Quarterly letter to our partners – Q1 2008

In stocks, it's the only place where when things go on sale, people get unhappy. If I like a business, then it makes sense to buy more at 20 than at 30. If McDonalds reduces the price of hamburgers, I think it's great.

- Warren Buffett

Comments on the markets and our businesses

Benjamin Graham, the father of fundamental analysis and Warren Buffett's mentor, compared the stock market behavior to a manic-depressive person. Almost 60 years after this analogy was written in the "Intelligent Investor", it is still the most appropriate description of the stock market. And it's always surprising to observe the irrationality of most of market participants (to call them "investors" would almost be an insult to true long term owners of securities).

Just a few months ago, private equity funds were buying low-quality companies at high priced. How to finance these purchases? Simple: issue some debt paper! Many mortgage lenders also issue paper of high risk (but with low risk yield). As long as house prices were trending upward, there were no problem. But as the house bubble cooled off, low-quality loans started to default.

Banks from all over the World danced to the tune of paper speculation and complex financial structure. But suddenly, those papers fund no buyer last summer. To this day, loses amounted to $230 billions worldwide. Even Swiss banks (with a reputation of being highly conservative) danced to the tune. And Canadian banks also ended up owning some low-quality paper.

Our approach to focus on high quality companies and not embark on fads helped us go through this crisis these last few months. Our companies did pretty well in this environment: they increase their earnings by 10% in 2007 and we believe will generate a similar increase in intrinsic value this year.

Our financial companies (American Express, Wells-Fargo and Bank of the Ozarks) – to this day – held up well.

Here are some news on our companies:

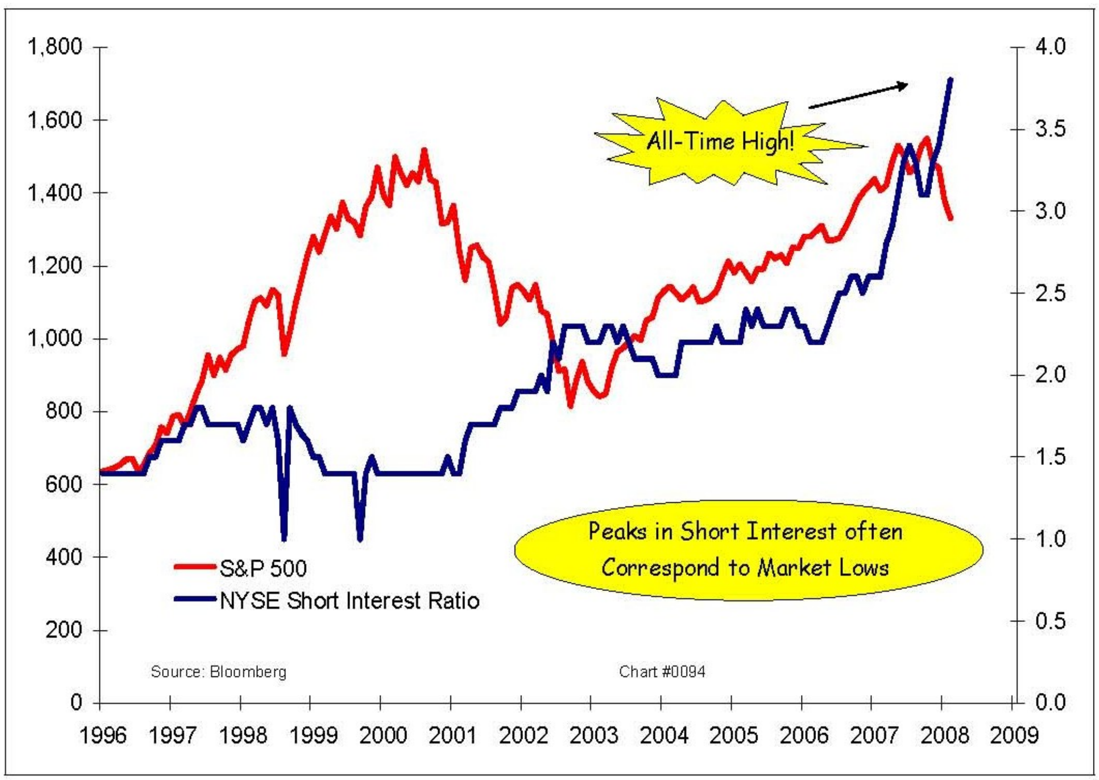
- Wal-Mart had a very good first quarter 2008. Sales were up 10% and earnings per share (EPS) 12%.
- Bank of the Ozarks increased its assets by 20%, its interest revenues by 19% and profits by 3% in the first quarter. Bank of the Ozarks is one of the few banks that have shown an increase in earnings during the quarter.
- In Q1, Fastenal increased sales by 16% and earnings by 26%. This trend continued in April as daily sales increased 17%.

- Walgreen's sales increased by 9.6%, 14.5% et 10.6% for the first three months of the year 2008.
- Johnson & Johnson increased revenues by 8% and EPS by 9%. J&J is helped by the weakness of the US currency as it gets 50% of its revenues from outside North America.

Although our stocks are going sideways for a few quarters now, it is vital to realize that they are increasing their intrinsic value by about 12% a year (earnings increase plus dividend). Since we look at our portfolio as the ownership of companies (not lottery tickets or casino chips), we focus on this parameter more than anything, knowing that the stock market will eventually reflect it. In fact, one way to look at it is that our intrinsic value increases by almost 1% each and every month that goes by.

Pessimism on Wall Street

Although we believe that owning stocks over the long run is the best of approach, the best time to purchase stocks is when pessimism is king! If the general moodiness of financial markets is not enough to convince you that participants are pessimist, here is a chart of the short interest ratio at the New York Stock Exchange (NYSE). It's an indicator of pessimism and at the same time of the return potential of stocks in general. The higher the short ratio, the higher the potential of future returns. Today's level is three times the one of the 1999 market peak when optimism was everywhere.



Source : BMO Capital Markets

Mutual funds purchases and repurchases are also a good reflection of market sentiments and return potential (in general, the public participants do the wrong thing at the wrong time). In the first quarter of 2008, Canadians bought $9 billions of mutual funds compared with $17 billions in Q1 2007. Of this $9 billions, $10.7 billions went into money market funds (that yield 2.6% these days, bellow the level of inflation). So, in addition to putting all new money in treasury bills, many participants sold their equity funds. To buy low is just not programmed in most of market participants' genes.

This crisis too will pass

During periods of high pessimism, it is wise to read (or re-read) writings of great thinkers. It can help to have some perspective on things. Abraham Lincoln, the famous American president, wrote these words in 1859 to an agricultural department (probably after a year of bad harvest):

> *It is said an Eastern monarch once charged his wise men to invent him a sentence, to be ever in view, and which should be true and appropriate in all times and situations. They presented him the words: "And this, too, shall pass away." How much it expresses! How chastening in the hour of pride! How consoling in the depths of affliction!*

O'Reilly Auto goes shopping !

In our last annual letter to partners, we indicated to great companies (like the ones we own) can take advantage of recessions by gaining market share. In the first quarter, O'Reilly Automative acquired CKS Auto for around $1 billion (half in stocks, half in assumed debts). O'Reilly paid $12 a share for CKS, a level 40% bellow its high of 2004.

O'Reilly increased its store number from 1800 to 3000, an 66% jump for an equivalent cost of 29% of its market value. O'Reilly did a similar move in 1998 (when they acquired HI/LO Auto supply) and EPS have increased by 365% since then.

Commodity bubble?

Strangely, the only segment of the market that has continue to go up in the last few months is the commodity market. It's ironic since usually cyclical sectors are the hardest hit by recessions.

What is different this time is that speculation – not fundamentals – have taken over the demand part of the commodity equation. It is estimated that 40% of commodity contracts are purchased not by actual user of the product but by external participants (pension funds, hedge funds, ETF, etc.). This non industrial demand is estimated at more than $200 billions at the present time. This demand is artificial and will not be able to sustain indefinitely the market (although their time horizon is far from that). In the mean time, it disturbs the equilibrium between offer and demand.

For example, in 2007, it is estimated that 62% of wheat contracts were owned by index funds. These funds can obviously "roll" their contracts into 2008. But at some point, to realize some return, they will have to sell their position (who wants to get dividends in wheat?). They certainly think that they will find other buyers (a variation of the "greater fool" theory). But as the real demand uses up 38% of production, we can ask the question: to whom will they sell to?

We continue to be agnostics on the level of commodities in general. But our experience of markets (and common sense) makes us believe that many speculators will end up with large "disappointments" at some point.

Al Gore in Montreal

I had the chance of attending Al Gore's conference in Montreal. Mr. Gore insisted once again on the importance for Canada to sign the Kyoto accord on the reduction of greenhouse gas emissions. What will prevent Canada to attain the Kyoto objectives in the future – in large part – is the explosion of Alberta's tar sands transformation into synthetic oil. This transformation produces 20% more greenhouse gas than more conventional oil production.

Of course, our job is to manage investments, yours and ours. Environment consequences are part – more than ever – of the fundamental analysis of future earnings of companies. So we would tend to avoid companies that we believe are not environment friendly. We would also look more closely at companies in the wind and solar energy production.

Conclusion

Although the recession has not been official yet, we like to keep in mind that historically they have lasted on average 10 months (compared to 57 months for expansion periods). Moreover, the stock market tends to discount many months in advance economic cycles.

We continue to be faithful to our philosophy to avoid predictions, both on the economic front and on the stock market. We do believe that our stocks are greatly undervalued these days and that consequently our return potential is higher than usual. Our companies are solid, well managed and have great long term perspectives.

Many partners would like to know *when* stocks will go up again. Of course, no one knows those things (except some bohemian palm readers in Brooklyn).

On the other hand, it is important to remember that stocks have yielded average annual returns of 10% over the long run. But more importantly, 90% of this return have been generated during only 1.5% of the stock exchange opened days. Money manager Robert Torray wrote recently that this statistic implies that odds are 66.5 to 1 against those who try to enter and exit the stock market at the "right" time.

As Woody Allen would say : « *80% of success is simply showing up* ».

We wish all of you a great quarter.

François Rochon

François Rochon and the Giverny Capital team