Letter to our partners – 3rd quarter 2009

Comments on Financial Markets

In our first quarterly letter of this year, we wrote that the market had touched a bottom when the S&P 500 fell to 677 on March 9, 2009. At the time, when many predicted nothing less than the end of the capitalist system, we spoke about the "opportunity of a generation". The market has since staged an impressive rally and the economic outlook is beginning to improve. In the third quarter, for example, the US economy grew at an annualized rate of 3.5%, the first growth in over a year. Although governmental stimulus programs generated approximately two thirds of this growth, we nonetheless welcome this news. Exports, bolstered by the weakness of the US dollar, also played an important role in this return to growth. Economic activity in Canada, on the other hand, remains flat (-0.1% in August and 0% in July).

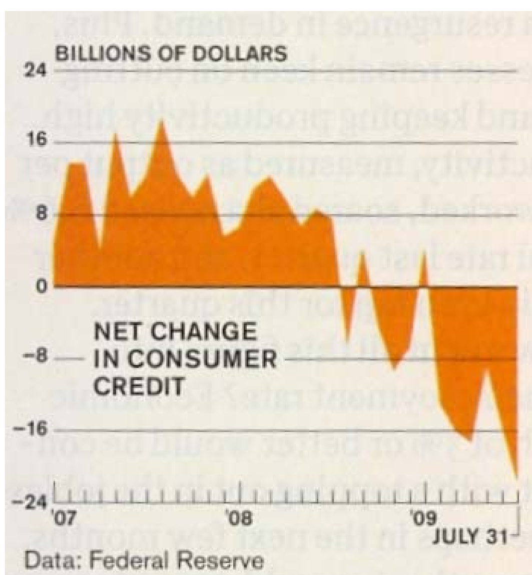
The Trade Deficit in the US and Canada

In the most recent month (August), the American trade deficit stood at $30.7 billion, about half the average level for 2008. While this doesn't yet seem reflected in the currency markets, we consider it excellent news for the US dollar.

At the same time, in Canada, the trade deficit was $2 billion due to a sharp decline in exports relative to imports (the consequences of the strengthening loonie, even if temporary, have not been negligible). Canada will most likely realize a trade deficit in 2009, its first in 34 years.

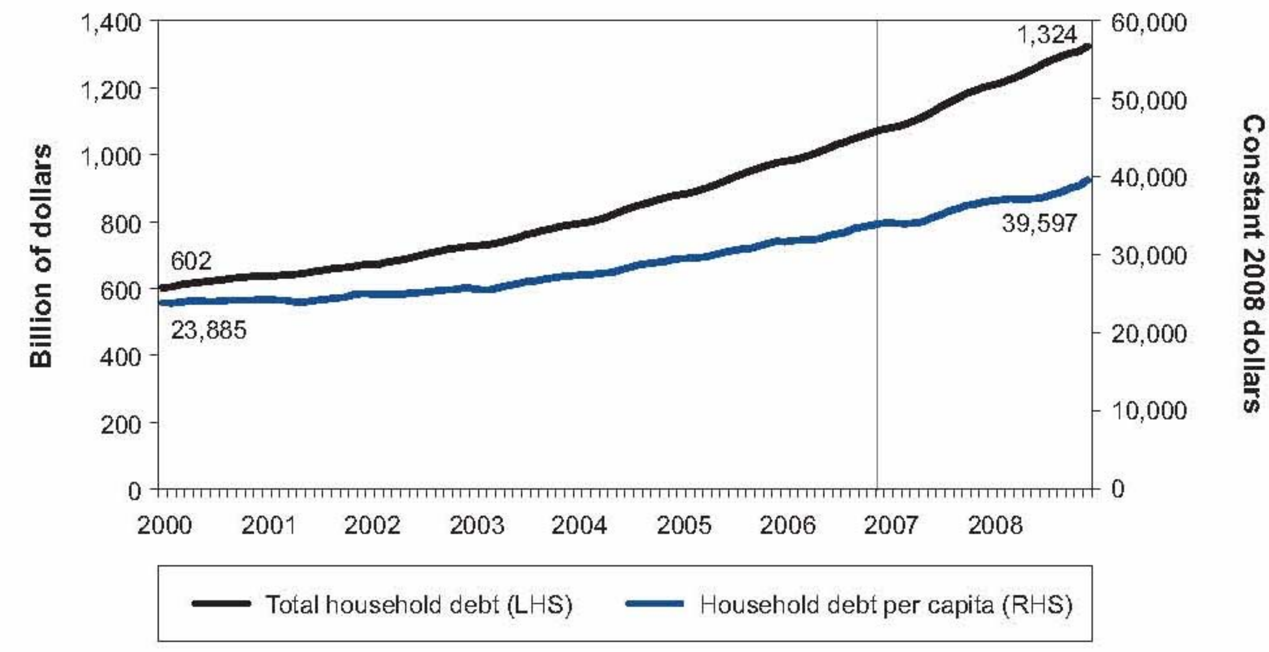
Consumer Debt in the US and Canada

Another piece of good news is that US consumers continue to reduce their debt levels. American households, as depicted in the graph below, began reducing their consumer debt in 2008 and the trend has continued during 2009.



Source : BusinessWeek

It's a very different situation in Canada: households continue to increase their indebtedness. The total household debt in Canada has doubled since 2000 and the debt level per person (in 2008-adjusted dollars) has risen from $23,885 to $39,597, a 66% increase in less than a decade.



Source: CANSIM 176-0032, 051-0005 and 326-0020; CGA-Canada computation

Another incredible milestone was reached in Canada during 2008: consumer credit per dollar of consumption of goods reached $1.06. In 2000, only eight years before, this number was at $0.67.

Golden Bubble?

It seems that gold becomes trendy at least once a generation. The last time that gold was as popular as it is today was in 1980 when it reached more than $800 an ounce. Twenty years later, for those interested in history, the same ounce of gold was trading at $250. It's one of a number of examples from the last decades that demonstrates the dangers of buying what is popular.

Many consider gold an investment. Yet, according to the strict meaning of the word, this is not the case. An investment is an asset that generates a return. At times, this is an present return (as with Treasuries), and at other times, it can be an estimated future return (as with stocks or real estate). Gold does not generate any return. As Warren Buffett said: *"Gold gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it* [Note: Fort Know or the vault of a Swiss bank]. *It has no utility. Anyone watching from Mars would be scratching their head."*

It is true, in times of distress, that gold has the virtue of acting as a universal currency. But if we consider that a century ago gold was trading at $19, its fiftyfold increase to today's price has barely outperformed inflation (just like Treasuries). When we compare this increase to the performance of stocks during the same period (which multiplied by a factor of 11,500), we realize that the only true shield against inflation has been the stock market. During this time, stocks performed 200 times better than gold, inflation or Treasuries.

This, of course, doesn't prevent speculators from pushing up the price of gold in the short term. Some of them believe that gold has become more rare and that production is decreasing. The numbers tell a different story: mining production has increased 7% during the first six months of 2009 and the $40 billion invested in new projects since the low of 2001 are expected to generate 450 incremental annual tons between now and 2014. The rise in the price of gold has also increased the value of scrap gold (old jewelry, teeth, old currencies, etc.), leading to consumers trading in some of their gold while prices are high. There was 900 tons of this type of gold exchanged during the first half of this year.

We actually see an inverse trend if we look to industrial and jeweler demand for gold, with a 20% decrease last year. It seems that the optimists' arguments for gold are more psychological and speculative in nature rather than based on an analysis of the fundamentals.

Negativism Towards the US Dollar

We find the US dollar on the other side of the popularity spectrum. An unrefined but often accurate method of assessing whether an asset is overvalued or undervalued (without necessarily getting into the game of stock market predictions) is to look at the level of optimism and pessimism towards a particular asset. In April of 2008, at the height of the natural resources bubble, the level of optimism towards the US dollar with currency experts was 6% (thus 94% were pessimistic). The Canadian dollar was trading at $1.00 at the time. No more than nine months later, the Canadian dollar tumbled to $0.78. At the same time, the level of optimism towards the US dollar was 93% (yes, the same "experts" had completely changed their minds). Today, after a sharp drop in the US dollar, the level of optimism is at 3% meaning that 97% are pessimistic—a historic record. We believe that the pessimism towards this currency is greatly exaggerated.

Our Companies

At Giverny Capital, as you know, we do not invest in the overall market or according to macroeconomic themes. We own outstanding businesses from around the world. Here is some news on a number of the companies in our portfolio.

- **O'Reilly Automotive** continues to successfully integrate last year's large acquisition of CSK Auto. Revenues climbed 13% during the last quarter while earnings per share (EPS) increased 58%. Overall organic sales rose 5.3%, with organic sales at the newly-integrated CSK Auto also rising—an excellent news. The outlook for the fourth quarter is good.
- The biggest surprise of the quarter came from **CarMax.** The company announced EPS of $0.46 while analysts were expecting $0.18. The financial arm of the company returned to profitability which was welcomed news (since it was our primary source of anxiety). The company continues to take market share in its industry as competitors exit the market. GM, for example, is shuttering a large number of dealerships that indirectly compete against CarMax. We met with the company in Richmond (Virginia) during the quarter and walked away convinced that the worse had passed for this company and that future years will be much better.
- During the third quarter, the Montreal-based company **MTY Food** announced a rise in revenue of 61%, caused primarily by its recent acquisitions of Tutti Frutti, Taco Time, and Country Styles. EPS climbed 27%, from $0.14 to $0.18 per share. The company now has 1534 restaurants under its numerous brands, with 64 opening in 2009—already exceeding its goal of 60 new restaurants for the year. The balance sheet at MTY Food remains debt-free and with $11.2 million in cash.

- **5N Plus**, another Montreal-based company, reported slightly disappointing results, though we consider them positive when we look at the company as a whole. While quarterly revenues rose 14% to $16 million and the order book rose 6% to $57 million, profits declined 25% due to factors unrelated to the company's operations: currency losses and other losses related to an acquisition which didn't materialize. The good news for the quarter is that 5N Plus renewed its agreement with First Solar, its most important customer. Margins will be slightly lower but the incremental volumes anticipated for 2010-2011 should compensate for the margin contraction. General Electric also announced its intent to enter the photovoltaic solar panel market which could materialize into a new source of revenue for 5N.
- Our three American banks announced good quarterly results. **Bank of the Ozarks** earned $0.50 per share, a 6% decrease from last year. The increase in the bank's reserve for bad loans masked an excellent 19% rise in net interest revenue and an exceptional margin level of 4.80%. At **Wells Fargo**, margins were 4.36% and net income rose 14% despite a very large increase in its reserves. The company's balance sheet continues to strengthen and its capital base is well ahead of the objectives set forth by the American government. Also, the bank's management announced that the peak in its bad debt reserves should be reached in early 2010. Finally, **M&T Bank** increased its net interest revenue by 12% and, after its reserves, EPS rose 8% to $0.98. The profitability of M&T Bank, however, is well below its true capacity (the bank's return on assets is only 0.78% which is about half of what we expect in future years).
- M&T Bank continues to benefit from the demise of many of its poorly-managed competitors. Nine branches of Brandford Bank in Baltimore, for example, were seized by the FDIC and reopened under the M&T banner. Our Buffalo-based bank, already well established in Baltimore, was thus able to get a hold of an additional $338 million in deposits.
- The Chinese company, **China Fire and Security Group**, announced excellent results for the second quarter: revenues climbed 37% and net income rose 24%. Gross margins reached a very high level of 64%. The company also upwardly revised its profit expectation for the year.
- **Hanfeng Evergreen**, our other Chinese business, also had a solid quarter: revenues were stable but profits increased 43%. Hanfeng's balance sheet continues to strengthen, with cash rising from $26 million to $92 million during the course of two quarters.
- The US government's infrastructure stimulus plan should soon benefit **Martin Marietta Materials**, one of the leading players in the aggregates industry. For 2009, we expect a drop in profit of around 29%. On the other hand, we expect that about 65% of the road reconstruction program will be spent in 2010.
- **Resmed**, our Australian medical products company focused on the sleep apnea market, announced an excellent quarter. Revenues increased 7% (15% if a constant currency level is assumed) and net income surged 55%. Resmed is doing particularly well in the US, with 20% growth and an increasing market share.
- **Pason Systems** continues to suffer from weak drilling activity in Canada and the US (its major markets) caused by extremely depressed prices for natural gas. Revenues tumbled 59% and profits went to zero. Despite this poor performance, the company remains in good financial health, with no debt and $154 million in cash.
- Revenues at **Knight Transport**, our Arizona-based trucking company, decreased by 4% (before gas surcharges) and net income decreased by 16%. The company has seen a slight improvement in its loadings which is a good sign. It's also worth noting that, in October, Knight was named to the Forbes list of "America's 200 Best Small Companies" for the 15th year in a row.

- **Fastenal** continues to make its way through challenging times: sales in August and September decreased by 21%. Still, the company continues to open new stores despite a difficult economic environment and its immaculate balance sheet remains a huge asset.
- The multinational, **Procter & Gamble**, announced its latest quarterly results: sales decreased 6% while net income increased 3%. The company also recently cut the price point on a number of its products in order to regain market share. Early results seem positive and P&G anticipates a return to growth during this quarter, with organic sales rising between 2% and 5%. This does not consider the effect of a weaker US dollar which should also help results.

We are confident, given the light shed by the financial performance of our companies, that the economic outlook continues to improve. According to our analysis, our holdings as a whole remain significantly undervalued and our estimates for future returns, as presented in our last quarterly letter, remain realistic.

Best wishes to all our partners for a great quarter.

François Rochon

François Rochon and the entire Giverny Capital team