Quarterly report – Q1 2007 ©

Our businesses

Although our stocks went sideways during the quarter, the underlying businesses continue to generate good growth in intrinsic value. In spite of the slowing growth rate in the Western World (North America and Europe), our companies should increase their value by about 11% this year, not far from our long term average of 15%.

Some news on our companies:

- Sales of Vista, the latest operating system produced by Microsoft are going very well (even better than those of XP on comparable basis). In the latest quarter, sales went up 32% and earnings 69%.
- **Walgreen's** released another great quarter with earnings up 25%, for a second consecutive quarter.
- **O'Reilly Automotive** had a good quarter : revenus we're up 14% (+7% in same store sales) and EPS we're up 20%.
- In spite of the new housing slowdown, **Mohawk Industries** had a good quarter: earnings up 8%. The company increased its guidance for 2007.
- **Resmed** increased its sales by 13% in Q1. Since sales we're up 50% last year, comparables we're quite tough. The company also announced a recall of one of its product: 7 out of 300 000 had a power supply problem (0.002%). The company decided to replace all of them and took a $60 million charge. Since they have $240 million in cash, they can afford it. And we believe it is obviously the best course of action. But Wall-Street did not like this news and sent the stock 10% lower.
- **Disney** had a very solid Q1 2007 : EPS up 43%.
- **Berkshire Hathaway** increased its intrinsic value by 18% in 2006. As usual, we're headed for Omaha in May for the annual meeting. We will send you our usual report on the meeting.

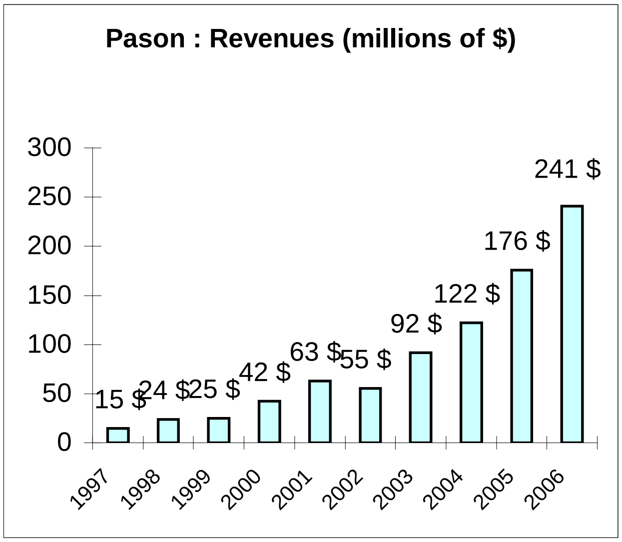
Johnson & Johnson

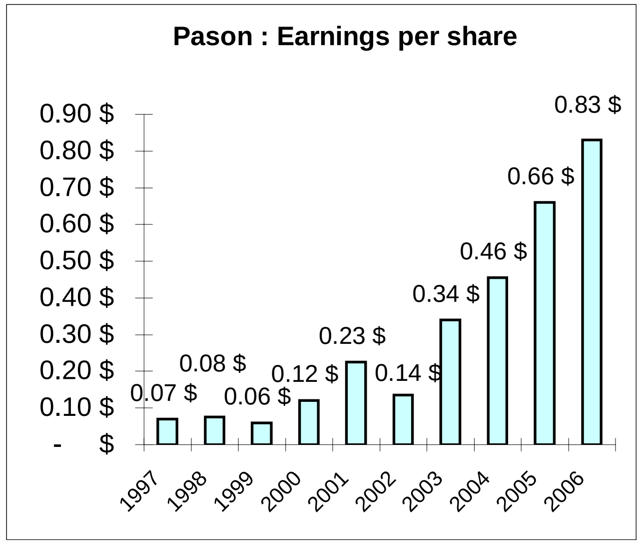
We've been following J&J since 1993. We had purchased shares in 2002 when it went to less than $45 during the summer (when there was a SEC inquiry in a Puerto Rico factory). But we sold them in 2006 when the company announced its intention of buying the company Guidant. We did not approve of that purchase. So our philosophy in such an instance is to sell. In turned out that Boston Scientific made a higher bid and won the "Guidant auction". It was a short lived victory because this acquisition has hurt BS a lot so far : EPS are down 60% and the stock has gone from $24 to $15.

A few months ago, J&J announced the acquisition of Pfizer's consumer products division. It is, in our humble opinion, a much better transaction. So we decided to repurchase the stock (at about the same price we had sold it).

Pason Systems

Since 2004, we are shareholders of this outstanding Calgary based company. Pason is specialized in oil fields electronic measurement systems. In Canada, it owns 90% of the market and in the US, in just a few years, market share have reached 50% at the end of last year. With net margins in the 25% area, Pason is one of the most profitable company in Canada. And we admire its CEO, Jim Hill.





The stock has done quite well since our purchase. But lately, it went down 20%. Growth should be a little slower in 2007. But we believe this is a short term event and we're very optimistic toward its future of selling its products all over the World.

Insider purchases

We have noticed a lot of insider purchases lately in our companies' stocks: Brown & Brown, Johnson & Johnson, O'Reilly Automotive et Wal-Mart. American Express was purchased by 8 insiders (we don't see that often!).

Also, a large investment house of New York (which we know well and admire greatly) has acquired 16% of Knight Transport's shares. Moreover, a portfolio management firm located in Austin (Texas), leaded by the legendary investor Arnold Van den Berg, just acquired 20% of W.P. Stewart. We're in good company being partners with such insiders.

A strange fad in Wall-Street

One question that partners asked me hundreds of time when they met me in the office is this one: "*You have such a simple approach. To buy great companies. To have a long term view. Not to embark in fads. Why isn't everyone doing the same thing?*"

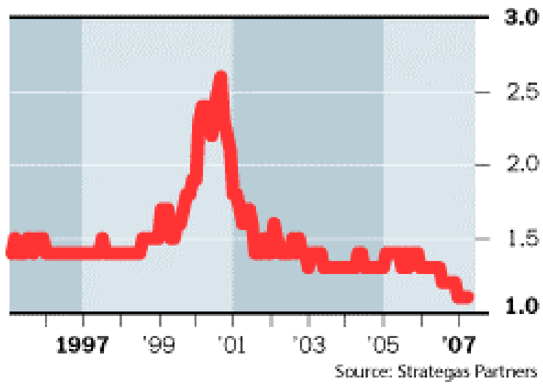
I always had the same answer: "*When you have good results, everyone embraces your philosophy. But when short term results are disappointing and that a certain area of the market is doing very well, it becomes very difficult for investors to keep their eye on the long term. It is never easy to be a contrarian and not to follow the crowd, particularly when it lasts for a few years*".

In 1998-99, we had two difficult years. American blue chip and big-cap technology stocks we're in fashion. Would you believe that GE traded at 45 times earnings, Microsoft at 60 times and Pfizer at 50 times? All those stocks – considered without risk at that time – are still trading lower than they were 10 years ago. In 1999, the tech bubble was rocking Wall Street. Companies without revenue we're trading at $1 billion in market cap and stocks like Yahoo! and Cisco we're trading at more than 100 times earnings. Seven years later, those two stocks are at a quarter of their 2000 peak.

Today, Wall Street has totally reversed its glasses : US blue chips and technology stocks are out of favor. And the 1998-99 favorites have been replaced by natural resources stocks (ironically, these are the same stocks that we're labeled "old economy" in 1999). And once again, many believe that we've missed the train of a "new era". As Yogi Berra once said: "It's *deja vu* all over again".

With the strength of cyclical stocks, we can observe a strange fad in the markets: good quality companies are trading at a discount to the "less quality" companies. There was a very interesting Les Affaires article published in March written by Bernard Mooney (included with this report). Mr. Mooney noticed that the best companies of the S&P 500 (classified as A+) we trading at a lower P/E than those of worst quality (classified C).

Two weeks later in the American weekly newspaper Barron's, we could read a similar analysis. They included this graph that shows the relative P/E of "growth" stocks compared with "value" stocks:



Historically, "growth" stocks are trading at a 50% P/E premium to the "value" stocks (in the large sense of the words). During the tech bubble, this premium reached 150%. Today, for the first time in many many years, there are no premium for quality.

Since we focus our capital investments in high quality growth companies, we are punished by this strange fad. Quality companies are cheap these days. That's probably why Warren Buffett has made lots of stock purchases lately for Berskhire Hathaway portfolios. Mr. Buffett has not been that active in the market since the beginning of the 1990s.

Expanding our horizons

As I indicated in our annual report to you, dear partners, we take our 2006 disappointing results seriously. We follow the fundamental of our companies closely and we are looking more than ever for new candidates for our portfolio. Certainly, we won't bend our selection process for the sake of embarking in today's fad. But we do want to expand our horizons to find opportunities all over the economic World.

We have always looked at foreign markets. In 1998, we invested in Hong-Kong during the Asian Crisis (those that invest with euphoria in China seems to have a short memory of the risks involved in paying high P/Es for stocks). In 2004, we acquired shares of an Australian company: Resmed. We still own it today.

In France, for example, we do find companies that would fit our approach : Groupe Danone, PPR SA, Sanofi-Aventis or L'Oréal. In UK, companies like Tesco, Diageo or WPP would also probably fit. There are great companies in Denmark (Novo-Nordisk), in Italy (Luxoticca) and in Finland (Nokia).

But valuations in Europe are not low these days. We're not ready to pay a premium just for geographical diversification purposes.

For example: the American company Wal-Mart trades at 15 times earnings compared with 19 times for the British company Tesco PLC. Both companies have the same growth rate and are dominant in different parts of the World. It seems to me that Wal-Mart has better prospects in the top two growing markets: China and India.   So we do not believe that Wal-Mart P/E discount is warranted. But Tesco is a also a great company and – at a price – could be a candidate for our portfolios.

In Canada, cheap stocks are scarce. As you know, around 80% of the TSX index is in resources stocks and financials (and we believe that banks in general are trading at a too high level). But we're starting to find opportunities in the now out-of-favor income trusts universe. We could make a purchase in the months to come.

Conclusion

Our companies are leaders in their market, many on a Worldwide basis. They continue to grow their intrinsic value at a superior rate. Moreover, their market valuation are quite attractive these days.

Over the years, "new era" fads always pass. And good companies prevail. So we have every reason to be optimistic toward the future of our investments.

As always, dear partners, we thank you for your trust.

François Rochon

François Rochon and all Giverny Capital's team