approximately $28 and the company only earned $0.80 per share. I knew, however, that the company could increase its profit margins and certainly improve its balance sheet. I told myself that I would not miss my chance a second time and I have followed the company very closely since.

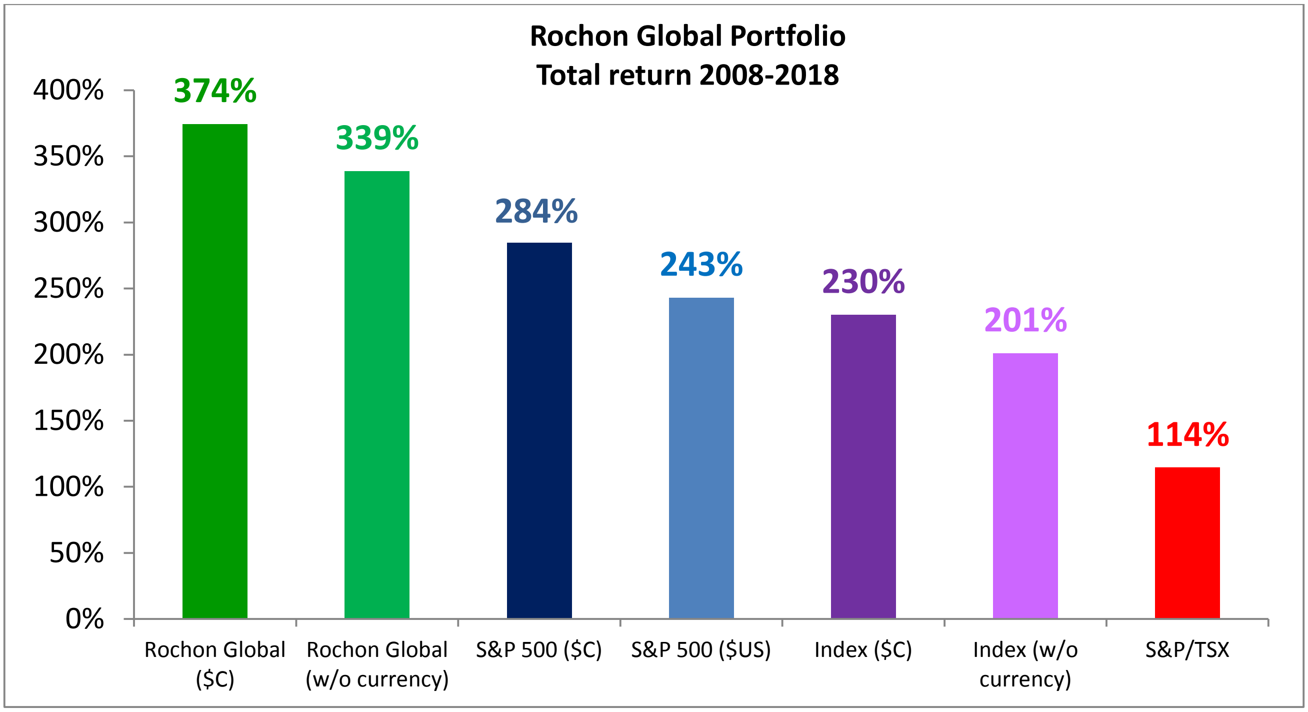
The stock never truly corrected on the stock market (even late last year) and the company realized EPS of $3.15 in 2018. The stock traded at the end of the year at $111, (i.e. at a P/E of 31x EPS forecast for 2019). This is a high valuation but justified by their impressive track record. We could have made four times our money in five years (in addition to the first triple from 2003 to 2008). As we have stated on a regular basis, we want to be cautious by waiting for a price for a stock that allows for a sufficient margin of safety. But wisdom is knowing how to discern when a high price is really justified. And in this case, we should have shown more wisdom. We even had two chances!

Conclusion: The 10th anniversary of "The opportunity of a generation"

A decade ago, I added a special page at the beginning of our annual letter which explained that we believed that the sharp drop in the market during 2008 and early 2009 represented "The opportunity of a generation".

Is is true that the economic situation in 2008-2009 was quite worrisome. A time horizon of a few years was needed to see beyond the grey clouds. While many investors were paralyzed in the face of the financial market meltdown, we saw it as a fantastic opportunity. We did everything we could to spread the word. I went on CBC television. I was also interviewed in the newspaper La Presse (February 14, 2009) and we even created a website (it still exists: www.occasiongeneration.com). We also organized a series of conferences throughout Quebec in early 2009. But we had to cancel several for lack of participants.

Ultimately, the capitalist world did not collapse and our portfolio did very well. Here are the returns of the Rochon Global Portfolio for the 10 years from January 1, 2009 to December 31, 2018:



Refer to Appendix B for disclosure statements on the Rochon portfolios. Index is a hybrid index (S&P/TSX, S&P 500, Russell 2000) which reflects the weight of the underlying assets at the beginning of the year.

Over 10 years, the Rochon Global portfolio generated a total return of 374% (16.8% on an annualized basis). Our comparative index group generated 230%, adjusted in Canadian currency, during the same period (12.7% annualized).

It was necessary to be optimistic vis-à-vis the capitalist system in late 2008 to invest in the stock market (or even just remain invested). But this optimism has been rewarded.

To Our Partners

We believe 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 in our opinion. Therefore we consider the appreciation potential for our portfolio, both in absolute and relative terms, to be well above average, especially when compared to other alternative asset classes, such as bonds.

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.

Thank you from the entire Giverny Capital team and we wish a great 2019 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 2018, 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 provides an extraordinary advantage to the intelligent investor. The person, however, who becomes affected by short-term market fluctuations (less than 5 years) and who makes 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 Rochon portfolios

- The Rochon 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 Rochon Global portfolio serves as a model for Giverny Capital's clients, but returns from one client to the other can vary depending on a multitude of factors. The returns indicated include trading commissions, dividends (including foreign withholding income taxes) and other income but do not include management fees. Portfolio returns of the Rochon Global portfolio have been generated in a different environment than Giverny Capital's clients and this environment is considered controlled. For example, cash deposits and withdrawals can increase the returns of the Rochon Global portfolio. Thus, the portfolio returns of the Rochon Global portfolio are often higher than the returns realized by clients of Giverny Capital.
- Past results do not guarantee future results.
- The Rochon Canada and Rochon US portfolios are parts of the Rochon Global portfolio.
- 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. Weighted indices presented may not be representative of the Rochon Global portfolio. In 2018 :

  - Giverny Global Portfolio: TSX 16% Russell 2000 40% S&P 500 40% MSCI EAFE 4%
  - 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 on the returns of the Rochon portfolio and indices are estimated to our best effort.
- The custodian of our client portfolios is National Bank Correspondent Network (NBCN) in Canada and TD Ameritrade Institutional in the US.
- The financial statements of the three portfolios are audited at the end of each year. The auditor's data are those provided by our custodian (NBCN). The auditor's annual reports are available upon request.
- For more information, please see the "returns" section of our website.