Giverny

Giverny Capital Inc.

Quarterly letter to our partners – 1st quarter 2009 ®

The economy and the stock market

During the first quarter of 2009, economies all over the World continued to be in recession. Unemployment rates continue to climb and the stock market had huge swings (up and down). We do not know when the recession will end (and believe that no one does). But we do some positive signs and want to share them with our partners:

- The manufacturing capacity index is a typical recession low. It does not mean that it won't go lower but we are at levels similar to past recessions lows. On the other hand, the weekly leading index is showing a slight turnaround (see figure 1).
- The US trade deficit showed huge improvements in the first months of 2009. It has been reduced by 50% since its peak of 2005. Adjusted as a % of GDP, it is similar to its 2000 level. It is quite a good news for the US economy. Canada has seen a trade deficit, for the first time in years, as its trade balance with the US has been reduced by 65%.
- The stock market touched a low on March 9th 2009 when the S&P 500 went to a level of 677. One little month later, it had climbed to 854, a 26% rally. Of course, no one knows if that low was the "last" or not. But historically, the stock market touches a low six months before the economic cycle does.
- As for the cycle, April is the 17th month of recession in the US. This makes it the longest recession since the 1930s. On the other hand, with a positive view, we can believe that we are closer to its end than of its beginning.

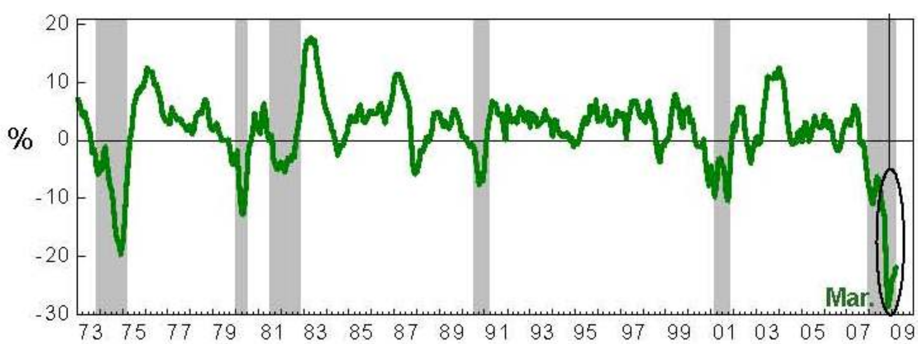

Figure 1 : Weekly Leading Index (monthly). In shades: recessions.
Source : Economic Cycle Research Institute (ECRI).

The inflation to come

During the quarter, the US treasury injected $1 trillion in the economy. It is a huge amount but it is only the equivalent of 3% of the total net worth of American citizens. But it is an addition to the other important aid to the banking system. So we believe that these interventions will have inflationary consequences over the long run. When and to what extent? Impossible to know.

During inflation times, the worst asset to own is liquidity. With interest rates bellow 1%, it is a guarantee of wealth destruction. And – irronicaly – this guarantee was in big demand during the quarter. In the US, 43% of mutual fund assets are invested in money market fund (a similar situation probably exists in Canada also).

Others believe that resources are a good investment during inflation time. Historical data does not confirm this belief. If fact, the CRB Index has a real annualized return of -1% since 1956. This translates into a 50% drop in purchasing power over that time frame.

The best asset to own is a business (in its owl or in parts through share purchases) which owns a competitive advantage that permits it to increase prices to maintain (or even increase) its level of real revenues (adjusted for inflation).

Take for example the Disney company. An entrance ticket to Walt Disney World had a cost of $9.50 in 1981, $33 in 1991 and $75 in 2008. There is no equivalent to a vacation at Disney World for the typical North-American family. So Disney has a strong competitive advantage and that makes their revenues (and its stock) shielded against inflation.

Another example could be Martin Marietta. Over the last 10 years, the company increased its aggregate prices by 5.5% on average, two times the level of inflation during that time.

News on our companies

- Carmax had a good first quarter considering the environment. Car sales were down 26% but earnings were up thanks to a return to profitability for its finance division. Its balance sheet has been improved: cash was up to $140 millions and the long term debt has been reduced to $178 millions (22% less than last year). The stock has done quite well in the stock market: it went up 50% during the quarter.
- American Express also improved its balance sheet. It was able to get huge levels of new deposits (which are virtually costless these days) since its conversion to a bank holding.
- Wells-Fargo has decided to cut its dividend by 85% to improve its capital ratio. At the same time, the company announced operating profits of $3 billions during the quarter, double what the analysts were expecting. We also observed 8 insider buying during the quarter, an excellent sign. The stock market was quite manic-depressive with WFC stock during the quarter. It fluctuated from $8 to $30 (as of May 7th, it is at $24). Who still believe that the stock market is efficient?
- Bank of the Ozarks had also a good quarter : EPS were up 20% helped by a one time gain on some securities sales. Its balance sheet is still very solid.
- O'Reilly continues to do very well in this difficult retail environment. Same store sales were up 5.7% and EPS were up 15% for the first quarter.
- Fastenal had a tough quarter. Sales were down 14% and EPS down 28%. Still, the company has no debt and is investing for its future: It has decided to open 2-5% new stores in 2009.
- MTY Food acquired Country Style during the quarter which should help increase sales by 25% this year.
- Our Japanese retailer, Nitori Co, released its final 2008 numbers (for the fiscal year ended February 2009). Operating earnings were up 27% to ¥33 billions. The company believes it can grow revenues by 8.5% in 2009.

The real estate situation in the US: stabilization in sight?

Real estate prices in the US have come down by more than 25%. This has made owning a home much more affordable for the average American household. In fact, mortgage payment on median priced home compared to family income is at a 20 years low (see figure 2). This level has been also helped by the decrease in interest rates. The very low level of new home built should indirectly help reduce inventory of unsold homes rapidly. At some point, there will be a shortage. So we believe that a stabilization of the real estate market is in sight. This should be positive for some of our holdings like Mohawk Industries and Martin Marietta Materials.

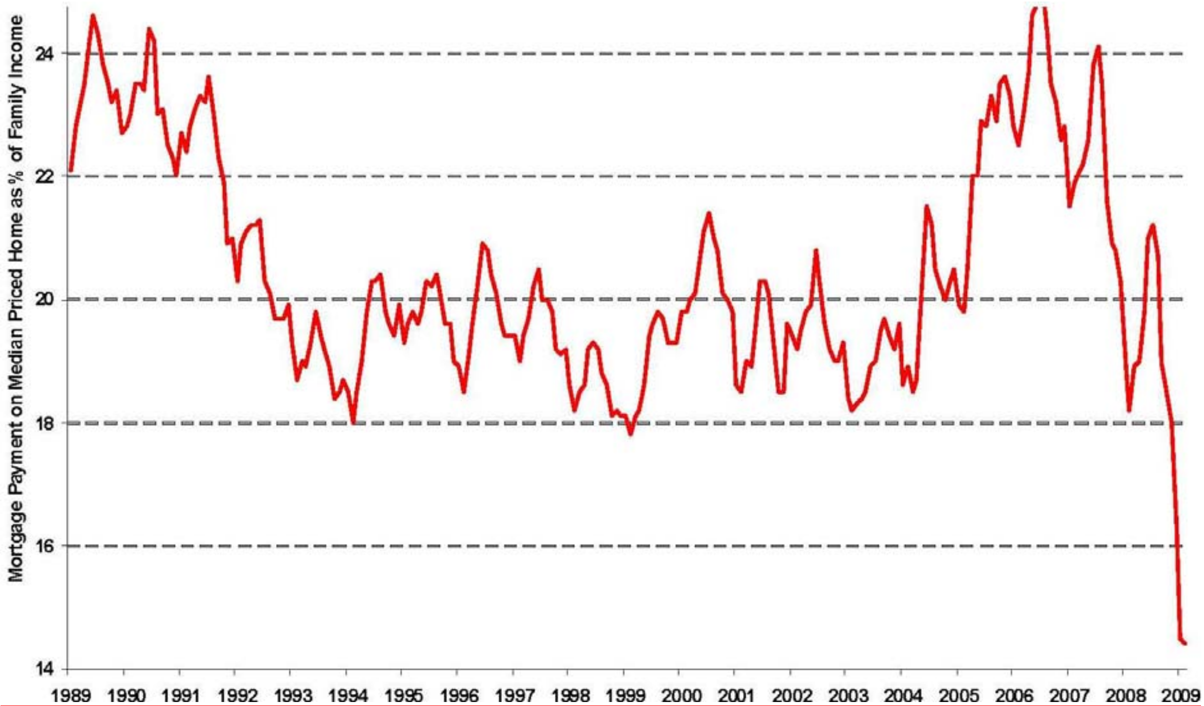

Figure 2 : Mortgage payment on median priced home as % of family income
Source : US National Association of Realtors and T2 Partners

Bargains in financial stocks

During the quarter, financial stocks in the US traded at levels we believed were incredibly cheap. We wanted to cash on that opportunity. Even by selling some of our "less undervalued" securities within our portfolio.

We decided to sell our shares of Walgreen's to acquire stocks in M&T Bank. We still like WAG but believe that we are acquiring a more undervalued security with MTB.

This Buffalo bank is well known to our partners since we were shareholders for many years. In 1998-99, we had bought shares at $40-45. At that time, the company had $21 billion in assets. In 2006, M&T earned $7.73 per share, 100% higher than its 1999 level. We decided to sell most of our shares (for valuation reasons) at levels over $100 a share.

In August 2008, the stock went to $60 and we decided to take a new look at it. We went to Buffalo to spend time with its CEO Bob Wilmers, a man we had admired for years. We came back reassured that the bank was solid and that it would make it through this crisis. I remember saying that if the stock would go down to $40, it would be a great buy since it would be a third of its estimated intrinsic value. This comment was meant more as wishful thinking than a prediction.

In February my wish came true! The stock went to less than $40 and we bought back shares. It is hard to believe that it is the same price as the one we first bought the stock some 10 years ago. There is one main difference: assets are three times what they were then. It is interesting to note – if I may add – that the stock continued to go down for a few days and reached a low of $29. A stock trading at a third of its value can go – on the short run – to even cheaper level. The stock market can be truly manic-depressive. As I write these words, the stock changes hand at $53.

Conclusion

We are finding bargains all over the world. Even in China, valuations have come back to earth (after some stratospheric levels in 2007). If we find other securities that we believe have even higher return potential than our existing investments, we will make some changes as we did in acquiring shares of M&T Bank. We don't like to sell our companies. But our constant objective is to optimize the return of our capital and at the same time reducing the intrinsic risk of our holdings.

So far so good: our companies have done much better than the average public company during the last year or so. Both on the fundamental front and on the stock market.

We believe that the return potential for our portfolio for the years to come is very high.

We wish all our partners a good quarter.

François Rochon

François Rochon and the Giverny Capital team