GIVERNY CAPITAL

Annual letter to partners 2020

Geneviève Cadieux
Elle et Lui (avec main de femme), 1997, diptych
Chromogenic print, mounted on plexiglass, aluminum frame
Each panel 195,5 x 159 cm, photo credit : Geneviève Cadieux
Giverny Capital Collection

Historical Summary

It has been more than 28 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; he participates actively in the investment selection process for the Rochon portfolio. In 2005, two new persons joined the firm who eventually became partners: Nicolas L'Écuyer and Karine Primeau. In 2009, we launched a US office in Princeton, New Jersey. Moreover, in early 2020, we established a partnership with a portfolio manager based in New York City who will head the office of the firm Giverny Capital Asset Management LLC in Manhattan. The directors of the US offices, Patrick Léger and David Poppe, share 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 importantly, our goal is to explain in detail the long-term investment philosophy behind the selection process of 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 2020 Letter

Since 2004, we have illustrated the cover of our letters with a copy of artwork from our corporate collection. This year we selected a photographic diptych by the Quebec artist Geneviève Cadieux entitled "Elle et Lui (avec main de femme)". It seemed to me like a fitting work in this year marked, among other things, by social distancing.

For the year ending December 31st 2020, the return for the Rochon Global Portfolio was 12.9% versus 15.1% for our benchmark, which represents a relative underperformance of 2.2%. The return of the Rochon Global Portfolio and the one of our benchmark include a loss of approximately 2% due to fluctuations in the Canadian currency.

Since its inception on July 1st 1993, our compounded annual growth rate has been 15.3% versus 9.5% for our weighted benchmark, representing an annualized outperformance of 5.9% 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. Since 1993, the US currency has depreciated by 0.6% relative to the Canadian Dollar, which corresponds to an effect of 0.0% 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%
2019	**25.6%**	22.3%	**3.3%**	-4.8%
2020	**12.9%**	15.1%	**-2.2%**	-2.0%
Total	**4969.2%**	**1103.5%**	**3865.6%**	**-0.6%**
Annualized	**15.3%**	**9.5%**	**5.9%**	**0.0%**

* All returns are adjusted to Canadian dollars
** Index is a hybrid index (S&P/TSX, S&P 500, Russell 2000, MSCI EAFE) which reflects weights of the 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 2020, it realized a return of 16.0% compared to 18.4% for the S&P 500. The Rochon US Portfolio therefore underperformed by 2.4%.

Since its inception in 1993, the Rochon US Portfolio has returned 4230%, or 14.7% on an annualized basis. During this same period, the S&P 500 has returned 1334%, or 10.2% on an annualized basis. Our added value has therefore been 4.5% 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%
2019	32.1%	31.5%	0.6%
2020	16.0%	18.4%	-2.4%
Total	**4229.7%**	**1333.9%**	**2895.8%**
Annualized	**14.7%**	**10.2%**	**4.5%**

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

In 2020, the Rochon US portfolio slightly underperformed the S&P 500. While we owned several high-tech holdings, our weight to this sector was less than that of the index which also led to slightly weaker relative performance.

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 2020, the Rochon Canada Portfolio returned 12.1% versus 5.6% for the S&P/TSX, therefore outperforming by 6.5%.

Over 14 years, the Rochon Canada Portfolio has returned 713%, or 16.1% on an annualized basis. During this same period, the S&P/TSX had a gain of 105%, or 5.2% on an annualized basis. Our annual added value was therefore 10.9%.

Year	Rochon 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%
2019	29.0%	22.9%	6.1%
2020	12.1%	5.6%	6.5%
Total	**712.9%**	**104.7%**	**608.2%**
Annualized	**16.1%**	**5.2%**	**10.9%**

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

Our largest Canadian holding is which rose 31% in 2020—the primary source of the higher returns for our Canadian portfolio.

Since 2007, the performance of our Canadian securities has been significantly higher than that of the S&P/TSX. We would like to repeat, once again this year, that a concentrated portfolio can drastically exceed the performance of the indices.

2020

Last year I wrote that "years follow each other but are never alike." We could certainly repeat this phrase to characterize 2020. The COVID-19 virus has hit us hard—our society, our loved ones, our freedom of movement and our economy.

The stock market fell dramatically in mid-March 2020 when the World Health Organization (WHO) announced that we were officially in a pandemic. In just a few weeks, the S&P 500 had fallen 35% from its high and the Russell 2000 had tumbled 40%. The rapidity of the decline was probably only matched by the crash of 1987. Several stocks dropped to very attractive valuations and we took the

opportunity to make a new acquisition: (we will discuss individual holdings further in the “Our Companies” section)

Then on March 23rd, the US government stepped in to support the economy in such a massive manner it made the bailout of the 2008 financial crisis seem like a dress rehearsal. The stock market subsequently rebounded in a dramatic fashion. Ultimately, US markets reached record highs at the end of the year. I have not found another instance in the history of the stock market where the market has corrected at least 33% and recovered everything in the same year. Who could have predicted this at the end of March? Investors who missed the best five trading days of March and April missed much of the recovery for the year.

We unfortunately lack the necessary perspective at this time to come to any valid conclusions regarding the long-term effects of this pandemic It certainly appears that the pandemic accelerated already strong trends toward online commerce. And telecommuting may remain part of our lives and impact various segments of the economy.

As always, our philosophy remains very simple: we own approximately twenty companies with solid balance sheets, conservative accounting, a durable competitive advantage and a management team dedicated to shareholders. And, of course, we are always cautious about the price that we are willing to pay for such companies.

Our companies performed extremely well given the very significant challenges of 2020. First, about half of our companies had record earnings per share (EPS). Our holdings in aggregate will have seen their profitability decline by roughly 3%. This is significantly better than the drop in expected profits for the companies making up the S&P 500 (which is a decline of around 11%).

None of our companies had to issue shares or go into significant debt to meet their obligations. They have therefore managed to do well in a very difficult year.

A Strange Thing

Warren Buffett has often said that "strange things can happen in financial markets". On April 20, 2020, a very strange thing did indeed happen: the price of a futures contract for a barrel of West Texas Intermediate crude oil deliverable for May fell from $18 to -$37 during the day. It was certainly strange to see the price of oil trading at a negative level. Sellers were presumably willing to pay buyers to get rid of their oil contracts (so they wouldn't have to receive barrels at home!)

Such a thing has never happened before to my knowledge and it completely defies common sense. This anomaly was certainly very short lived but it was certainly long enough to ruin speculators using margin to buy these contracts. This shows us all that almost anything is possible in the world of financial markets in the short term and that using margin always carries a small probability of disaster. Even if the odds are 0.01% of losing all your capital, why take such a chance? And it seems even more baffling to me for someone who is already rich.

The fact that nonsense sometimes happens in financial markets obviously does not change our philosophy of behaving as owners of businesses. It is those who focus exclusively on short-term market quotes who put their financial future in the hands *of others*. We must never forget that while in the long term, the stock market adequately reflects the intrinsic value of companies, the stock market only reflects the opinion of what *others* think a company is worth in the short term. This opinion is

generally pretty fair and reasonable but, for strange reasons, can sometimes turn out to be downright ludicrous. This brings me to the next section of the letter.

The flavor of the day

What seems peculiar to us in recent months is that in this world where the comfort of our certainties has been turned upside down, we are witnessing a level of stock market speculation that is not unlike that of the end of 1999 and early 2000. This speculation seems localized mostly in certain sectors of the economy which have experienced strong growth during the pandemic: software, cloud computing, electronic commerce, etc.

As in the past, these euphoric segments have realistic strong anticipated growth rates. It is the almost infinite extrapolation by many investors that is unrealistic and in turn can create danger. It is not uncommon to see companies trading at 60, 80, or even 100 times their profits (and these profits are often not even adjusted to exclude actual expenses such as stock options). And this is when there actually is a profit! Otherwise, analysts can come up with an alternative: the price-to-sales ratio.

In the 1999 annual letter, I had raised the issue of high valuations of many tech companies. I then told a little fable to illustrate the low regard for stock valuations by many analysts back then: *a farmer bragged about owning a pig worth a million dollars. A friend of his asked him how he could be so sure of his pig's worth. He replied: "Nothing could be easier: I got it in exchange for two chickens worth $500,000 each."*

Two decades later, a whole new generation of speculators is invading the markets these days. For many, the intrinsic value of a business is irrelevant. A stock that goes up and an exciting story are often the only fundamental parameters guiding their choices.

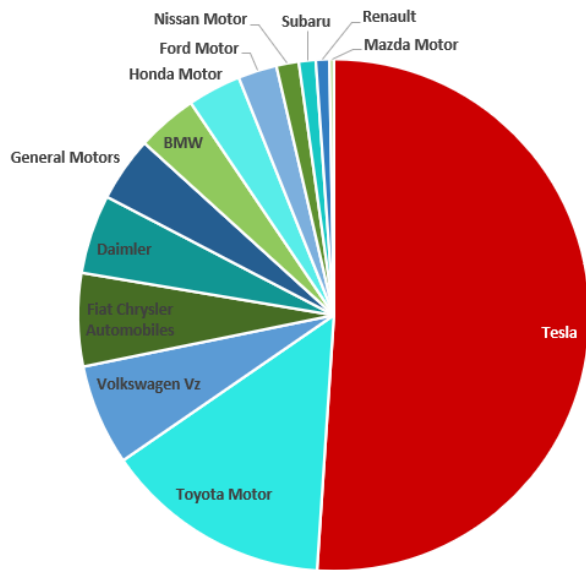
There is of course nothing immoral about speculating. But a dose of realism is appropriate: the consequences of speculation are similar to those who spend their evenings at the casino. A few lucky people come home in a limousine while the majority return barefoot. As Mark Twain would probably say: "History doesn't repeat itself but it often rhymes."

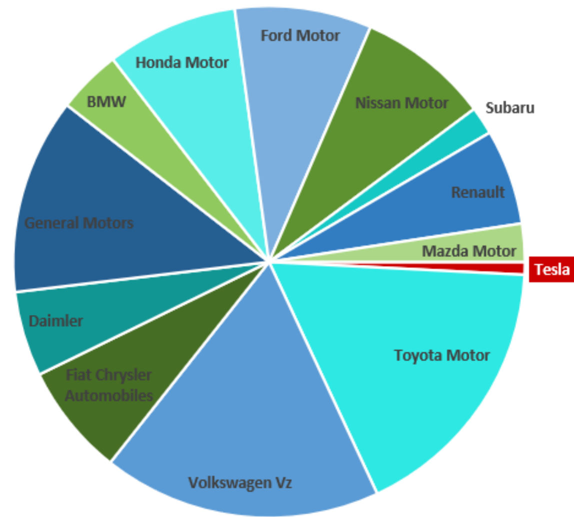
A few segments of the stock market would qualify this year for this section of the annual letter. It can be delicate to point to a particularly trendy segment. The goal is not to denigrate a company or to be condescending to certain fellow investors. Our goal is simply to share with our partners our vision of what seems risky in terms of stock market valuations.

I dare to take the example of Tesla, a phenomenal company if there ever is one. It is interesting to raise the point that Tesla stock, at its current level, has a market capitalization of approximately $800 billion which is higher than all other car manufacturing companies in the world combined. Yet all the other companies in the sector sell 120 times more cars annually than Tesla.

This graph sums it all up:

Market Capitalization **Unit sales**





Sources: Factset, wheelsjoint.com

Five-year Post-mortem: 2015

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 2015, but here are a few remarks from reviewing the annual letter from that year.

In 2015, we acquired our first shares in AMETEK. EPS grew by 50% between 2015 and 2019—the stock has more than doubled. The share's P/E ratio on the stock market is therefore higher than when we first bought it. It reflects, in our opinion, the fact that AMETEK is a high quality business.

We also invested in Stericycle back in 2015 which was not a good investment for us. The company faced great pressure on its operating margins and we had to resign ourselves to selling, unfortunately at a loss. It was still a good decision to cut this investment short as the stock is lower today than when we sold it four years ago.

Keeping AMETEK and quickly selling Stericycle is in line with the rule stated by the legendary investor Philip Carret in his book published in 1930: "Be quick to take your losses, reluctant to take your profits".

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 owners 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. 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."

	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%	4%	29%	25%
1999	16%	12%	-4%	12%	21%	9%
2000	19%	10%	-9%	15%	-9%	-24%
2001	-9%	10%	19%	-21%	-12%	9%
2002	19%	-2%	-21%	13%	-22%	-35%
2003	31%	34%	3%	12%	29%	16%
2004	21%	8%	-12%	20%	11%	-10%
2005	14%	15%	0%	15%	5%	-10%
2006	14%	3%	-11%	24%	16%	-8%
2007	10%	0%	-10%	-4%	5%	9%
2008	-3%	-22%	-19%	-31%	-37%	-6%
2009	0%	28%	28%	6%	26%	20%
2010	22%	22%	0%	50%	15%	-35%
2011	17%	6%	-11%	18%	2%	-16%
2012	19%	23%	4%	9%	16%	7%
2013	16%	42%	26%	8%	32%	24%
2014	13%	19%	6%	10%	14%	4%
2015	11%	4%	-7%	1%	1%	0%
2016	9%	10%	1%	4%	12%	8%
2017	14%	20%	7%	14%	22%	11%
2018	20%	-8%	-28%	23%	-4%	-26%
2019	10%	31%	20%	3%	31%	29%
2020	-2%	15%	17%	-9%	18%	27%
Total	1850%	2179%	329%	436%	871%	435%
Annualized	12.6%	13.3%	0.7%	6.9%	9.5%	2.6%

* 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

This year, the intrinsic value of our companies, as a whole, declined by about 2% (with dividends included). Despite some of the changes to our portfolio during the year, we consider our estimate of the EPS growth at our companies during 2020 to adequately reflect their economic realities. The performance of our portfolio on the market was a gain of roughly 15% (excluding currency effects). Our stocks therefore realized a price performance that was far greater than their underlying economic performance.

The companies in the S&P 500 experienced weaker growth in their corporate earnings, with profits dropping by approximately 11% (about a drop of 9% when we add dividends). The S&P 500 still had

a total performance figure of 18% (in $USD). The difference between the intrinsic performance of the companies in the S&P 500 and the performance of the index is hence greater than ours.

Profits of companies in aggregate decline during a recession. But this drop is always temporary in nature and corporate profits should hit new records during the next economic cycle (possibly as early as 2021).

Since 1996, by our calculations, our companies have grown their intrinsic value by about 1850% and their stocks have achieved a total return of approximately 2179%. On an annualized basis, the estimated intrinsic performance was 12.6% versus 13.3% 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.

<u>Stock market equations</u>

Last year was overwhelming on so many levels that it would be good to review our basic principles regarding stock market investing with our partners. Since we have described our investment philosophy on various occasions in the past, I thought of going there this time with a different approach inspired by my scientific upbringing (and with a bit of humor added).

During my university studies at the École Polytechnique of Montreal, I was a big fan of electromagnetic physics. And I was fascinated by Maxwell's equations. These are a set of coupled partial differential equations that, together with the Lorentz force law, form the foundation of classical electromagnetism, classical optics, and electric circuits. They describe how electric and magnetic fields are generated by charges, currents, and changes of the fields. The equations are named after the Scottish physicist and mathematician James Clerk Maxwell,

In the same vein, wouldn't it be interesting to try to simplify and unify the complex world of the stock market into four equations?

Here is therefore a proposal of four formulas which could, in my opinion, summarize the main lines which govern rational investment in the stock market.

1. Equation of convergence between Intrinsic Value and Market Value

$$\lim_{n \to \infty} (Vm)_n = Vi$$

This equation states that in the long run (*n* being the unknown number of years), a company's stock market value (*Vm*) eventually converges to its intrinsic value (*Vi*).

2. Equation of wealth increase

$$\triangle \text{ W} = \sum \text{P (y)}$$

This equation states that the level of increase in stock market wealth (W) is the sum of the aggregate patience (P) over a time variable (y).

3. Risk decrement measurement equation

$$D = \ln(\frac{\theta}{\delta})\, x^2$$

This equation states that D represents the logarithmic decrement of the risk of an investment which is proportional to the level of profit margins (θ) of a company which is reduced by its level of debt (δ) multiplied by the level of the competitive advantages squared (x^2).

4. Equation for the normalization of parameters influencing returns

$$R_S = \frac{1}{\sqrt{2\pi\sigma}}\; e^{(\frac{\mu}{\sigma})^2}$$

This equation simply states that stock market returns (R_S) eventually follow a normalized curve proportional to the rationality (μ) of an investor and inversely proportional to the parameter of his (or her) *crowd following instinct* (σ).

Our Companies

Note: This section of the annual letter is always long. We want to provide you with an accurate update of the companies in our portfolio companies. In fact, we are trying to present you with the information we would like to know if our roles were reversed. Stock prices are as of December 31st, 2020.

Section of the letter reserved for Giverny Capital's partners

The Podium of Errors

"It is not sufficient to say that we were wrong; we must say how we were wrong."

- Claude Bernard

Following in the "Givernian" tradition, here are our three annual medals for the "best" errors of 2020 (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 much more costly than errors from commission (purchases)… even if we don't see those on our statements.

Bronze Medal: Floor & Decor

As you know, we purchased shares in Five Below in March 2020. At the same time, we also considered another chain of retail stores: the Floor & Decor flooring company. We knew the company well because it has benefited from the popularity of new LVT (Luxury Vinyl Tile) flooring. This new coating method is experiencing strong growth and we were very aware of it because it had negatively affected the competitive advantage of a company that we held in the portfolio for several years, Mohawk Industries. We knew the strength of the Floor & Decor business model as well as the senior management. Unfortunately, since we had started to follow the company, the stock was regularly trading at high multiples.

That changed last March. The stock fell from a high of $60 to $25 in a matter of weeks. In early April, after speaking with senior management, we made the decision to buy shares at around $30. We were anticipating EPS of $1.50 for 2021 and therefore the valuation seemed reasonable to us considering the excellent long-term growth prospects.

The stock then climbed more than 10% on the very day we wanted to buy it and we hence decided to wait for a return to "our" price. Results improved quickly and the stock never returned to "our" price. The stock is currently trading for $102 and we now expect EPS of around $2 for 2021.

Silver Medal: Taiwan Semiconductor

When François Campeau joined the Giverny team, a stock he loved was Taiwan Semiconductor (TSM)—the world's leading semiconductor foundry. I looked at the company in detail and liked its balance sheet, strong competitive advantages and the culture established by senior management. Historically, its annual growth rate had been around 10-12% but its stock valuation was rarely high (around 15 times earnings on average). The reason is that its profits are cyclical (because they are linked to the capital expenditure of the sector) and its business model requires regular and significant capital expenditures (several billion dollars per year).

TSM's outlook in late 2019 and early 2020 looked better than ever. For new foundry technologies of 5nm (I won't go into detail because it is complex) and possibly 3nm, the company seemed to have little competition. It even seemed plausible that Intel could eventually subcontract TSM for its production of microprocessors which would be phenomenal for the latter. At the end of 2019, the stock was

trading in the $50 range which was a record high and also at a slightly higher P/E than normal. I still decided that the company should be part of the portfolio because its competitive advantage moat seemed to widen drastically. We just had to wait for a "better" price....

...2020 was an extraordinary year for TSM with EPS growing by over 50% and the stock has more than doubled (TSM is currently trading at $127).

Gold Medal: Pool Corp.

I met a prospective client about 14 years ago who had just sold his swimming pool service business. We had discussed the industry in detail and one company stood out as dominant: Pool Corp. It is a highly competitive industry with few competitive advantages. But consolidation and economies of scale can help reduce a company's cost structure (and therefore develop an advantage). Also, reputation for quality can also create an advantage. I had studied Pool Corp in detail but found its business to be too sensitive to the economy as well to the residential construction market (and in 2006 that was a real cause for concern).

The company had EPS of $1.74 in 2006 and the stock was trading around $36. My fears were valid because EPS fell to $0.95 in 2008-2009 but the good news was that company nevertheless remained profitable despite the cyclical volatility. The stock fell to a low of $11 in 2009. So I had the opportunity to buy the stock at a very good price (6 times the profit earned in 2006).

I never bought a share. Among other things, I had misjudged the recurring nature of the services linked to the maintenance of a swimming pool. The company went quickly back on the path of growth and achieved EPS of $8.42 by 2020, an annualized growth rate of 12% compared to 2006. Part of the 2020 results are probably magnified by the fact that most people spent the summer at home. Still, the fact remains that Pool Corp has done an exceptional job.

The stock is now trading at $325. It is true that the stock market valuation is quite high (35x the expected profits for 2021). But this does not change the fact that the company has quintupled its intrinsic value in 14 years. And that we missed the opportunity to achieve a stock return of more than 800% over this period.

And of course, we also missed a potential gain of almost 3000% if we had bought it in 2009.

<u>Conclusion</u>: The Big Picture

After almost three decades of investing in the stock market, I am convinced that the biggest mistake investors make is the propensity to want to predict financial markets. Whether it is waiting for a "better" time to buy or selling in anticipation of buying "lower". Or simply selling while waiting for the situation to be "clearer".

Still, investing in stocks is a winning strategy in the long run. Historically, US companies increase their profits by about 6-7% per year and pay a dividend of around 2%. This generates an annual return of 8-9% from simply owning a solid group of companies. And if we decide to be selective about the companies we choose and pay attention to stock market valuations, it is possible to do even better (which has been our experience for almost 28 years now).

Of course, over the decades, our civilization has encountered its share of challenges—the list is too long to go through. The 2020 pandemic is just one calamity that humans have had to overcome. When a new crisis arrives, the stock market can drop quickly and drastically. Many investors then lose any long-term perspective and focus only on the crisis and the short-term uncertainty it engenders.

Peter Lynch wrote an excellent paragraph on this subject in "Beating the Street", an exceptional book that I read when I started out in 1992. He talks about always keeping "The Big Picture" in mind. And when that's not enough to hone in his thinking, he then focusses on an even broader perspective on things ("The Even Bigger Picture"). He explains that during crises, we must refocus our attention on the great progress of our civilization, on the resilience of our capitalist system and on the capacity of humans to find solutions to their problems. And don't lose sight of the extraordinary rewards generated by stocks over many years—and this, against all odds.

It is not easy in our world of immediacy to keep an eye on the long term and not be affected by the sometime huge short term fluctuations of the stock markets. In the age of smartphones and ubiquitous social media, it is almost inhuman to remain indifferent to the countless opinions of others. But impassive to outside opinions and the resulting stock market fluctuations, one must remain. The easiest way to do this is to give yourself a golden rule that I have followed since the very start: do not try to predict the stock market, stay invested in solid companies and only focus on their intrinsic value.

When you rule out the possibility of trying to forecast the markets, when you constantly keep a positive long-term outlook in mind, you remove a major potential drag on your own returns. Wittingly, you make a conscious decision to let time do its work.

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.

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 2021 to all our partners.

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 2020, 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 2020 :
  - ➢ Rochon Global Portfolio : S&P/TSX 13% S&P 500 42% Russell 2000 42% MSCI EAFE 3%
  - ➢ Rochon US Portfolio : S&P 500 100%
  - ➢ Rochon 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 and Charles Schwab 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.

Forward-looking information

Some information set forth in this letter constitutes forward-looking information which involves uncertainties and other known and unknown factors that may cause actual results or events to differ materially from those anticipated in such forward-looking information. When used in this letter, words such as "expects", "anticipates", "intends", "may", "believes" and similar expressions generally identify forward-looking information. In developing the forward-looking information contained in this letter, the manager has made assumptions (for ex.: with respect to the outlook for the global economy and publicly traded companies).These assumptions are based on the manager's perception of factors believed to be relevant (for ex.: historical trends, current conditions, expected future developments). Although the manager believes that the assumptions made and the expectations represented by such information are reasonable, there can be no assurance that the forward-looking information will prove to be accurate. Actual results or events may differ materially from those expressed or implied in the forward-looking information. Giverny Capital Inc. undertakes no obligation to publicly update or revise these forward-looking statements.