Giverny Capital Inc.

Quarterly report – 3rd quarter 2007 (all rights reserved)

Our investment philosophy

As you know, our approach has never been macroeconomic based. Quoting Warren Buffett, the legendary investor who inspired our investment philosophy, the activity of investing is to acquire companies (in its entirety or partly through stocks of public companies). Mr. Buffett adds that he has never attempted to predict the economy, markets fluctuations, interest rates, recessions, etc. He wants to own companies with superior economic fundamentals for the very long run. Also, he prefers to buy them when they unpopular, therefore, undervalued.

Like him, we always avoided market fads and short term speculations. We have concentrated our energies on analysing businesses and their intrinsic value.

Mr. Buffett insists that a superior company necessarily has a competitive advantage that he compares to a moat protecting an economic castle. We find them in companies with solid trademarks (for example, Procter & Gamble and Disney), offering specialized services (Morningstar), working in market niches (Fastenal), with significant scale advantages (Walgreen's) or with exclusive and dominating technologies (Pason Systems and Microsoft).

In an environment characterized by an economic slowdown that touches many sectors of the North-American economy, our companies continue, in their whole, to increase their profits and their intrinsic value. This intrinsic growth should be around 10% this year. But lately the stock market severely punishes the slightest difference between results and forecasts (often optimistic) of analysts. A company can miss by $0.01 the EPS projection and see its stock decline by 5% and even 10% in only one trading session.

We have been investing since 1993: we know that economic slowdowns and market clouds are temporary. We went through the Asian crisis in (1997-1998) and the big bear market of 2000-2002. It is not always easy, but we remain disciplined, emotionless and we always keep our eyes on the ball of the fundamentals of our companies.

Our Canadian companies

We did very well from 1993-2003 with Canadian companies such as Bombardier, Uni-Select, Manulife, BMTC Group Inc. and Liquidation World. The main reason is that we were able to buy them at very low price-earnings ratios (8 to 12 times). In 1995, for example, we bought BMTC at 8 times earnings when the company had a growth rate of approximately 25% per year. The stock afterwards increased by 2000%. Unfortunately, after its increase of the recent years, the Canadian stock market offers less opportunities of this kind lately.

But this is not stopping us in our search for great investments. Our acquisitions of Calgary based Pason Systems and Mullen Group in 2004 allowed us to own companies selling specialized equipments and services to energy companies (therefore we are indirectly taking advantage of the growth of drilling activities in the West). If oil prices continue to climb, natural gas is far from the peak it was at the end of 2005. Services related to natural gas are an important part of the profits of those companies. Therefore, this year, Mullen and Pason do not have the growth rate they had in 2004 and 2005. They remain however, excellent companies with good perspectives on the long run. Also, Pason has excellent results with its American division even including the US currency loss.

Four years ago, we discovered a very interesting small enterprise in Quebec: MTY Foods. Back then, the company was on the verge of divesting its computer division and concentrate on its chains of restaurants for shopping centers. Since then, MTY made many acquisitions to solidify that division. Today, the perspectives still look very good and we decided to buy shares. The president, Stanley Ma, owns 25% of the actions and is – in my opinion – an excellent businessman. The stock is not easy to buy (the company is still small) nevertheless, we were able to slowly take a participation lately.

Finally, we considered many income trust stocks, a sector which went down following the government announcement to eliminate their fiscal advantages. Even when using a normalized income tax rate, certain stocks appear to be highly undervalued at their actual levels.

But in general, valuations of Canadian stocks are historically high. More than ever, we have to be very selective in our choices.

The Canadian dollar

It is very difficult not to talk about the Canadian dollar. Since approximately 85% to 90% of our companies are located outside Canada (Canada represents only 3% of the world economy) we are unfortunately affected by this parameter.

Being generally agnostic about currency levels, we never wanted to be « short » the Canadian dollar, but we are severely punished all the same.

We always believed that nobody can predict the movements of the financial markets on the short term. Economy strategists are masters in the art of following trends. They use a language that seems scientific, but in reality their «analysis» means that *what has moved up recently will continue to move up* or *what went down recently will continue to drop*. If it was that easy to get rich, all the strategists “who know the future” would be in the Bahamas filthy rich instead of having a job.

In spite of our agnosticism, we have listened to the concerns of our partners regarding the Canadian currency and, last year, we tried to respond to those concerns. We read a lot on the subject of PPP (Purchasing Power Parity) and the analysis of the OECD, the international economic organization.

The OECD evaluates the PPP of the Canadian dollar at approximately 81¢ in American currency. This estimated intrinsic value has been quite stable for several years. On the other hand, speculators can bring the quoted markets at surprising levels on a short period. At the beginning of 2002, the currency dropped under 62¢. Just a few years later, the currency is at $1.05. As much as it was undervalued by 23% at the beginning of 2002, it is 30% overvalued at the actual level. Such disparity may seem incredible but it is what a cold and emotionless analysis from an objective international organization indicates.

It is very important to remember that as long as foreign assets are not converted in Canadian dollars, exchange rate losses are not realized. Patience is imperative about this uncontrollable parameter.

Warren Buffett and gold

Gold is near new records nowadays. Except for when we acquired shares of Franco-Nevada ten years ago - I greatly admired Pierre Lassonde - we never owned shares of a gold company.

Gold is a commodity “worst” than the others. At least, we are using wheat, oil and copper for practical activities (to eat for example!). The majority of gold serves as a speculation tool and the minority for jewels (but a minority that is not without its importance my girlfriend reminds me frequently).

Once more, Warren Buffett offers a wise response concerning investment in gold. He gave the following reply at his annual meeting a few years ago: « *If Martians were to observe the activity of human beings for many many years, they would not understand one of their activity: They are digging something yellow out from the ground, process them and put them in the vaults and never touch them again*».

Asian markets

A few quarters ago, we decided to invest more in international markets. As indicated in our recent correspondence, we decided to invest in a Japanese company, the Nitori chain, and we are looking at many others that are potentially interesting in that country. The situation in Japan is the opposite of the one existing two decades ago. Back then, the companies had weak balance sheets and were making low returns on capital. And the stock market valuations were more than excessive (sometimes even 100 times earnings). Today, the companies we are looking at have nice balance sheets, earn good profits (Nitori achieves ROE of 17%) and their market valuations are very reasonable.

Last spring, we looked at several Chinese and Hong-Kong stocks. In 1998, we invested in Hong-Kong when the Hang Seng index was down 50%. It is not the situation today since the Hang Seng increased more than 60% in the last year and the Shanghai stock exchange (China) jumped 100% since January only.

The P/E ratio of the Chinese index is presently at 46 times.

Our capital – yours and mine – is precious and we must always be careful with market valuations. In China, the margin of safety seems very thin at these levels.

Europe

In Europe, we also find very interesting companies but – these past few years – the market valuations of the ones corresponding to our criteria are often very high. For example, when studying the medical and pharmaceutical sector, we found some exceptional companies in Switzerland. We are waiting for more interesting prices but we could be very active in that area in the near future.

« Value Investing » and John Templeton

Our approach to invest in companies and not in casino coins (95% of people consider stocks this way) has a name: Value Investing. First and foremost, we want to acquire outstanding companies. But we require a margin of safety: We want to acquire our stocks well below the intrinsic value. Undervaluation is only possible in time of pessimism. And the greater the pessimism, greater are the chances to find undervalued stocks.

The irony of it is that human nature is not naturally "wired" that way. He is not attracted by something unpopular and surrounded by moroseness! On the contrary, he has the animal instinct to escape what makes him suffer.

The legendary value investor John Templeton was an important mentor for our firm. As Warren Buffett, he recommends investing in what is surrounded by pessimism.

« *To do better than the others, you have to do something <u>different</u> than the others. There is only one reason why a stock becomes undervalued: it's because people are selling it. Therefore, buy what people are selling!* » Sir John Templeton reminds us.

The stock market is more and more global. When a market exchange does well on the planet, capitals that flows to it must necessarily come from somewhere else. This is why certain markets then become undervalued. Highs and lows of the different stock markets are not as correlated as before. On the contrary, certain stock markets appear to be "inversely correlated".

What is very popular these days are all the sectors related to natural resources as well as emergent markets, like China. What appears to be quite undervalued to us are several American (mostly of big capitalization) and Japanese stocks.

In spite of those words of wisdom, it is very difficult to go against the crowd. We take the chance to "under-perform" on the short term (it is our situation since the beginning of 2006). Nevertheless, we believe that it is the price to pay in order to obtain better results in the long term. We paid that price in 1998-99 when investors rushed to buy technology stocks (Nortel and the other high-flyers). And we were rewarded in 2000-2002 during the subsequent collapse of this sector, when « quality » came back in style.

I wish to thank you again for your trust.

I wish you a good quarter.

François Rochon
President
Giverny Capital Inc.