ValueInvestor INSIGHT
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Keeping It Simple

Even the best companies – or their industries – go out of favor from time to time. That's when Francois Rochon's "capitalist antennae" are their most receptive.

Though interested in the stock market from an early age, Francois Rochon didn't put investing high on his early list of career choices. "I saw the market as a big casino populated by shady characters – not the place for a serious career," he says.

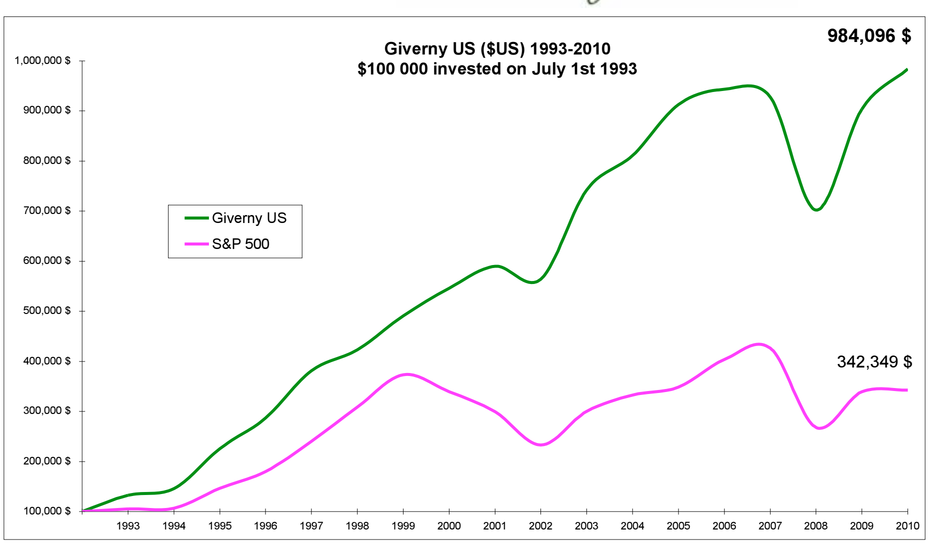
After three years as an engineer, his passion for stocks proved too strong to resist. He joined a large Montreal investment firm in 1996 and two years later started his own firm, Giverny Capital. Since the beginning of 1999, investing mostly in U.S. stocks, he's earned a net annualized 7.6% for his investors, vs. a 0.8% gain for the S&P 500.

Finding plenty of what he considers high-end companies trading at pedestrian prices, Rochon sees opportunity today in areas such as restaurants, flooring, entertainment and medical devices. See page 2

INVESTOR INSIGHT

Francois Rochon
Giverny Capital

Investment Focus: Seeks companies with what he considers premium prospects for earnings growth at times when they're trading at discount-to-the-market prices.



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FEATURES

Investor Insight: Francois Rochon

Francois Rochon of Montreal's Giverny Capital explains why he believes buy-and-hold investing is far from dead, why he puts so much emphasis on finding outstanding managers, why it's rare that he's not fully invested, and why he sees significant upside potential in Medtronic, Walt Disney, Lumber Liquidators, Omnicom and MTY Food Group.

You've said complication scares you when it comes to investing. How does that manifest itself in your strategy?

Francois Rochon: I look for great companies in businesses I understand and which I believe have competitive advantages. Warren Buffett had a wonderful quote, that if a company has a bad past and a great future, he'll miss it as an investment opportunity. We want companies that have had great pasts and then focus our analytical attention on whether and why the future should be great as well.

The complications that scare me are things like overburdened balance sheets, regulation and less-than-transparent accounting. The fewer liability items on the balance sheet the better, and I'll typically filter out companies that can't at least pay off their debt, including any negative working capital, with four years' of current net income.

One classic mistake I made in not keeping things simple was owning for some time the shares of Health Management Associates, a hospital chain. Fighting through all the regulatory issues, dealing with public and private insurers, the complicated accounting for uninsured patients, all that made the business extremely difficult. Those are not the types of businesses we favor.

How would you define your investable universe?

FR: I say we'll look at anything, but in reality we have several filters that narrow the universe pretty quickly. One is that the company has to be profitable, which removes roughly 50% of the stocks traded worldwide. Our filters on debt levels screen out a great number of companies and I also take out just about everything commodity-related – like oil and gas, gold, steel, copper or timber – where it's almost impossible for companies to have a competitive advantage. There are some rare steel companies I admire like Nucor and Posco, but only when I don't think investment success rests primarily on the price of the commodity, which I don't believe I have any edge in predicting.

Most of our initial research is on finding the true standouts in any given business. That's largely a numbers-driven exercise, focusing on returns on equity, margins, and growth in key sales and profitability metrics – all in comparison with the competition. We've identified more than 400 companies – primarily in the U.S., but not exclusively – that we could imagine owning and that we try to keep fairly close track of.

Does cap size matter?

FR: The quality of a business is not necessarily linked to size, so market cap isn't a criterion for us. We have owned very big names such as Microsoft or Procter & Gamble, but we're also happy to invest in small gems as well. One good example we've owned for a few years is Bank of the Ozarks [OZRK], a small regional bank based in Little Rock, Arkansas. The founder, George Gleason, started the company with something like $10,000 when he was 24 and has built it very methodically and conservatively over the past 30 years. It earns a high return on assets, controls costs very well and has a great loan-quality track record. When we met with Mr. Gleason, it seemed like he knew almost every loan the bank had made. Warren Buffett says there are far more banks than there are good bankers, and we think Gleason is one of the best. We doubled our position when the stock went down in 2008 and still don't believe the share price reflects the fact that earnings can grow maybe 15% annually for many years.

Francois Rochon

Institutional Bias

As with many self-taught investors, Francois Rochon's informal education started with the books of investing legends: Benjamin Graham's *Intelligent Investor*, Philip Fisher's *Common Stocks and Uncommon Profits*, and Peter Lynch's *One Up on Wall Street*. He wrote to ask Warren Buffett for copies of his annual shareholder letters, a full package of which arrived in the mail a short time later. "I came to understand the market wasn't the big casino I thought it was," says Rochon, "but instead a place where you could use intelligence, judgment and rationality to build wealth."

After moonlighting as an investor while working as an electrical engineer, Rochon took the plunge in 1996, joining a well-known Canadian money management firm in his native Montreal. While he learned a lot, he concluded he wasn't cut out for a large institution. "They said the right things about being fundamental long-term investors, but then at the end of every month that you didn't beat the market you had to explain in great detail why you were underweight this or overweight that. The focus was too much on short-term performance, which to me just isn't the best way to invest."

You're based in Montreal, so why is your portfolio so American?

FR: The primary reason is that the American pond is ten times bigger than the Canadian one. Add to that the fact that probably 50% of the companies traded in Canada are resource-based and therefore we typically avoid them, the ratio of potential ideas in the U.S. is even higher.

We consider the U.S. very close to home, physically (we're closer to New York than Cleveland is!) and culturally. It's easy for me to understand companies like Buffalo Wild Wings or Outback Steakhouse or Wal-Mart, where I've eaten or shopped. It's harder for me to get the same feel for a company based in Brazil or Poland.

What situations tend to catch your eye for further study?

FR: We don't have a regimented idea-generation process. I find screens tend to focus you too quickly on valuation, when I'm most interested first on the quality of the business.

I like to say my capitalist antennae are always on, so most often our ideas just come from tracking what's going on at the 400 or so companies we follow on a regular basis. We've had our eye on both MasterCard and Visa since they went public, because they enjoy many of the classic elements of a high-quality business. But for a long time neither traded at a price we were comfortable paying, until a few months ago when concerns over changing regulation for debit and credit card fees hit the stocks, with Visa falling 25-30% over the course of a few weeks. In our judgment, the market was overreacting to the actual impact Visa is likely to see from fee restrictions, making the stock – at our purchase price of around $70 – highly undervalued. [*Note*: Visa shares currently trade at just under $70.]

Of course just because the stock of an interesting company cracks doesn't mean we always buy. In the case of Starbucks, for example, we weren't convinced even after the valuation fell sharply in 2007 and 2008 that the company's growth prospects in what we considered a saturated market were sufficient to justify owning the stock. Similarly for Whole Foods, when the stock went down sharply in 2008 we didn't buy because in our view they had taken on too much debt in buying Wild Oats Markets. In retrospect, we certainly would have done well to buy in either case, but we felt we had safer options that have also turned out quite well.

ON OUTPERFORMANCE:

We expect our companies to grow at twice the long-term average of the S&P 500. That's how we'll outperform.

What's a love-to-own-at-a-better-price stock for you today?

FR: We own a few shares of Hennes & Mauritz [HMB:SS], the value-priced fashion retailer based in Sweden but with operations all around the world. We consider it an excellent company with bright prospects, but the stock price is a bit too high for us to build a more substantial position.

Going back to the types of situations that catch our eye, another common theme for us is to buy into market leaders when their sector or the overall market is out of favor. We believe Omnicom [OMC], for example, is the best and most geographically diverse advertising company in the world, but in 2008 its shares got below 10x earnings – from 20-25x typically – because it was fairly obvious its near-term prospects were poor. While there's a lot of turmoil in the advertising business, we think Omnicom provides an essential service and that the business will continue to generate high incremental returns on capital. Because we take a longer-term perspective than the market usually does, we're thrilled to invest in the best companies in good-quality businesses that we believe will eventually recover.

Describe your valuation methodology.

FR: It's quite simple. We estimate what we think a company can earn in five years and then apply the P/E we believe the market should give it. If the resulting price is at least double the current share price – giving us a 15% annual return – we're willing to buy.

Our strong preference is for the upside to come primarily from earnings growth rather than a P/E increase. We want to believe our companies can increase earnings on average by twice the long-term 6% average annual growth of S&P 500 companies. That's how we're going to outperform: since 1996, earnings at our portfolio companies grew an average of 12% per year, twice the rate of those in the S&P 500. Over that time our stocks did the same 6% per year better than the market.

Using one of my favorite stocks today as an example, we think Wells Fargo [WFC] on a normalized basis five years out should earn roughly 1.5% on assets, which translates into more than $5 per share in net income. With that kind of performance, the market should apply at least a 12x multiple to the stock, which would result in a share price of $60. At today's price [of $23.50], we believe Wells is a better investment today than it has been in the past 20 years.

How many positions do you typically maintain?

FR: Generally around 25, so a full position is 3-4%. We will own more of what we think has the most upside, although it's very rare for us to let a position go above 10% of the portfolio.

Since I consider buying a stock a long-term commitment – our average holding period is more than five years – I'll typically start with a 1-2% position and then see how it goes. No matter how hard I try, there's just nothing to focus one's attention like having money on the line. If I get more comfortable with the management and the business and feel I understand it better and better, we'll increase the position as long as the valuation is still compelling.

Are you usually fully invested?

FR: Yes. At our asset size and especially as time horizons in the market have contracted, I haven't yet found it difficult to find ideas that meet our criteria.

Given your turnover, we take it you haven't concluded, as many have, that buying and holding is passé?

FR: Maybe it makes me old-fashioned, but investing to me is about owning great companies for many, many years. Managing through cycles has always been a part of running businesses and of investing, but I'm not convinced it's possible over time to accurately judge when the next recession will be, when interest rates will go up or down, or when the market is about to reverse course. At least I don't believe I can do it.

People look at what happened from the peak of the Internet bubble to the bottom of the financial crisis and seem to forget that stocks pay off in the long run because companies earn higher profits – of 6-7% per year – while paying dividends on top of that. So equity investors would do fairly well just owning the market, but I think I can improve on that by buying companies that grow their intrinsic value faster than the market and holding on to them. I can't imagine trading a strategy that I feel puts the odds in my favor for one I don't believe I'll ever be able to execute.

Turning to more specific ideas, describe your investment case today for Walt Disney [DIS].

FR: I consider Disney a crown jewel of American capitalism, with unparalleled assets. I like to say that Mickey Mouse has three great qualities: he's highly popular worldwide, he's immortal, and he has no agent. That's an excellent metaphor for what the company does – create franchises that it owns and controls and can benefit from across a wide variety of businesses and geographies.

They released this year a new movie version of *Alice in Wonderland*, which was first created in 1951. With that first version, they basically just made money selling movie tickets. Since then they've re-sold the same content to recurring generations, through different media and around the world. It's like owning an oil field that never runs out and costs very little to maintain. That's a good business.

The newer parts of the business are equally impressive. ESPN is virtually a monopoly national sports channel, with extremely high market power and benefiting from strong secular consumer demand. In theme parks, when Disney World opened in Florida in 1971, the price of a daily ticket was $3.50. They've since increased price every year but one, to today's $82, which comes out to an impressive 8% growth per year, much higher than inflation.

One key part of our thesis is confidence in Bob Iger, who we believe is making all the right moves since taking over as CEO in 2005. He's gotten out of less attractive businesses such as radio and the Miramax movie studio, while investing in businesses like Pixar and Marvel, which play perfectly to Disney's strengths. He's reoriented the business focus to making great animated movies, which has a positive impact over long periods on so much of what they do.

INVESTMENT SNAPSHOT

Walt Disney
(NYSE: DIS)

Business: Diversified entertainment and media company with five operating units: TV networks, movie studios, parks and resorts, consumer products and interactive.

Share Information
(@8/26/10):

Price	**31.94**
52-Week Range	25.25 – 37.98
Dividend Yield	1.1%
Market Cap	$61.09 billion

Financials (TTM):

Revenue	$38.19 billion
Operating Profit Margin	17.8%
Net Profit Margin	10.5%

Valuation Metrics
(@8/26/10):

	DIS	S&P 500
Trailing P/E	15.4	16.5
Forward P/E Est.	13.4	12.9

Largest Institutional Owners
(@6/30/10):

Company	% Owned
Fidelity Mgmt & Research	4.8%
State Street	3.6%
Vanguard Group	3.5%
BlackRock	2.6%
Southeastern Asset Mgmt	2.5%

Short Interest (as of 8/13/10):

Shares Short/Float	2.6%

DIS PRICE HISTORY

THE BOTTOM LINE

Francois Rochon considers the company a classic example of an exceedingly high-quality business trading at a surprisingly pedestrian price, of less than 15x estimated 2010 earnings. He believes the company can double its earnings per share in the next five years and earn by then an 18x multiple, translating into an $80 share price.

Sources: Company reports, other publicly available information

Weighing at least somewhat on all media companies is concern over the economics of changing distribution in an Internet age. How do you assess that here?

FR: I don't profess any unique insight into how that plays out, but I fall back on the premise that if you own what people want to see, it's not going to matter so much how they access it. What you want is to create enough excitement around your content that people will pay for it, regardless of the distribution method. Disney has proven over a long period of time its ability to create that excitement.

There is certainly risk that cable companies over time try to pull back on what they're willing to pay for ESPN, or that Internet distribution of movies doesn't prove as profitable as DVDs were. But in the five years I've owned Disney stock – as the distribution of media continues to evolve – the company's earnings have increased 68%. That's 10% per year over a pretty tough period, which makes me optimistic about their ability to navigate a changing environment.

How can such an admired company have an undervalued stock, currently trading just under $32?

FR: At less than 15x the $2.20 or so we expect the company to earn this year, the stock doesn't at all reflect the earnings growth we expect over the next five years. We think earnings per share can double over that period, through a combination of revenue growth, much of it international, and margin improvement from a more attractive business mix and operating leverage in all its key businesses. We see net margins going from 10.5% today to closer to 12.5% in five years.

The stock has historically traded at 20-25x earnings, but even at 18x our 2015 earnings estimate, we arrive at a target price of close to $80. It may not always be a smooth ride, but that would be a quite satisfactory destination.

Is Medtronic [MDT] a great-company-in-an-out-of-favor industry type of idea?

FR: The company is a leader in almost every product category in which it competes and has done an excellent job of broadening its product mix beyond pacemakers, defibrillators and heart valves to include devices such as insulin pumps, glucose meters and spinal implants. The products mostly address non-discretionary problems and either save lives or dramatically improve lives. You can postpone the purchase of a car, but you don't postpone getting a defibrillator put in. The same goes for insulin pumps if you're diabetic, or for spinal implants if you're suffering from acute back pain. Given how essential the products are to customers' health, the business isn't too cyclical and earns very high net margins of 20%.

We like that the device business tends to be much more stable than other healthcare areas like pharmaceuticals. They've obviously grown and diversified since then, but if I compare Medtronic's business from when I first started researching it in the mid-1990s with today, they're basically still in the same businesses with the same market positions. You constantly have to improve your products' capabilities, but for the most part, doctors are reluctant to switch from devices they know and trust.

INVESTMENT SNAPSHOT

Medtronic
(NYSE: MDT)

Business: Worldwide developer and marketer of a broad range of medical devices, including pacemakers, defibrillators, insulin pumps, heart valves and stents.

Share Information
(@8/26/10):

Price	**32.28**
52-Week Range	30.80 – 46.66
Dividend Yield	2.9%
Market Cap	$34.96 billion

Financials (TTM):

Revenue	$15.82 billion
Operating Profit Margin	32.5%
Net Profit Margin	19.6%

Valuation Metrics
(@8/26/10):

	MDT	S&P 500
Trailing P/E	11.6	16.5
Forward P/E Est.	9.3	12.9

Largest Institutional Owners
(@6/30/10):

Company	% Owned
Capital World Inv	5.5%
Wellington Mgmt	4.7%
Vanguard Group	4.0%
Primecap Mgmt	3.9%
Capital Research Global Inv	3.7%

Short Interest (as of 8/13/10):

Shares Short/Float	1.3%

MDT PRICE HISTORY

THE BOTTOM LINE

The market's assessment of the company's prospects is at odds with Francois Rochon's expectation that secular demand for its products and share buybacks can help lift earnings per share at a 10% annual clip. At what he believes would be a reasonable 15x his $5 EPS estimate five years' out, the shares would trade at $75.

Sources: Company reports, other publicly available information

The market's perception of Medtronic has changed dramatically. Ten years ago the stock got as high as $60 and traded for 55-60x earnings. Revenues and earnings have tripled since then, but the stock is down 40% and the P/E is now 10x.

What's going on?

FR: Part of it is that the stock was overvalued ten years ago. Part of it is that the growth prospects of a company three times bigger usually don't warrant the same P/E. But what seems to most trouble the market is concern about what healthcare reform will do to Medtronic's business. In particular, medical-device companies were singled out for specific taxes to help fund the reform package. The market seems to be saying not only that that's bad, but that there may be more yet-to-be-defined pain as well.

We're not nearly so pessimistic and believe the revenue benefits of tens of millions of new people having insurance coverage for Medtronic products will more or less compensate for any incremental taxes. If we're right, the question then is whether Medtronic is well-positioned to grow in the future, and we think they are. They spend heavily on product development, which has allowed them to at least maintain leading shares in what should be continually growing markets – the incidence of the problems their products treat will only go up as the population ages. From top-line growth of 5-7%, some margin improvement and some share buybacks, we expect annual EPS growth of at least 10%.

What upside do you see in the shares, now near a 52-week low of $32.30?

FR: The company should earn $3.40 per share this year. If we're conservative and assume that grows only 8% – less than we actually expect – that would result in an EPS five years from now of $5. At even a 15x multiple – again, less than what we would consider justified – that would result in a share price of $75.

There's always some risk a superior competitive product hurts one of their key businesses, but that hasn't really happened since the company sold its first pacemaker in the 1950s. We just think there's a very large margin of safety here. This isn't some run-of-the-mill business, it's the best medical-device company in the world – trading at 10x earnings.

Switching gears, describe your interest in discount flooring retailer Lumber Liquidators [LL].

FR: I knew very little about Lumber Liquidators when I saw it listed maybe six months ago in a ranking of the best small companies. They basically buy wood at wholesale and transform it into hardwood and laminate flooring that they sell in company-owned retail stores, mostly serving urban areas from suburban locations. They claim to sell at a 20-30% price discount to the industry, passing on efficiencies by selling greater volumes from larger-footprint stores in less-expensive areas. The average ticket is about $1,500.

Over the past five years the company has grown from 76 stores to more than 200. Revenues increased from $245 million in 2005 to $545 million last year, from both same-store-sales growth as well as all the new stores. The profitabil-

INVESTMENT SNAPSHOT

Lumber Liquidators
(NYSE: LL)

Business: Discount retailer of hardwood and laminate flooring sold through more than 200 company-owned stores located almost exclusively in the United States.

Share Information
(@8/26/10):

Price	**19.99**
52-Week Range	19.33 – 33.41
Dividend Yield	0.0%
Market Cap	$548.1 million

Financials (TTM):

Revenue	$597.5 million
Operating Profit Margin	8.4%
Net Profit Margin	5.2%

Valuation Metrics
(@8/26/10):

	LL	S&P 500
Trailing P/E	18.2	16.5
Forward P/E Est.	16.7	12.9

Largest Institutional Owners
(@6/30/10):

Company	% Owned
Fidelity Mgmt & Research	15.0%
T. Rowe Price	4.3%
Friess Assoc	3.9%
Aster Inv Mgmt	3.6%
Century Capital	3.4%

Short Interest (as of 8/13/10):

Shares Short/Float	24.6%

LL PRICE HISTORY

THE BOTTOM LINE

The company's low-cost model has allowed it to grow smartly through the residential real estate downturn and positions it well for future growth in a fragmented market, says Francois Rochon. If a doubling of the store base results in the $2.70 EPS he expects in five years, he believes the shares will trade then at closer to $50 per share.

Sources: Company reports, other publicly available information

ity record is equally impressive: net income last year was $27 million on average shareholders equity of about $130 million. Given that the equity included $35 million in cash, the return on operational equity was 28%. All of this, by the way, has happened during a time in which the real estate market has been mostly awful. I've heard it said that if you sell for less, consumers will find you even if you're in the middle of the ocean. Lumber Liquidators appears to be taking clear advantage of that.

Describe the company's current competitive environment.

FR: In hardwood flooring, Lowe's and Home Depot combined have about 23% of the market, while Lumber Liquidators now has around 11%. The other two-thirds of the business is fragmented among smaller independent retailers, from which we expect Lumber Liquidators to continue to take market share.

Are you still expecting significant growth?

FR: Management expects to double the number of stores to around 400 over the next five years, which we think is a plausible target. We also believe there's an excellent chance that same-store sales will grow over that time as well. That's partly because hardwood flooring and laminates are increasingly preferred over carpet and should continue to take a bigger share of the flooring market. At some point the housing market might even rebound a little bit, which would also improve same-store sales.

We estimate that revenues will grow at least 18% per year over the next five years, 15% coming from new stores and 3% from an uptick in same-store comps. With no expected margin improvement, that would result in earnings per share of around $2.70 in 2015. Given how well Lumber Liquidators has performed in such a difficult industry environment, we think that might turn out to be conservative if the residential real estate market comes back from the dead earlier than anticipated.

What five-year target do you have for the shares, now around $20?

FR: If they hit our growth numbers, we'd expect the shares to trade for at least 18x earnings five years out. That works out to a target price of close to $50 per share.

The short interest in the stock is nearly 25%. Why do you think that is?

FR: It's difficult to say. It's lower today, but the P/E has recently been above 20x, which may strike some short sellers as too high for a company serving the residential real estate market. We'd argue that skepticism is unfounded in this case, given that the company now has $50 million in net cash on its balance sheet and has continued to grow so well through a terrible part of the cycle.

Looking closer to home, what do you think the market is missing in MTY Food Group [MTY:CN]?

FR: This is a Montreal-based company that franchises 25 different restaurant banners in Canada. They have every type of chain you can imagine, from sushi to Greek to burgers, with most of the locations in mall food courts.

The company at one point consisted of a computer-services business and a small restaurant division. In 2003 management decided that franchising restaurants was a much better business than computer serv-

INVESTMENT SNAPSHOT

MTY Food Group
(Toronto: MTY:CN)

Business: Montreal-based franchisor of more than 20 branded restaurant concepts, with 1,600 current locations found primarily in Canadian shopping-mall food courts.

Share Information
(@8/26/10, Exchange Rate: $1 = C$1.06):

Price	**C$11.44**
52-Week Range	C$8.06 – C$12.98
Dividend Yield	0.0%
Market Cap	C$218.7 million

Financials (FY ending 11/09)

Revenue	C$51.5 million
Pre-Tax Profit Margin	34.8%
Net Profit Margin	23.8%

Valuation Metrics
(Current Price vs. TTM):

	MTY	S&P 500
P/E	15.3	16.5

MTY PRICE HISTORY

THE BOTTOM LINE

The company's growth-by-acquisition strategy makes it difficult to forecast earnings, says Francois Rochon, whose thesis for MTY's stock comes down to price. After cash, he says, the shares trade at 11x this year's expected earnings: "For a company that has grown 30% per year with a shareholder-focused CEO, that's pretty cheap."

Sources: Company reports, other publicly available information

ices, so they got out of computers and have since grown the food business very quickly and profitably, mostly through acquisition. The number of restaurants has increased at a 28% compound rate since 2003, to more than 1,600, while earnings per share has grown 30% per year, to over 90 cents (Canadian) this year. The recession hasn't really hurt them much: earnings this year will be 80% higher than they were in 2007.

Isn't growth tough to forecast when the strategy is based on acquisitions?

FR: Yes, so this is a case where we're putting a lot of faith in management doing the right thing. The CEO, Stanley Ma, owns 26% of the company and he has proven to be an excellent steward of shareholder capital. The company has a clean balance sheet, uses conservative accounting, and has been extremely disciplined in allocating capital. One company he acquired last year originally balked at his offer price three years ago and he walked away. It was only when they agreed to a reduced price that a deal got done.

We still see plenty of potential for further consolidation in the industry, but are comfortable that if earnings can't be wisely reinvested, management will pay the money out to shareholders. As Warren Buffett says, most managers are willing to grow intelligently if they can, or in other ways if that's not possible. We don't consider that to be a risk with Stanley Ma.

What upside do you see from the recent share price of C$11.45?

FR: It's difficult here to estimate a target price. The way we look at it, after netting out C$1 in net cash, the stock currently trades at only 11x estimated EPS this year of 92-93 cents. For a company that has been growing 30% per year and is run by a disciplined and shareholder-focused CEO, that's pretty cheap.

Do you have general advice on selling?

FR: Our bias toward buying and holding has at times made us too quick to rationalize a problem that hits one of our companies as temporary and "already priced into the stock." If the problem turns out to be more long-term and fundamental, it's likely not fully discounted into the current price at all. We've been blind at times to fundamental changes in a company's business because we think the quick 25-30% drop in the share price makes the stock too cheap to sell.

One technique that helps me avoid that is to regularly look at what we own and ask as objectively as possible if we would buy the exact same portfolio if we were starting from scratch with the same amount of money. For positions where the answer is no, the likely reason is that the company's situation has fundamentally changed, but I haven't fully admitted it yet.

We're not hearing the pessimism from you that many money managers tell us they feel today. Why?

FR: One of the biggest mistakes investors make is to look at the last few years and assume that's the new norm. If recent years have been volatile and unrewarding, that's what people generally expect the next few years to be like as well.

Normalized earnings for the S&P 500 over time have grown 6-7% per year. Given the recession, earnings today are still probably depressed 20% from what would be a normalized level. If earnings get back to the normalized trend, the S&P 500 would be earning something like $120 per share in five years. Put a 16x P/E ratio on that, and you've got a 1,900 target. That's not a market call, but it tells me that the earnings power for many companies today is not being reflected in their share prices. We believe we own such undervalued companies and we'll be patient for the value to be recognized.

Whatever the environment is we try to remain humble, which means maintaining our discipline of buying only great companies with strong balance sheets when they're priced with a wide margin of safety. It's when you're not humble that you end up doing things that will make you humble. VII

Disclaimer

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Performance presented is gross of fees and is as of September 10th, 2010.

Annual returns are audited by PricewaterhouseCoopers through December 31, 2009. Returns before 2000 are based on private portfolios managed by Francois Rochon (also audited).

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