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Patience as Key to Value-Focused Investing

FRANÇOIS ROCHON, GIVERNY CAPITAL



FRANÇOIS ROCHON is President and Portfolio Manager at Montreal-based Giverny Capital. Mr. Rochon was educated as an engineer at the École Polytechnique of Montreal, and worked as a Researcher and Network Engineer for INRS-Telecom and Teleglobe Canada. After managing family accounts between 1993 and 1996, he joined Montrusco & Associates as an Analyst and was managing U.S. accounts totaling more than \$250 million. In 1998 he founded Giverny Capital, a private wealth management firm rooted in his investment philosophy of owning outstanding companies for the long term. Mr. Rochon has written for numerous media outlets and offers a twice-monthly investing column in Montreal's *The Gazette* newspaper. A chapter in Andy Kilpatrick's book, *Of Permanent Value: The Story of Warren Buffett* is written about Mr. Rochon's career.

SECTOR — GENERAL INVESTING

(AEG505) TWST: Please introduce us to Giverny Capital and the products and services you offer.

Mr. Rochon: It's pretty simple. We manage money through discretionary accounts, so it's private wealth management. We invest with a long-term horizon and a fundamental approach. We're big fans of Warren Buffett's philosophy. We select about 25 securities that we own, on average, five to seven years. We work with TD Ameritrade as a custodian.

TWST: You mentioned Warren Buffett. What does value investing mean to you?

Mr. Rochon: We try to buy companies well below their intrinsic value. There are various approaches to this. But essentially, we define intrinsic value by trying to determine two things: What can a company earn in five years, and what is a reasonable assumption for the p/e ratio in five years? Then we try to buy in at half or less of what we think it will be worth in five years so that we can attain a 15% yearly return on our investment.

TWST: What leads you to sell a stock when you are holding it for five, six, seven years?

Mr. Rochon: There are four reasons that we would sell a stock. First, when we realize that we made a mistake, which we ac-

cept will happen from time to time. Second, when we think the fundamentals have deteriorated. When something is going wrong, we try to assess if the reasons we purchased the company a few years back are still valid. If we feel that the situation has changed or their competitive advantage, "moat," compared with other players has changed, we'll consider selling. Third, we can sell when we think that a stock is overvalued. That happens once in a while. If we think a stock is highly overvalued and the potential within the next five years is limited, we'll sell it. And fourth, and this is probably the most common one, we'll sell because we found a better opportunity. In that case, we still like company A, but we've found a company B that we think will do even better.

TWST: You've said the most important ingredient to investing is patience. Tell us a little about how you apply that to your philosophy and process.

Mr. Rochon: The first part of being patient is waiting for a good price to acquire companies. Sometimes it takes many years between the time that we start to follow a company and the moment that we purchased shares. In a few cases, it was more than 10 years. The second part, once we purchased a stock, is being patient to get the reward of our research. The way to remain patient is to consider ourselves owners of the company, so that whatever the

Highlights

François Rochon of Montreal-based Giverny Capital shares his ideas on value investing, which have propelled his group's Global Portfolio to a 14%-plus annualized gain back to 1993. Mr. Rochon tends to buy and hold a concentrated group of stocks when they sell at a significant discount to their intrinsic value, and he believes the most important ingredient to successful investing is patience. He shares his process along with a few key holdings and the rationale behind those investments.

Companies include: Wells Fargo & Company (WFC); M&T Bank (MTB); Bank of the Ozarks (OZRK); Fastenal (FAST); CarMax (KMX); The Walt Disney Company (DIS); Union Pacific (UNP); Berkshire Hathaway (BRK-A) and JPMorgan Chase & Co. (JPM).

stock does in the stock market over the short run doesn't really affect us. As long as the intrinsic value is growing, we don't mind if the stock falls or does nothing. We have had a few securities do very little for three or four years, but we knew that the intrinsic value was increasing, so we were patient.

“As long as we believe that the company's intrinsic value increases at a very good rate, which I would define as more than 12% a year, we don't mind if the stock does nothing. If we can purchase more of a stock at an even lower ratio or at an even bigger discount to the intrinsic value, we'll gladly do it.”

It's really a question of attitude toward market fluctuations. We're really focused on what we think the company is worth, along with what's happening with the company's earnings prospects and its competitive advantage within the industry. As long as we believe that the company's intrinsic value increases at a very good rate, which I would define as more than 12% a year, we don't mind if the stock does nothing. If we can purchase more of a stock at an even lower ratio or at an even bigger discount to the intrinsic value, we'll gladly do it.

TWST: In your literature you mention four portfolios — Global, U.S., Canada and an Equity Fund, which you use as models for your private wealth accounts. Tell us about the portfolios.

Mr. Rochon: It's very simple. It's mostly my own accounts. The Global portfolio is the combination of all the stocks combined in my portfolio. It's made up of Canadian stocks, U.S. stocks, and sometimes a few foreign stocks. Giverny Canada is just the Canadian part. The Giverny U.S. is just the U.S. part. So the Canada and U.S. portfolios are parts of the Global portfolio. The equity fund is a pooled fund created, also with TD Waterhouse as a custodian, for our clients that is modeled on the global Giverny portfolio. But it is available only to Quebec residents.

TWST: When you say 15 to 25 stocks, do you mean overall or within each of those branches?

Mr. Rochon: It's about 25 overall. Sometimes we have a few others as a way to know more about a company, but I would say that more than 95% of the assets is within 25 names.

TWST: And U.S. investors can work with you?

Mr. Rochon: Yes, we're registered in the U.S. We have a U.S. office in Princeton, N.J., and we work with TD Ameritrade as a custodian.

TWST: Your global portfolio claims better than 14% annualized return going back to 1993. Would you speak briefly about the factors that lead to those results?

Mr. Rochon: The main reason is because we own outstanding companies that have grown their intrinsic value at something close to 14% a year. We were able to purchase some of them at very good prices, which usually has compensated for the inevitable mistakes here and there. We like to think that we're very, very

prudent. We try to avoid anything that we don't really understand. We try to avoid any fads or popular industries, companies that are cyclical or are very dependent on commodities' prices. We avoid anything that is too changing or technological for our taste. Our philosophy is try to avoid losses, big losses. And I think a big reason for good returns is that we didn't have terrible years. During the bear markets of the last 20 years, we've done much better than the index because we owned superior companies, companies that have durable earnings power, good balance sheets and good management. They were able to withstand economic storms, which we accept will happen from time to time.

TWST: Would you give us an idea of what's in the portfolios right now?

Mr. Rochon: Yes, for instance, for the last few years, we've been buying banks. We own **Wells Fargo** (WFC), which we like very much. We also own **M&T Bank** (MTB) and a little bank in Arkansas called the **Bank of the Ozarks** (OZRK), which we think is probably one of the best-managed banks in the U.S.

TWST: What is it about that one that sticks out for you?

Mr. Rochon: I think **Ozarks** is very well-managed. They are very conservative in their loans so they have very low charge-off ratios. They are very low-cost, so their efficiency ratio is much lower than the average. So they can earn much higher return on assets than the average. They earn something like 2% on assets, which is tremendous. We like the CEO, George Gleason. We think he is a great banker. **Ozarks** is not very well-known and not very well-followed, but it has been growing 15% to 17% a year for many, many years now. And it's still very small, so we think it can continue to grow at a rapid rate in the future.

1-Year Daily Chart of Wells Fargo & Company



Chart provided by www.BigCharts.com

We've owned a retailer called **Fastenal** (FAST) for many, many years. We bought that in 1998, so it's been close to 15 years in portfolio. The stock has done very well. It's very well managed. We also like **CarMax** (KMX), the big used-car auto retailer. We bought it in 2007.

In terms of bigger names, we own **The Walt Disney Company** (DIS) since 2005. We bought in the day Bob Iger was named CEO, and we think he is one of the best CEOs in corporate

America. And lately we bought **Union Pacific** (UNP), which we think will do very well going forward.

“People always have this emotional relationship with stocks, and once they have been bitten by something, it takes a while to get back into it. I think investors were burned by the banking industry in 2008, and it’s going to take many years of earnings growth to really get people more enthusiastic about this industry.”

TWST: Let’s talk about something you’ve held for a long time. Would you take us through how you got in and why you stayed so long on a particular stock?

Mr. Rochon: What we really like about **CarMax** is they really changed the industry, which was mostly dominated by moms-and-pops for many, many years. They offer consumers a very good deal, and a very good guarantee. They buy their cars at a very good rate. So for the consumer, I think it’s a much better experience owning used cars. And even though they have 119 large super stores, they still have less than 3% of the market. It’s very fragmented, it’s a very big market, and we think they really have a very big competitive advantage.

For a few years during the recession they put their new store opening program on hold, but lately they started to open new stores. We think they can probably increase new stores by 50% to 60% in the next five years. And they’ve been profitable every year. Even during the recession, they’ve been profitable. Since we bought it, earnings have doubled. So they’ve been growing very well even during this very tough environment, and we think they can continue to grow 15% to 20% for many years. Thomas Folliard, the CEO, is young, 48, and we think he has been implementing the right culture. His growth plans are promising.

TWST: And just to get an insight into your process, what happened in 2007? What made it look like a value at that point?

Mr. Rochon: It wasn’t that cheap on traditional valuation methods because we probably paid something like \$20, so we paid more than 20 times earnings. We just thought that **CarMax** could continue to grow 15% a year for many years, and it has doubled since we bought it. So far we’ve been right on that. The stock had a little correction, down 67%, during the 2008 downturn, but it came back and it is about double what we paid, simply because earnings per share have doubled during that time frame. We think they will do that in the next five years also. So it is a good value because we believe the stock does not totally reflect the fact the company should continue to increase its intrinsic value at a very rapid rate.

TWST: What about an example of something you bought fairly recently?

Mr. Rochon: The reason we bought **Union Pacific** is, and we talked about this in our annual letter, that we used to own **BNSF** before **Berkshire Hathaway** (BRK-A) purchased it. We like the fundamentals of the rail industry. This summer we went to meet the

president of a big company, and he told me that he thought that **BNSF** and **Union Pacific** are almost a duopoly in the western railroad industry. Now, one good thing about the western part of the United States is that it’s growing very fast thanks to the oil and gas shale development. Volume should continue to go up. We also believe that **Union Pacific** and **BNSF** have a very good cost structure, and they have been able to increase the price they charge for their volume. If you look at the last five years, **Union Pacific** increased its pricing by about 5% a year, which is very good in this low-inflation environment. We also think they are very shareholder-conscious: They repurchased close to \$6 billion of shares in the last few years. If you combine the volume increases, margins improvements and the pricing gains with returning money to shareholders, we think they can grow their earnings per share at about 12% to 15% a year going forward. The p/e ratio is about 15 times, so we think it’s reasonable.

TWST: You mentioned a banking theme. What led you there a few years ago and where does that stand now?

Mr. Rochon: For quite a while, bank stocks were very cheap. People were afraid of them, and to some extent, they still are. For example, **Wells Fargo** and **JPMorgan** (JPM) trade at about nine times forward earnings. We think that many banks are undervalued. Our two regional banks, **M&T Bank** and **Bank of the Ozarks**, are still growing pretty fast by making good acquisitions. But I would add that it is not really the banking industry as such that we like; it’s really that we think that we own the three best banks in the U.S., because to us, their CEOs are the best of the sector. We think these are top guys, and one of the reasons that we were able to purchase them at very attractive level is because investors in general were very pessimistic about this industry. They are now a little less pessimistic than a few years ago, but the industry is doing much better. The real estate market is doing a little better. So anything linked to mortgages should do better going forward. We still think everything is in place for a good five years for the sector and particularly for our three banks.

1-Year Daily Chart of CarMax



Chart provided by www.BigCharts.com

TWST: What do you think investors are missing when they look at Wells Fargo these days?

Mr. Rochon: People always have this emotional relationship with stocks, and once they have been bitten by something, it

takes a while to get back into it. I think investors were burned by the banking industry in 2008, and it's going to take many years of earnings growth to really get people more enthusiastic about this industry. But it will come back. **Wells Fargo** has done pretty well lately, but we think the next five years looks even more promising. It's strange, you never know exactly when or why Wall Street will come back into it, but I am reassured by the fact that in the long run, the stock market always reflects the intrinsic value of the businesses. You don't know exactly what the timing will be, but in the end, if we're right about the company, we'll be right about the stock.

TWST: Tell us a little bit about your research process.

How do you define the intrinsic value of these companies?

Mr. Rochon: We try to keep it very, very simple. If it's too complicated, we'll put it in the "too hard" pile. First, we look at what the company does, and if I don't get it in a few phrases, it's too complicated for me. When I think I understand what the company does, I will look at the financial statements. It has to be a very profitable company. It has to have good return on capital. Then we look for some kind of durable competitive advantage. Our main questions are, why is the company earning superior returns, and will these advantages still be present over the next five years? We look for very simple situations.

If you look at **Bank of the Ozarks**, **Fastenal** or **CarMax**, these are simple businesses to understand. We look for financial statements that are pretty easy to understand, too, because we don't like it when there are too many things that can go wrong. We are very wary of companies that have low margins, complicated accounting and high levels of debt. And as I said, we try to see what kind of earnings power they can have in five years, and what kind of p/e ratio would make sense. From there, intrinsic value has to be a very simple calculation. You don't need computers to do it. For example, we think **CarMax** can earn \$4 a share in five years. You put a 20 p/e ratio on it, so it's an \$80 target price in five years. If we can purchase the stock at \$40 today, we should do OK. It's as simple as that, when things go as planned. Of course, we try to make it a little more precise than that, but that's the general idea.

The key thing is that we are quite sure of the earnings in five years. If we are not sure, if we think there are many things that can go wrong within this scenario, it's too risky for us. But if we understand the business and we are pretty comfortable that the company will earn X dollars in five years, the risk is not too high.

TWST: How do you incorporate risk management into your portfolios?

Mr. Rochon: First, we tend to have an average weight of about 4%. Sometimes we go a little higher, but we don't really go higher than 10% in a single stock. We accept that probably one stock out of three that we purchase won't do as well as expected for

whatever reason. So by pulling a limited amount, 4% or 5% in a single stock, we think we manage the risk very well on that part. Obviously, the way to reduce risk is to find companies that have very low intrinsic risk. The financial risk is low because they have a very clean balance sheet. Also, their business risk is low because they are dominating their industry and their industry has good fundamentals. And we want companies that have a competitive moat; they have something very peculiar that makes it very hard for competitors to take their market share. People tend to underestimate that, but when you have a very big competitive advantage, the intrinsic risk of your business is pretty low.

Finally, if you have a great CEO managing the business, doing intelligent things with the money and with the capital allocation, the risk level is lower. So we try to manage risk on many levels, and then we buy stocks at a very good price. The less we pay compared to intrinsic value, the lower the risk. We've bought some stocks in 2008 or 2009 at probably a third or even at a quarter of intrinsic value, so to us the risk level was very low. The market felt that the risk was high, but we knew that the intrinsic risk was very low.

TWST: What are the two or three best reasons a long-term investor should look closely at Giverny?

Mr. Rochon: We try to focus on finding the best of the best of businesses, and we try to look everywhere. We are very prudent. And we keep things very, very simple. We have the luxury, since we are a small firm, of being able to buy almost anything, an advantage very large funds don't have. We can buy a **Bank of the Ozarks**. And we are very, very patient. On Wall Street, it's a rare quality.

TWST: Is there anything else you wanted to cover?

Mr. Rochon: I collect contemporary art, and when you build a portfolio, it's a little bit like putting together an art collection. It's a similar attitude. You want to find masterpieces, and you want to find the best of the best companies, companies that will be considered masterpieces in five or 10 years, ideally. When you are trying to focus on finding gems, I think that it simplifies things and it becomes much easier. You stay away from anything that is not outstanding.

TWST: Thank you. (MJW)

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