Letter to our partners – Q2-2008 ©

> *A stock-market decline is as routine as a January blizzard in Colorado. If you're prepared, it can't hurt you. A decline is a great opportunity to pick up the bargains left behind by investors who are fleeing the storm in panic.*
>
> \- Peter Lynch

Market comments

Stock markets all around the globe went down in the last few months. The Shanghai Index (China) is down 57% from its highs, Bombay (India) down 40%, Dublin (Ireland) down 50%, Seoul (South Korea) down 25%, Nikkei (Japan) down 30%, FTSE (UK) down 20% and DAX (Germany) down 25%.

In August, markets regained some ground but still we're finding bargains all over the World. The difficulty lies in the wide choice of opportunities…

Your questions

We pursue our tradition of publishing a Q/A in the second quarter report, which is usually at the mid year before our annual meeting where we answer all your questions. Our goal: to help you better understand our focus on great businesses and long term approach. As always, we received lots of questions from our partners. We will try to answer most of them by choosing the most recurring ones.

Q: How would you explain the huge fall of Bank of the Ozarks? In just one day, the stock crashed by 10% !!

A : Bank of the Ozarks' stock has been quite volatile this year. I looked up the price of the stock the day you wrote us (July 7th). The high of the day was $16.39 and the low $13.81, a gap of 18%. As I write these lines, the stock is $23 so it's up 50% from that day. So the stock "crash" was nothing to worry about. The market can be irrational on the short term.

Latest quarterly results were – once again – very good. Interest income went up 22% but the company decided to be cautious and took an increase of 220% in reserves. Even after those charges, earnings were up 6%. Very few banks had an increase in profits during Q2 2008.

On July 16th and 17th, two insiders bought the stock. We share their enthusiasm.

Q: I would like to know how is the financial health of our two banks: Bank of the Ozarks and Wells-Fargo.

A: Our two US banks are doing well. They avoided the "sub-prime" mess and are still profitable this year. But they are not immune to bad loan charges during a recession. They both increased their reserves. Bank of the Ozarks should have record earnings but for Wells-Fargo, it will be tougher. My estimates is for a reduction of 17% in EPS this year. In this environment, it is quite acceptable.

Q: In your opinion, which stock has the biggest potential in the long run?

A: Well, it's not easy to answer for many reasons. We own around 25 securities because it is impossible to know in advance which one will do better than the others. If we did, we would just own that one stock.

A company like Johnson & Johnson has a low risk level but its growth potential is not as high as a smaller company. But to have a 10-15% annual return is not that bad a thing. What we're really looking for is to find an investment we can realize 20% a year. So we tend to acquire companies that evolve in a large market and have a competitive advantage that will permit them to grow within that market for many years. Great companies are those that go beyond that: they create their own market !

One company that we have owned for a while – 10 years – is Fastenal. The company has grown their earnings per share (EPS) by 18% a year since 1998 and the stock is up 700%. The company is still doing very well: in the latest quarter, EPS were up 26%. So we continue to be enthusiastic that this investment will continue to yield good results.

Q: How long will it take for those that invested when the US dollar was strong to regain the currency loss?

A: The huge increase in the Canadian dollar has indeed affected the adjusted value of our investments outside the country. We do believe that eventually (and perhaps not that far away in the future) the increase in our foreign companies value will surpass the currency loss. If, for example, O'Reilly Automotive goes up 200% in 5 years or so, it will have compensated the currency loss by a wide margin.

We also believe that the Canadian dollar could be overvalued at its current level and that a return to a more normal level would cut in half the currency losses (on paper) of the last few years. We do not believe to have an expertise in predicting currency levels in the short term. We always have been agnostic in that area. But as we have indicated in the past, the OECD values the Canadian dollar at a PPP (*Price Purchasing Parity*) of $0.82, 16% lower than today's level.

Q: Do you believe the Canadian dollar will go down one day? Canada is doing so much better than the US…

A: To continue answering the last question, in the long run value always wins in the market. This PPP estimate by the OECD makes some general sense. Because, the GDP per capita is 17% lower in Canada than in the US. Statistic Canada also comes to that conclusion in a efficiency report they published a few years ago.

1) Hours worked per capita in Canada is 90% of those in the USA
2) The productivity per Canadian worker is 92% of its US counterpart.

So : 90% x 92% = 83%

From 2002 to 2008, real GDP growth has averaged 2.5%, both in Canada and in the US. So the 1000% increase in oil price doesn't seem to have had a huge impact on the Canadian economy growth rate. In fact, if we look at history, by far the most important parameter in Canadian GDP growth has been the US GDP growth.

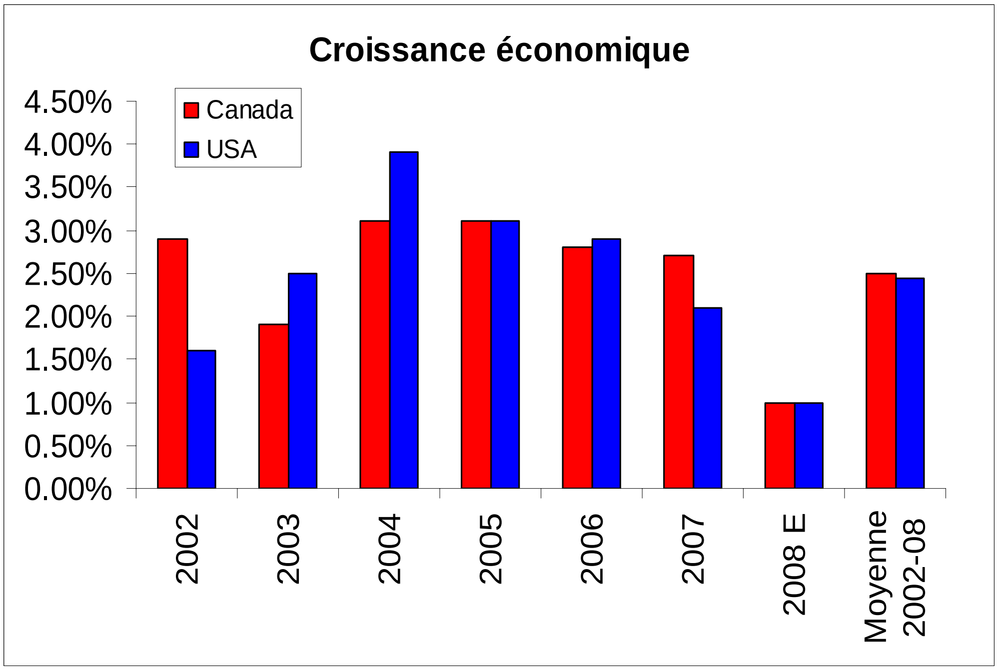


Figure 1: Real GDP Growth in Canada compared to the USA

The fiscal situation is – on the other hand – quite different. The Canadian government runs a surplus and the US a deficit. But it's a society choice more than anything else. If in the US they would tax their citizens to a level they do in Canada, there would not be any more deficit.

Q: What do you think of companies like Zenn, electric cars or any other environment friendly way of transport?

A: As a great economist once said: "The solution to high oil prices is high oil prices". The pressure to find both environmental and economical alternatives to the traditional car is higher than ever. In 2010, it is estimated that lots of electrical car will come to the market like for example the Mitsubishi i MiEV. Another type of car is also been experimented in California these days: the hydrogen car !

So this is probably a long term and perhaps quite irreversible trend. The difficulty is to find companies that have a great future but also a great present. We avoid companies that are not profitable. This discipline removes from our pound of ideas lots of innovative companies. A company that is profitable and that seems that have a bright future is the Indian company Tata Motors. Its micro-car Nano (at $2500) seems to have a huge potential in many countries. Tata is also working on a electric car and a compressed gaz car (The Air Car). The latest quarterly results of Tata were a little disappointing but we are following the company closely.

As for the Quebec based Zenn, it is quite small and highly unprofitable (the have cumulated $19 millions in losses on an initial capital of $27 millions). It seems very early to consider investing in that company, even though it is a fascinating and promising enterprise.

Within a young and dynamic industry, it is hard to predict which companies will be the winners. Let's take for example the early years of the Internet. The first companies to offer a search engine were eXcite, Altavista, Looksmart, Lycos, Alltheweb, Galaxy (Gopher), WebCrawler and many others.

In the end, it was the last to enter the market more than 10 years later, Google, that became the only real winning investment.

Q: Do you maintain a North-American orientation for stock selection?

A: As we've written in our latest letters to partners, we want to globalize our portfolios. We have already invested in Japan and Australia. We also own US companies that get a huge part of their revenues abroad (Johnson & Johnson, Microsoft, Procter & Gamble or American Express).

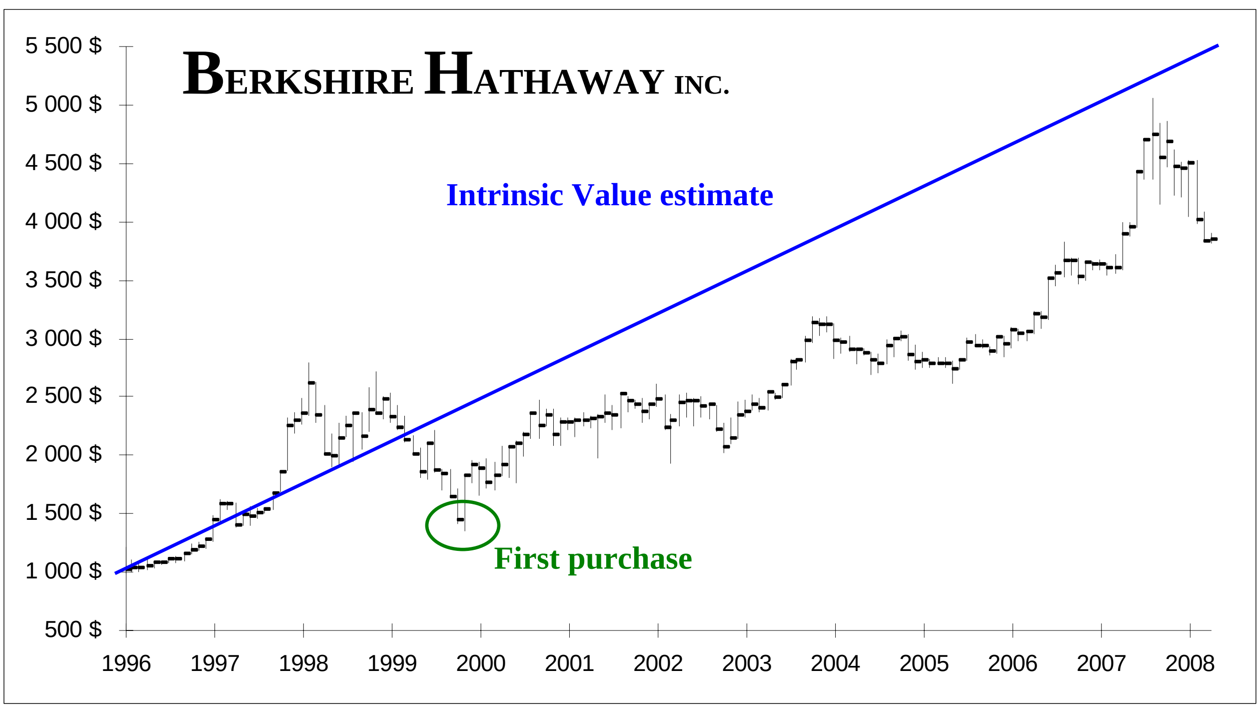
European markets have gone down a lot in 2008. Irish banks trade at 6 times earnings. We find bargains in the UK, in Sweden, in Germany and in Switzerland. Lots of stocks that looked expensive last year are down 50% or so. They now look very cheap.

We're also looking in India, in South Korea (the Seoul market trades at 10 times) and China.

So it is still our objective to have a higher portion of our assets outside North-America over the next few years. It will obviously depends on the opportunities available.

Q: Our biggest investment is in Berkshire Hathaway. The stock went up 40% last year but lost almost all its gains this year. Is the market worried about Mr. Buffett's age? Do you believe the stock to be undervalued? What would happen if Mr. Buffett died?

A: In our 2005 annual letter, we included a graph of Berkshire Hathaway stock price and compared it to our estimates of intrinsic value. Two years and one half ago, the stock was at $2900 and our intrinsic value estimate at $4200. Today, the stock is $3800 and we believe it's worth $5500. So the stock looks to us still undervalued by a wide margin.



It is a certainty that Mr. Buffett will die one day. For the present time, he is in excellent health and has planned his succession in details. We know of many of the candidates and are confident they would do a great job. So I don't believe it would be wise of us to avoid buying a great company at a great price because it could go down at some point in the future (perhaps more than 10 years).

In fact, Mr. Buffett once said : “The day I die, buy the stock of Berkshire Hathaway !”

Q: With the crash of the US residential real estate market, shouldn’t we avoid a carpet company like Mohawk Industries ?

A: It is true that the residential real estate market in the US has its worst correction since the 1930’s. It has indeed affected Mohawk since 15% of its revenues came from that sector. I still believe that Mohawk is a great company managed by a great man in Jeff Lorberbaum.   He made a brilliant acquisition a few years back when he purchased the Belgium company Unilin (a leader in laminate floors). This division is doing well this year and helps Mohawk to keep a reasonable level of profitability.

Mohawk stock looks cheap at $60 if we take into account they earned $7 per share in 2007. In the next few years, I do believe Mohawk can earn $10 a share. With a modest P/E of 12-14x, this would mean that the stock could double in a five years time horizon or so.

Since housing prices have come down by 15% in the US, the worst could be behind us. The real danger does not lies within industries that has come down a lot and that everyone avoids. It lies in market that have done well for a while and in which investors are happy and almost numbed by years of good returns.

If we look at the next chart, we could conclude that it is perhaps in Canada’s residential real estate market that the real danger lies. The average house sells for $575 000 in Vancouver and $450 000 in Calgary. These are areas I would avoid.

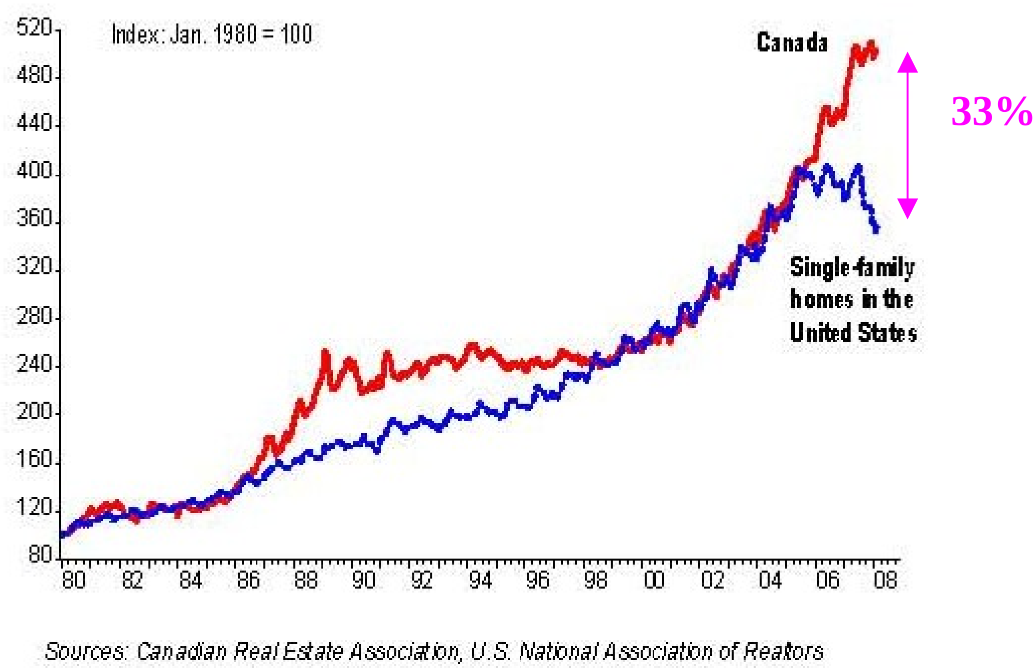


Figure 2: Housing price in Canada compared to the USA (Source : FBN)

Q : What are you predictions of returns for our portfolios?

R : We don’t make short term predictions on our portfolios returns. We do have objectives which are stated in line with our philosophy of focusing on intrinsic value performance of our companies.

We have stated that we want to earn returns in the 12-14% range over the long run. We will attain these objectives (as we have since 1993) by owning companies that yields these intrinsic returns. If we look at the period of 2003 to 2007 (5 years), we did not attain our objectives. We explain this by a rare phenomenon the combined a general P/E contraction of our stocks and a huge loss on currencies. If we look at these figures (annual returns), we can understand what happened.

Earnings increase of our companies +18%

- 5,5% P/E contraction from 19x to 15x

- 9,5% Increase of the Canadian Dollar

Total annual return +3%

So let's apply this analysis forward to try to estimate what the years from 2008 to 2013 could yield in terms of annual return:

Earnings increase of our companies +10-14%

P/E increase from 15x to 19x +4%

Canadian dollar within $0.95 and $0.82 +1-5%

Total annual return +15-23%

So we believe our stocks have the potential to realize excellent returns over the next 5 years. Even without any "bonus" from a lower Canadian dollar, we believe our stocks can yield returns in the 14-18% range.

The sad thing is many investors want to sell their stocks after a few years of decrease although it is precisely when their return potential is much higher. The simple extrapolation of the latest years returns in the future becomes the worst enemy of those that forget that a stock is a part of a company and the key is to focus on its intrinsic value .

Q: Is this "bear market" similar to the others or are we in a new economic era that will be different than those of the past?

John Templeton once said that the most dangerous words in finance are "This time is different". I believe that economic highs and lows are parts of the capitalist system. They are unpredictable and surprises most businessmen. Moreover, the manic-depressive character of the stock market amplifies those cycles. So the key to earn good returns is not to fall into the mental sickness of the stock market (and its syndrome is quite contagious).

I have a scientific background so I'd like to take an analogy from the world of mechanical physic to help our partners understand the important concept of return potential of stock when they are depressed.

When the market has gone up a lot, is has lots a kinetic energy ("momentum" to use a more familiar word). At the kinetic energy peak, the potential energy is at its lowest level. When the market has gone down a lot, its kinetic energy is almost nil and the potential energy reaches a peak. Stocks in general have lots of appreciation potential at that moment.

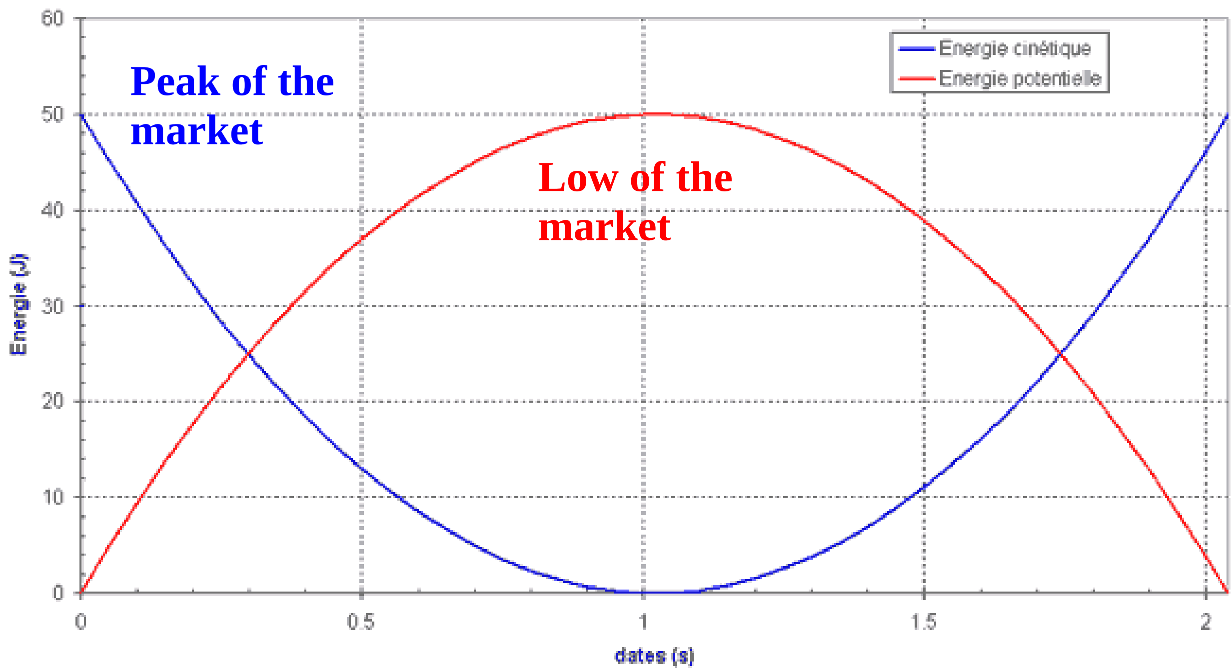


Figure 3: Kinetic energy (in blue) compared to potential energy (in red).

These market highs and lows – highly unpredictable – follow an important long term trend <u>up</u> that is in line with companies' profit increases (6-7% a year) and the dividend they return to investors (2-3% a year).

This is why that, in the long run, stocks have yielded total returns of 10% a year to their stockholders (at least those that kept them long enough).

Q: Will you invest in companies linked to the infrastructure reconstruction?

A: We do share your enthusiasm toward that trend. Our first investment in that line of thought has been Martin Marietta Materials, a company leader in the aggregate industry. We believe that it is the company with the best competitive advantage even though companies like Vulcan Materials, Cemex (in Mexico) or CRH (in Ireland) are also good companies.

We also admire some of our engineer firms like SNC Lavalin, Genivar or Stantec. We would transform that admiration into investments when we also believe that the stock price is attractive.

Q : Do you find opportunities in Canada these days?

A: The Canadian market return in 2008 has been quite misleading if we measure it by the S&P/TSX index. Its –5% return masks the huge bear market that has affected a large number of Canadian securities. On one hand, resources based stock (40% of the TSX Index) have continue to do well yielding returns in the 20% area. But the other 60% is a complete different story. On average, they are down something like 25%.

Here is a table of a dozen well know Canadian companies and their stock returns in 2008:

Companies	2008
Alimentation Couche-Tard	-41,1%
Astral Media Inc.	-34,4%
Bank of Montreal	-16,7%
Canadian Tire Corp	-28,6%
Gildan	-38,3%
Jean Coutu Group	-29,7%
Power Corp of Canada	-25,1%
Quebecor Inc.	-31,8%
RONA Inc.	-34,4%
Sun Life	-26,1%
Tim Hortons Inc.	-25,4%
Transat	-43,8%
Yellow Pages	-33,1%
Average	-31,4%

Source : Factset Research

In the 2004-2007 period, we found few opportunities in Canada. This situation has changed considerably in the last few months. So we are looking in depth…

Q: Now that you have gone many times to Omaha at "Woodstock of the capitalists" (the Berkshire Hathaway annual meeting), would you say you are going for:

a) the social ?
b) business ?
c) listen again and again to Mr. Buffett and Mr. Munger ?
d) to beat Bill Gates at bridge ?
e) none of the above ?

A : I kept this amusing question for the end of the report. I believe that the key to succeed in any activity is to passionately love that activity. So our best weekend of the year – to Nicolas, Jean-Philippe and I – is the Berkshire annual meeting in Omaha !

I would answer to your question **f) all of the above.** First, to go the Berkshire meeting is very instructive for us. Not only are Mr. Buffett and Mr. Munger the best investors of all time, they are also share their great wisdom. It is an important for us to return to the basis of our investment philosophy especially in a period where it is out of favor in the markets. So I could answer c).

It's been 10 years since my first Berkshire meeting, so I've been able to meet lots of people over the years. These contacts have become friends in many instances. We now organize dinners with friends from all over the globe that gather in Omaha. Exchanging ideas with them is very constructive. And they are not without advantages for Giverny Capital's partners. For example, a friend from Genève (Switzerland) told me about a great Swiss company that I would never have heard about without him. So I would answer a) and b).

Finally, as for d), we had a lot of questions from our partners as to if Nicolas and I beat Bill Gates at bridge last May. Well, the answer is: we did not count points. But we had lots of fun and so did M. Gates so we'll sure try to relive the experience in 2009 !

I wish all of you a great quarter !

François Rochon

François Rochon and Giverny Capital's team.