Giverny Capital Inc.

Quarterly report – Second quarter 2007 ©

Comments

For the last 18 months, our « good temperament » towards market quotations has been tested as our market performance does not reflect the intrinsic performance of our companies. Since the start of 2006, our stocks have increased their value by about 20% (14% in 2006 and around 6% in 2007 after two quarters) but our stocks have increased by only 5% in the stock market. Moreover, the increase of the Canadian Dollar has reduced these already low returns. During the period, the indexes have done pretty well mostly fuelled by the basic materials sectors and private equity deals (like the one with BCE).

It is not always easy, but we have to keep the eye on the ball : What matters is that the majority of our businesses are yielding record profits and they are worth much more today than a year ago. Our owner's earnings (see the definition in our annual report) should be up by about 11% in 2007.

Rarely since 1993, have our stocks been so undervalued. So we are very optimistic.

We continue to be proactive. We look for new companies all over the World. We have purchased a few new stocks during the quarter (Morningstar and Nitori, a Japanese based company).

Your questions

We pursue our tradition of publishing a Q/A in the second quarter report, which is usually 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 our 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 : Our stocks have not done as well as the index lately. Why is that?

The legendary investor John Templeton once said: "The first ingredient to do better than the others is to do something DIFFERENT from the others". So our approach is to focus our capital in twenty or so outstanding businesses, which is a small number compared to the index or our competitors (the average mutual fund owns sometimes more than100 names). So we will always have different returns than the index over a short period of time.

Lately, quality stocks are unpopular. What is in fashion are cyclical stocks and low-quality companies (because they can be targets of private equity funds).

Around 40% of our portfolio is in high-quality "blue chips" that are quite out of favor. Here is a table that explains most of our underperformance in 2006:

Company	Market Performance 2007	EPS Growth 2007/2006	Value vs Market	EPS Growth 2006/2001	% of portfolio
Berkshire Hathaway B	-1%	19%	-18%	15%	8%
Walgreen	-2%	17%	-18%	17%	6%
Disney	1%	15%	-15%	13%	5%
Microsoft	3%	16%	-16%	9%	5%
Johnson & Johnson	-7%	9%	-13%	15%	4%
American Express	1%	16%	-12%	18%	4%
Wells-Fargo	-5%	11%	-11%	16%	4%
Wal-Mart	4%	10%	-4%	13%	3%
Procter & Gamble	-2%	14%	-16%	12%	2%
Median	**-1%**	**14%**	**-15%**	**14%**	**40%**
S&P 500	**8%**	**7%**	**1%**	**14%**	

As you can see, these nine blue chips – probably nine of the best companies in the World – should increase their intrinsic value by around 14% in 2007, a similar increase than the one of the last five years. But their stocks have –1% in the market this year. They were cheap at the beginning of the year, they are cheaper today.

During the period, the S&P 500 did a little better than its intrinsic growth. Compared to the index, these nine stocks had a -9% difference which created a relative performance of -4% for our portfolio, even though, these are clearly superior businesses.

Q : With the population aging rapidly, the pharmacy sector should do well in the future. Why is the stock of Walgreen's not moving up?

Walgreen's poor performance lately is a good example of the unpopularity of quality stocks these days (and since it is a big weight in the portfolio it brought down our performance). Walgreen's is an outstanding company that has maintained a 16% growth rate in the last 10 years. There are some uncertainties with the Caremarx acquisition by CVS but so far, quarterly results have been as expected.

We first bought shares of Walgreen's in January 2003 at around $29. Since then, earnings per share have increased by 88% (17% annually), which is a fabulous performance.

2003	2004	2005	2006	2007 E
$1.21	$1.44	$1.65	$1.93	$2.27

Table 1 : Walgreen's EPS since 2003

The stock has climbed to $45 lately so it's up 55% since 2003 (12% annually), so the stock has done 33% less than the underlying business performance.

What added to that underperformance was the increase of the Canadian dollar from $0.63 to $0.95 during that period. So the 55% gain in US dollars was reduced to 3% in Canadian dollars. Therefore, a 88% increase in underlying value was just "translated" in a 3% gain for us, a very disappointing result.

If Walgreen's continues to increase its intrinsic value by 17%, the stock will eventually reflect it. If in the next four or five years, EPS increase another 88%, the stock should do quite well. If the P/E goes to 25 times (its historical ratio), it would climb by 137%. In addition to this, the Canadian dollar will not always disrupt our returns.

In summary, we are still very optimistic about that investment.

Q: Our stocks are not popular. I'm worried that if the market goes down, our stocks will continue to lag. Should we keep more cash on hand?

We are not in the prediction business. We are in the investment business: we own shares of great companies. In market corrections, usually, what goes down the most is what reached overvalued levels at the peak. If we look at the last big correction, in 2000-02, what went down was the technology stocks. In 1999, all the capital went into those stocks and investors that did not own these popular names underperformed by a huge margin. But when the tech stocks went down, those that remained disciplined and true to value were rewarded. During that period, we overperformed the S&P 500 by 58% in three years.

What is overvalued these days, in my opinion, are the cyclical and lower quality stocks. Our companies are not overvalued and should be much less affected by a return to realistic levels.

We can't control or predict markets. But I believe by owning great companies for many years, bought at a cheap level, we should do well over the long run, regardless what the market does.

Q : We bought shares of Berkshire Hathaway a few years ago. It has not done very well. What is wrong with Warren Buffett ?

There is nothing wrong with Warren Buffett nor with Berkshire Hathaway. Last year, the company had a very strong year and 2007 is shaping up quite well so far.

As you can see on the chart, the stock has followed a 12% normalized increase in its intrinsic value in the last years. I believe that the value of the stock is something like $5000 today so it's quite undervalued at its $3600 actual level.

Berkshire Hathaway is one of the best companies in the World but like other quality companies it is out of favor in the stock market. Warren Buffett is investing a lot these days, purchasing many billions in new stock investments. Like us, he must see a lot of value out there! As for the succession plan, we are very confident that in 10 or 15 years, Berskhire will still be in good management hands. So there is no reason to worry about that investment.

We are taking the opportunity to continue to purchase shares of Berkshire.

Q : Why are we still holding on to W.P. Stewart ?

W.P. Stewart (WPS) is a very good money management firm. They have the same problem as we do: quality stocks that they invest in are out of favor. So the firm loses assets. I believe that its stock holdings are solid and they should do well in the long run. Here is the portfolio:

DISNEY WALT CO	**7.9%**
PEPSICO INC	**7.7%**
AMERICAN EXPRESS CO	**7.7%**
TARGET CORP	**7.6%**
PROCTER & GAMBLE CO	**7.6%**
WALGREEN CO	**7.5%**
QUALCOMM INC	**6.6%**
KELLOGG CO	**6.3%**
SCHWAB CHARLES CORP NEW	**6.0%**
GENERAL ELECTRIC CO	**5.9%**

These are all great companies that should do better than the S&P 500 over many years. So if they do, assets will go back up and profits should be up accordingly.

I know that it is frustrating to see the stock down 40% from our cost. But the company has a solid balance sheet. The managers own 50% of outstanding shares. A great fund manager just acquired 25% of the stock and the client's holdings are great investments.

Our opinion at Giverny Capital is that we should continue to be patient.

Q: We always hear about a troubled US economy, huge trade and fiscal deficits and consumers in trouble. What do you think about the situation?

We follow the teachings of the great money masters – Warren Buffett, Peter Lynch, Philip Fisher – who don't make macro-economic calls. Their approach (and ours) is to own great companies, purchased at reasonable prices and own them for many years.

I can give my you my thoughts on the US economy even if our investment approach is not top-down based. The USA is the strongest economy in the World by a huge margin. Almost half the wealth in the World is US based even though they make up only 5% of the population. The total net worth – after subtracting all debts – is \$60 trillions (that's \$60 000 billions). Of that amount around \$5 trillions is in cash equivalent, enough to buy all Canadian public companies four times.

The US government runs a fiscal deficit but we must not forget that they lowered income taxes by 20% in 2000, and that the sales taxes are much lower than in Canada. Their deficit has been reduced by 75% since 2004: it went from 4% of GDP to 1% lately. But the media doesn't talk about that….

The trade deficit is huge (although it went down lately). A yearly trade deficit of \$700 to \$800 billions is a big number. But it has to be measured not only against yearly GDP but also to the net worth.

Let's say that the \$60 trillions in net worth goes up 5% per year (the average has been closer to 6% in the last 50 years), this means that net worth goes up \$3 trillions per year, which is around four times the level of the trade deficit. So there is an increase of \$2.2 trillions per year in net increase – after the trade gap – in total wealth. Which is not that bad. We are far from insolvency.

As for our portfolio, we don't consider that it is pegged to the US economy. Many of our businesses have revenues all over the World (like Johnson & Johnson and American Express). Also, we own Canadian stocks, Australian stocks, etc. So our portfolio should be viewed as a collection of outstanding businesses that generate revenues from many parts of the planet, not just from the US.

Q : What is this new company you bought : Nitori Sapporo?

As we indicated in our last quarterly report, we are expanding our horizon beyond North America more than ever. We have looked at Asian companies for the last 10 years. In 1998, we invested in Hong Kong. In 2004, we invested in Resmed, an Australian company.

Nitori is our first investment in Japan. It is a retailer that sells furniture and home goods (a little like a mixture of IKEA and Bed Bath & Beyond). The company has done very well in a tough environment for Japanese retailers. It has grown 20% per year and their perspectives are still very good. We also like the fact that the founder, Mr. Akio Nitori, owns 12% of shares.

Q: Will you continue to invest internationally? What about China?

We have found lots of interesting companies these last few months in International markets, in South-Korea, in Italy, in Austria, in the UK and even in Slovakia. But, the information is not as complete as for US or Canadian companies so we have to be very careful.

One country that we like is India: there are lots of outstanding companies. What refrains us are valuations. We have found a few great businesses that we like and understand but we wait for lower P/Es before investing some of our money.

In China, it is similar: great growth but high valuations. The political side of the equation frightens us a little (the communist government can intervene often in the operations of businesses). There is lots of speculation in the Chinese stock market these days, so we're very cautious.

Studying international companies is a long process because we want to have lots of information before investing our precious capital. Prudence and our partner's capital preservation are still are main preoccupations.

Thank you for your trust and have a great quarter.

François Rochon

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