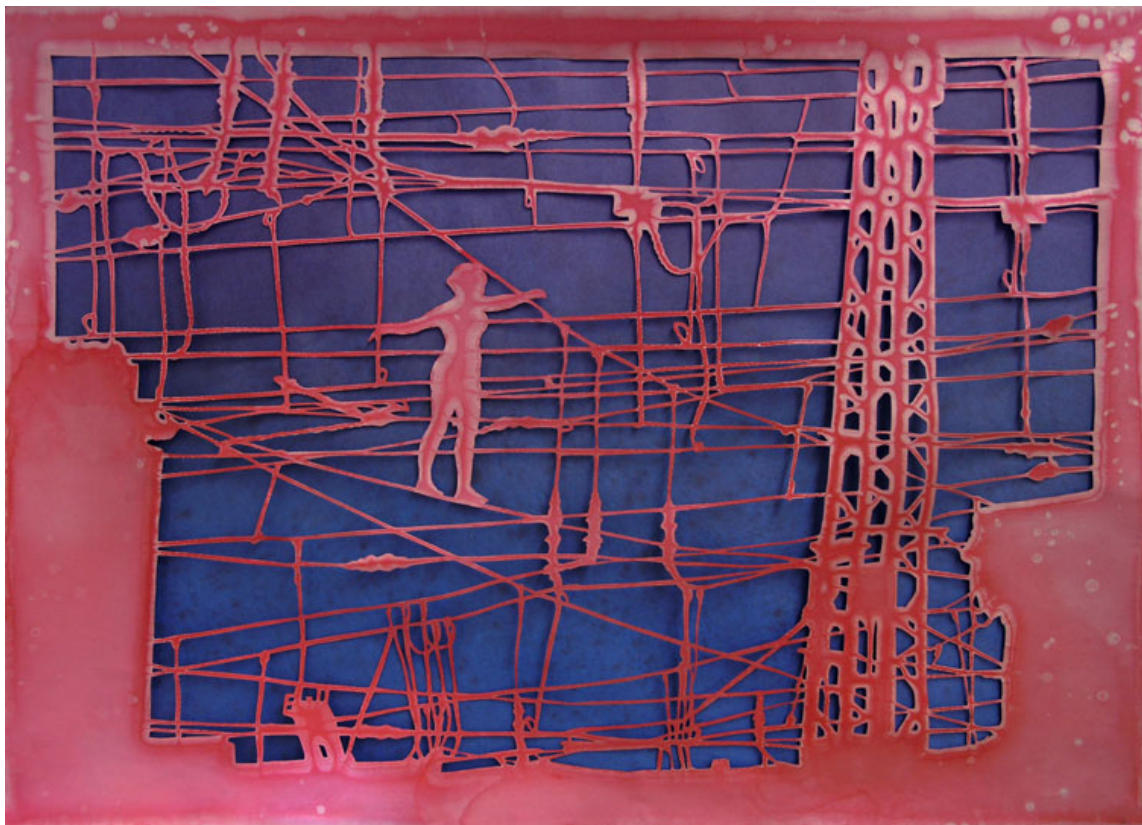


Giverny Capital Inc.

Annual Letter to our Partners
2009



Ed Pien
Girl on a wire, 2009
Giverny Capital Collection

Giverny Capital Inc. – 2009 Annual Letter [©]

For the year ending December 31st 2009, our portfolio's return was 11.8% versus 12.2% for our weighed benchmark. Our annual return, which included a loss of approximately 16% due to fluctuations in the Canadian currency, was therefore 0.4% lower than our benchmark.

Since our inception, on July 1st 1993, our annual compounded rate of return has been 13.8% versus 6.7% for our weighed benchmark, or an annualized outperformance of 7.1% over this period. When we exclude the effect caused by the appreciating Canadian currency since our inception, which represents an annualized increase of 1.2%, our portfolio has returned 15.1% annually versus 7.9% for our benchmark. Our long-term (and ambitious) objective is to maintain an annual return that is 5% higher than our benchmark.

The Artwork on the cover of our Letter

We illustrate the cover of our letter with a copy of an artwork from our corporate collection since 2004. We chose the work of Ed Pien, a Canadian artist of Taiwanese descent, for this year's cover. The piece, titled "Girl on a wire", seemed the perfect representation of 2009 which was an emotion-filled year when investors felt as though they were walking a tightrope across what seemed, at times, like an economic ravine.

The Giverny Portfolio (in Canadian dollars): Returns Since July 1st 1993.

Return *	Giverny	Index **	+ / -	\$ US/Can	S&P 500	+ / -	Giverny ***	Index ***	+ / -
1993 (Q3-Q4)	37.0%	9.5%	27.6%	3.3%	8.4%	28.6%	34.4%	7.4%	27.0%
1994	16.5%	3.7%	12.7%	6.0%	7.3%	9.2%	12.0%	-0.3%	12.3%
1995	41.2%	24.0%	17.2%	-2.7%	32.9%	8.3%	43.8%	26.3%	17.5%
1996	28.0%	22.8%	5.2%	0.3%	22.7%	5.3%	27.7%	22.5%	5.2%
1997	37.7%	28.6%	9.2%	4.3%	36.7%	1.0%	33.4%	24.5%	8.9%
1998	20.6%	18.8%	1.8%	7.1%	37.7%	-17.0%	14.5%	12.8%	1.7%
1999	15.1%	16.3%	-1.2%	-5.7%	14.1%	1.0%	20.6%	21.9%	-1.3%
2000	13.4%	3.2%	10.2%	3.9%	-4.6%	18.0%	9.7%	-0.2%	9.9%
2001	15.1%	-0.4%	15.5%	6.2%	-5.7%	20.8%	9.4%	-5.3%	14.7%
2002	-2.7%	-18.3%	15.6%	-0.8%	-22.0%	19.3%	-2.0%	-17.7%	15.7%
2003	13.6%	14.0%	-0.4%	-17.7%	5.7%	7.9%	33.7%	34.1%	-0.5%
2004	1.6%	6.2%	-4.5%	-7.3%	2.8%	-1.1%	8.3%	13.1%	-4.8%
2005	11.5%	3.6%	7.9%	-3.2%	1.6%	9.9%	14.5%	6.7%	7.8%
2006	3.5%	17.0%	-13.5%	0.2%	15.7%	-12.3%	3.3%	16.8%	-13.5%
2007	-14.4%	-12.0%	-2.4%	-14.9%	-10.0%	-4.4%	-0.3%	2.2%	-2.5%
2008	-5.5%	-22.0%	16.5%	23.1%	-21.7%	16.3%	-21.5%	-35.4%	13.9%
2009	11.8%	12.2%	-0.4%	-13.7%	9.6%	2.9%	27.7%	27.7%	0.1%
Total	743.1%	191.1%	552.0%	-18.1%	179.2%	563.9%	924.9%	251.3%	673.6%
Annualized	13.8%	6.7%	7.1%	-1.2%	6.4%	7.4%	15.1%	7.9%	7.2%

* Green section: all returns are adjusted to Canadian dollars

** Index is a hybrid index (S&P/TSX, S&P 500, MSCI EAFE, Russell 2000) which reflects the weight of the underlying assets

*** Estimated without the effect of currency

Note: Canadian dollar returns audited by PricewaterhouseCoopers

The Giverny US Portfolio

We have been publishing the returns of the Giverny US Portfolio, which is entirely denominated in US dollars, since 2003. The Giverny US Portfolio corresponds to the American portion of the Giverny Portfolio. In 2009, the Giverny US Portfolio realized a return of 28.7% compared to 26.5% for our benchmark, the S&P 500. This return and our benchmark are all in US dollars and include dividends paid during the year. Since its inception in 1993, the Giverny US Portfolio has returned 803.8%, or 14.3% on an annualized basis. During this same period, the S&P 500 has returned 239.5%, or 7.7% on an annualized basis. Our added value has therefore been 6.6% annually.

Year	Giverny US	S&P 500	+/-
1993 (Q3-Q4)	32.7%	5.0%	27.7%
1994	9.9%	1.3%	8.6%
1995	54.8%	37.6%	17.2%
1996	27.0%	23.0%	4.1%
1997	32.9%	33.4%	-0.4%
1998	11.0%	28.6%	-17.6%
1999	15.9%	21.0%	-5.1%
2000	11.3%	-9.1%	20.4%
2001	8.1%	-11.9%	20.0%
2002	-4.4%	-22.1%	17.7%
2003	31.6%	28.7%	2.9%
2004	9.3%	10.9%	-1.6%
2005	12.5%	4.9%	7.5%
2006	3.3%	15.8%	-12.4%
2007	-1.7%	5.5%	-7.2%
2008	-24.3%	-37.0%	12.7%
2009	28.7%	26.5%	2.2%
Total	803.8%	239.5%	564.3%
Annualized	14.3%	7.7%	6.6%

Note: Giverny US returns audited by PricewaterhouseCoopers - S&P 500 returns comes from Standard & Poors

Giverny Canada Portfolio

We introduced a portfolio that is 100% focused on Canadian equities in 2007. This corresponds to the Canadian portion of the Giverny Portfolio. In 2009, the Giverny Canada Portfolio returned 28.2% versus 33.3% for our benchmark. Since 2007, the Giverny Canada Portfolio has returned 15.7%, or 5.0% on an annualized basis. During this same period, our benchmark had a loss of 1.8%, or a loss of 0.6% on an annualized basis. Our annual added value is therefore 5.6%.

Year	Giverny Canada	S&P/TSX	+/-
2007	19.7%	9.8%	9.9%
2008	-24.6%	-32.9%	8.3%
2009	28.2%	33.3%	-5.1%
Total	15.7%	-1.8%	17.9%
Annualized	5.0%	-0.6%	5.6%

Note: Returns audited by PricewaterhouseCoopers

Giverny International Portfolio

We introduced an international portfolio in 2008. This portfolio corresponds to the portion of the Giverny Portfolio that represents companies domiciled outside of North America. In 2009, the Giverny International Portfolio returned 12.9% versus 10.0% for our benchmark, the MSCI EAFE (adjusted to Canadian dollars). Since 2008, the Giverny International Portfolio has had a loss of 5.6%, or a loss of 2.9% on an annualized basis. The MSCI EAFE had a loss of 20.0%, or a loss of 10.7% annually, over the same period. Our annual added value was therefore 7.8%.

Year *	Giverny Intl	MSCI EAFE	+/-
2008	-16.3%	-27.3%	11.0%
2009	12.9%	10.0%	2.9%
Total	-5.6%	-20.0%	14.4%
Annualized	-2.9%	-10.7%	7.8%

* All returns are adjusted to Canadian dollars

Note: Returns audited by PricewaterhouseCoopers

2009: A Year in Review

We began our 2008 Annual Letter with a simple phrase: “The opportunity of a generation.”

We wrote this in February of 2009 when the markets were freefalling to levels not seen since 1997. There were plenty of bargains and some of the world’s best companies were trading at enormous discounts to their intrinsic values. We may never see these sorts of valuations again in our lifetime (except for maybe Jean-Philippe who, with his daily diet of kefir, is likely to live to 120).

During the first quarter of 2009, many of the companies in our portfolio were trading at a third, and in some cases, at a quarter of their intrinsic values. We invested every dollar we could find, our own as well as those of some of our courageous partners, into these bargains. The markets and our portfolio rebounded and our holdings rose nearly 28% for the year (12% when adjusted to Canadian dollars). This 28% return on the Giverny Capital Portfolio was slightly less than our corresponding benchmark due to the underperformance of three large holdings that spanned across our three portfolios: Berkshire Hathaway (US), MTY Food (Canada), and Nitori (International). Despite this underperformance in the stock prices of these holdings, it is important to note that these companies still had a good year in 2009 when we assess their progress in growing their intrinsic values.

The market’s sharp rise since its March 9th bottom will not make us forget that 2009 was perhaps the worst year in economic history since the Great Depression of the 1930s. It was unthinkable just a few years ago that the aggregate revenue of all companies would drop by 20% in a single year. Never would we have heard chatter about a possible nationalization of the American banking system—the very foundation of the best capitalist society in history. The Irish banking system collapsed while the British banks, formerly the crown jewel of banking, struggled to survive. The stock markets in the BRIC (Brazil, Russia, India and China) tumbled between 55% and 75%.

I remember a conference last March where my longtime friend Bernard Mooney attempted to convince a skeptical audience that this was the time to invest in the market. Certain attendees were visibly hostile and shouted that this was the end of capitalism.

In the beginning of the year, many investors, including some of the most experienced, had a significant portion of their portfolio in cash and highly liquid investments, despite the fact that the return on these investment was essentially nil. For a short period of time, the return on US Treasury bonds was negative. Rarely, if ever, have we reached such a level of pessimism. At the bottom of the market, as we mentioned in last year's letter, there was enough liquidity in the US to purchase all the companies in the S&P 500. Still, there is little use having all this liquidity if you wait for an even lower level to buy into the market...

And at the end of the day, capitalism survived, the system did not collapse and those who were courageous to hold onto their shares were rewarded.

What lessons have been learned from the crisis of 2008-2009?

We find it helpful to read historical writings in times of pessimism in order to keep current events in perspective. Abraham Lincoln wrote in 1859:

"It is said an Eastern monarch once charged his wise men to invent him a sentence to be ever in view, and which should be true and appropriate in all times and situations. They presented him the words: 'And this, too, shall pass away.' How much it expresses! How chastening in the hour of pride! How consoling in the depths of affliction!"

It is the nature of our civilization, for better or for worse, to have periods of both economic expansion and economic contraction. When we look at our scorecard, however, our civilization has made constant progress—progress towards a higher standard of living.

But one of the side effects of our system is that during periods of expansion, some participants try to hasten their journey towards greater wealth by using the lever of debt. This works for some time and the neighbor, who considers himself just as intelligent, concludes after considerable reflection: "Why not me?" This continues to work for a while... until a period of contraction presents itself, always without an official announcement. And those who were imprudent are punished. Unfortunately, during several quarters, all participants are punished whether they acted prudently or not.

Many people who have lost their jobs, for example, were forced to sell stock at abnormally low prices. But this wasn't the case for everyone. Those who have the opportunity to wait for better days should remain emotionally immune against market drops. Because, at some point, the market will rise and reach new heights as the upward human quest for progress return to its historical road.

Economists who attempt to predict such cycles and the market in the short term fail to realize that they need to keep track of several hundred million factors which are the several hundred million human beings who participate in this vast activity. What's involved here doesn't just entail tracking a dozen economic indicators. Such economists remind me of the scientists from a thousand years ago who simplistically separated all the elements into four: earth, water, air, and fire.

Here are the lessons we can draw from the crisis (note: some of these were principles already known):

- Everything that cannot rise forever will someday stop. This certainly occurred with the speculation on derivative products, technology stocks in 2000, American residential real estate

in 2005, Dubai real estate earlier this year, biotech companies in the early 1990s and with the price of oil in more recent years. These are just a few recent examples!

- It is the nature of things that with every economic cycle, some businesses disappear while new ones are born. This reminds us of the cycle of life here on Earth.
- Companies that went bankrupt all had faced a common pitfall: too much debt. The companies that withstand crises are most often the ones with solid balance sheets and with leadership that is prudent, trustworthy and devoted. Isn't this perfectly logical?
- Warren Buffett once said that investors should not be in the market if they are not willing to accept a temporary drop of 50% in the values of their portfolios. I always mention to our partners that that this was likely to happen once in their life as an investor—I knew it would happen but I didn't know "when".
- Many investors who were on margin at the beginning of 2009 were forced to sell at the worst possible time. An investor who uses margin to invest can do well for 30 years and then lose everything in a single day of irrational market movements.
- The irrationality of short-term market fluctuations makes derivative products extremely volatile (options, swaps, etc.) When many people try to sell these instruments at the same time, derivative products can become worthless overnight. When this is combined with leverage (debt), you end up with an explosive cocktail.
- The good news is that the market, as Ben Graham wrote 60 years ago, ultimately renders an accurate assessment of the intrinsic value of companies over the long term. To remain calm and rational in the face of wild fluctuations in stock prices is, beyond the shadow of a doubt, the most significant quality an investor can have or try to have.
- At the end of the day, in order to build wealth, there is a simple approach which we have followed for 17 years at Giverny Capital: investing for the long term in high-quality companies purchased at attractive valuations—investing in companies that will survive the crises of our civilization and the short-term irrationality of our economic system.

But even such a sound philosophy isn't enough to succeed in the market—another quality is necessary. In 1949, Ben Graham wrote the following in the conclusion to "The Intelligent Investor":

"Have the courage of your knowledge and experience. If you have formed a conclusion from the facts and if you know your judgment is sound, act on it—even though others may hesitate or differ." (You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right.) Similarly, in the world of securities, courage becomes the supreme virtue after adequate knowledge and a tested judgment are at hand."

Review of the Decade

2009 wasn't the only difficult year in the last decade—quite to the contrary. The beginning of the decade started on a note of extreme overvaluations, particularly with technology stocks. The NASDAQ reached 5000 on March 6, 2000, a level not to be reached again anytime soon. Investing in the market, aside from a few sectors tied to natural resources, has not been a pleasant experience since. Over the course of the last 100 years, the last decade was the only decade when the S&P 500 actually lost value aside from the 1930s. The market that was highly overvalued in 1999 is one that became highly undervalued in 2009.

A significant number of companies disappeared almost overnight over the last decade (the corporate cemetery is full of companies formerly believed to be indestructible). Nevertheless, others were born

or reborn and became titans of industry within a few years (Google, Apple, Amazon, Intuitive Surgical, PetroChina, Tata Group, etc.) If there is one constant in the business world, it is change!

In the graph below, we can clearly see that the most important world indices experienced very modest gains over the last decade, well below their average 10% annualized returns. The market returns were further weakened by an additional 3% annually due to the strengthening Canadian dollar over the last 10 years. The Loonie climbed from \$0.69 to \$0.95 over the decade.

Out of the markets in the West, Canada was one of the only markets to counter this trend, with an approximate annual return of 5.6%. It is worth noting, however, that Canada only represents 3% of the world economy. While Canada benefited from its high concentration in natural resources over the last ten years, it is also important to consider that Canada is well behind many countries in terms of productivity and innovation in knowledge-based industries such as technology and medicine.

Decade 2000-2009	Annualized Returns	In \$CAD
MSCI World	0.2%	-3.0%
UK	0.9%	-2.4%
Japan	-5.7%	-7.8%
US	-1.0%	-4.1%
Average	-2.3%	-5.3%
Canada	5.6%	5.6%
Giverny Global	7.2%	4.4%

The holdings in the Giverny Global Portfolio had an annualized return of 7.2% which outperformed our benchmark by over 6% on an annualized basis. In Canadian dollars, our annualized return was 4.4%. We are confident that the intrinsic value of the companies in our portfolio increased at a much higher rate than their average annual market performance of 7%.

We also believe that the current level of the Canadian dollar is higher than a level that would be in line with purchasing power parity between the Canada and the US (which would be around \$USD 0.84). We are therefore confident that the appreciation of the Loonie since the year 2000 is unlikely to continue to such a degree (if any) in the next decade.

We can conclude that the next decade is likely to differ sharply from the preceding one in terms of returns, for both world indices as well as our portfolio.

Owner's Earnings

We do not evaluate the quality of an investment based on short-term stock quotations, but instead, take the perspective of ownership in the companies in which we invest. As such, we analyze the growth in earnings for our companies and study their long-term prospect.

Each year, we present to you a chart indicating the growth in the intrinsic value of the companies in our portfolio using a method created by Warren Buffett: owner's earnings. This enables us to estimate

the intrinsic value of our companies by adding the growth in earnings per share and the average dividend yield of our portfolio.

The intrinsic value of our portfolio companies remained flat for 2009. This is nothing to write home about but we are satisfied given the extremely challenging economic environment.

The market value of our companies, according to the stock quotes provided by the market, increased 28% in 2009. This increase in market values made up some of the lost ground in terms of the relative difference between intrinsic value and market value that had developed over the last several years.

Year ***	Giverny			S&P 500		
	Value *	Market **	Difference	Value *	Market **	Difference
1996	14%	29%	15%	13%	22%	9%
1997	17%	35%	18%	11%	31%	20%
1998	11%	12%	1%	-1%	28%	29%
1999	16%	12%	-4%	17%	20%	3%
2000	19%	10%	-9%	9%	-9%	-18%
2001	-9%	10%	19%	-18%	-11%	7%
2002	19%	-2%	-21%	11%	-22%	-33%
2003	31%	34%	3%	15%	28%	13%
2004	21%	8%	-12%	21%	11%	-8%
2005	14%	15%	0%	13%	5%	-8%
2006	14%	3%	-11%	15%	16%	1%
2007	10%	0%	-10%	-1%	6%	6%
2008	-3%	-22%	-19%	-30%	-36%	-6%
2009	0%	28%	28%	3%	27%	23%
Total	386%	344%	-42%	79%	132%	53%
Annualized	12%	11%	-1%	4%	6%	2%

* Estimated growth in earnings per share plus dividend yield

** Market performance, inclusive of dividends

*** Results estimated without consideration of currency fluctuations

Since 1996, according to our calculations, the intrinsic value of our companies has increased by 386% (nearly a fivefold increase) while their stock prices have increased by 344%. In the long term, despite the ups and downs of various economic cycles, the stock prices of companies will follow the growth in earnings per share of their underlying businesses fairly closely.

It should be noted that our stocks outperformed the S&P 500 since 1996 (by about 5% annually) for the primary (and simple) reason that their underlying businesses outperformed the S&P 500. It is in this manner, rather than through any speculation on market quotations, that we intend to continue meeting our objective of outperforming the market.

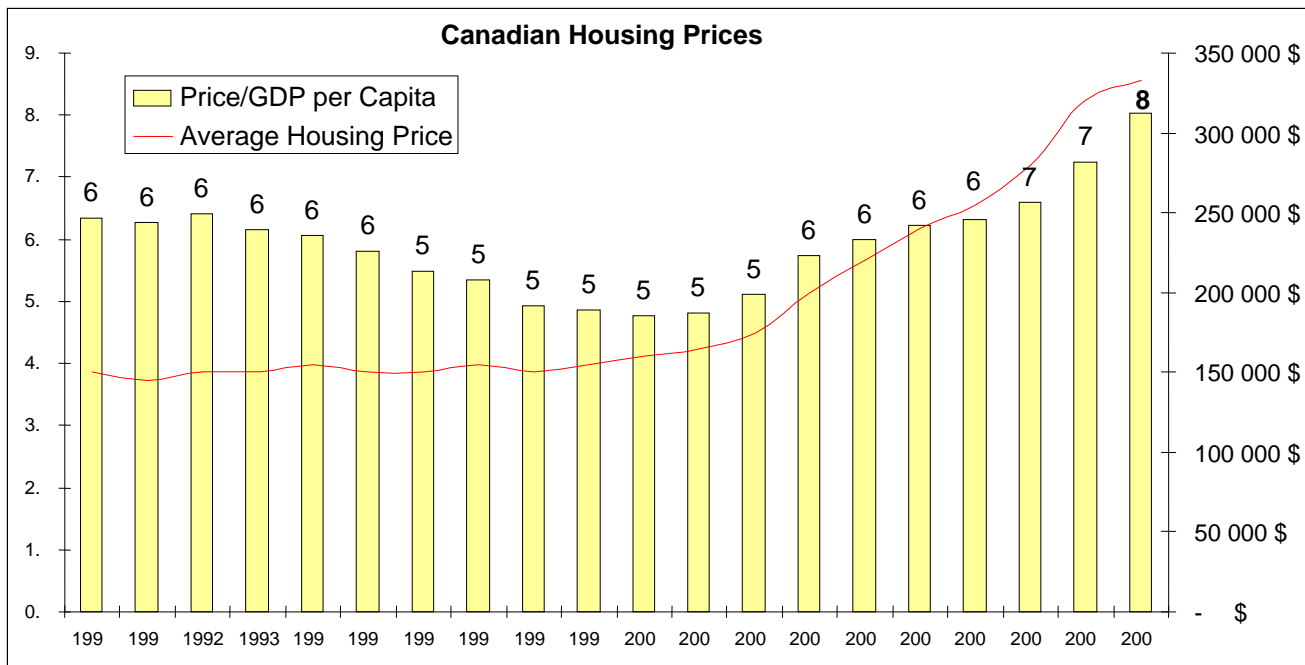
The Flavor of the Day for 2009: Canadian Residential Real Estate

We are asked regularly about the current flavor of the day—in other words, what we should avoid. After technology stocks in 1999-2000 and natural resource stocks in the last couple of years, the segment of the market which we consider alarming is the Canadian residential real estate market.

Warren Buffett likes to say that there is no greater sedative than money easily made. While Canadian residential real estate has been a tremendous source of wealth since 2000, those with a longer memory will recall that real estate prices didn't move one iota during the preceding decade. So, the first phase of this increase is a simple "catch up" on the price of the intrinsic value of a home (typically tied to disposable income per capita). Like all assets linked to supply and demand, a sharp increase often creates its own momentum which leads to a second phase of an increase when fundamentals can be left behind in favor of speculation.

The beauty of the capitalist system is that its invisible hand always ultimately equilibrates prices—each exaggerated rise is therefore followed by a readjustment. This occurred during the most recent recession in the US as well as nearly all countries in Europe. The decrease in the US was of a magnitude not seen since the Great Depression (-30%), with enormous consequences on the overall economy.

Canada, to this day, has avoided this readjustment in prices—with the reason seemingly more rooted in politics rather than economics. The federal government strongly encouraged banks to continue lending with the assistance of the Canadian Mortgage and Housing Corporation (CMHC) to support borrowers. Canadian consumers, boastful about the fact that housing prices had not fallen, continued to spend and even, in some cases, considered themselves immune to the global recession. Housing prices continued to rise.



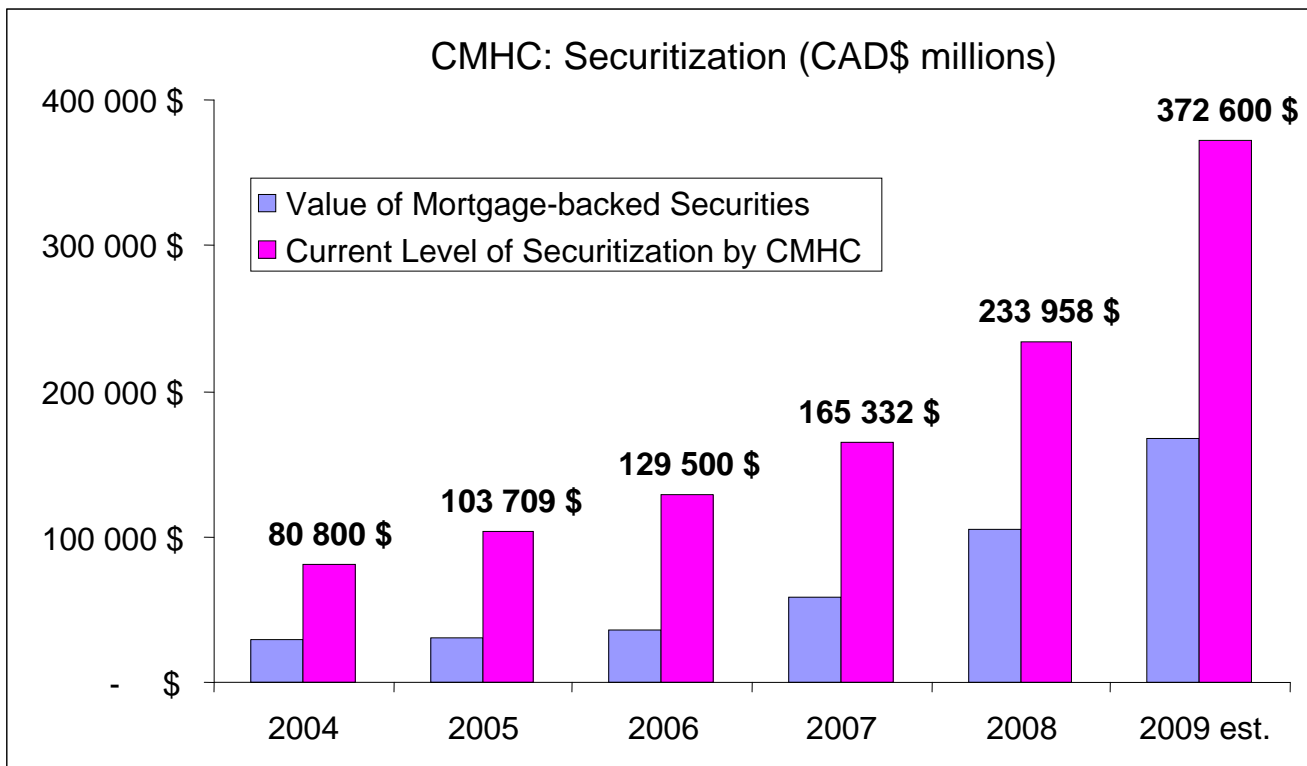
Source: Giverny Capital Inc.

We can see that the average price of a home sold in Canada reached \$333,000 in 2009. If we look at this number through the lens of GDP per capita, this is a ratio of 8:1. The historical average for this ratio is 6:1. We conclude that current prices are roughly a third higher than their historical prices, especially in western Canada.

In the US, during the great real estate bubble, a large portion of mortgage titles were transferred from banks to the quasi-governmental agencies, Fannie Mae and Freddie Mac. These mortgage titles were subsequently securitized and sold on secondary markets. When housing prices collapsed, the

American government was forced, in order to save the system from floundering, to take over Fannie and Freddie and the billions of dollars in securitized mortgages that they stood behind.

Back in Canada: in order to counter the recession, the federal government decided to encourage the CMHC to increase its level of involvement in residential mortgages. The CMHC therefore increased its level of mortgage securitization and, with the seal of approval from the federal government, had no problem finding eager buyers thirsting for guaranteed fixed rate investments. From 2007 to 2009, in only two years, the total for securitized mortgages supported by the CMHC ballooned from \$CAD 165 billion to \$CAD 373 billion.



Source: 2008 CMHC Annual Report

This financial commitment on the part of the CMHC is a significant potential liability on the part of the Canadian federal government—and I think we all know who could end up with the bill. Canadian banks do not hesitate to provide loans to home buyers since they know that the CMHC is essentially guaranteeing a significant portion of the loan. Fueled by low interest rates and accessible money, Canadians continue to buy houses at ever-increasing prices. Here's how we summarize the situation:

- Canadian housing prices in relation to GDP per capita is at a record level
- Mortgage rates are at rock-bottom levels (many are able to borrow at 2%) which means that mortgage payments are abnormally low in relation to the cost of homes.
- Money is easy to borrow, thanks to the CMHC which repackages these debts and resells them to people looking for a savings vehicle.
- The percentage of equity to assets at the CMHC has dropped from 4.2% to 2.8% over the last five years.
- Home buyers are convinced that the price of their homes will never drop. Real estate is somehow viewed as an investment without risk. Our general experience in the markets tells us that real risks are at their apex when they are perceived to be at their low point.

No one knows the future and we are the last to want to play the prophets of doom. We just happen to believe that housing prices are high, especially in the west and in Ontario, and that these artificially high levels seems to us propped up by political rather than economic arrangements. We keep this in mind and our investment decisions are affected accordingly.

There is, of course, many non-financial advantages to owning your own home. There is no doubt that home ownership is a source of great personal fulfillment for human beings—and, in the long term, housing prices will continue on their upward movement. But it is important to realize that all the ingredients are in place for potentially several years of difficulty as prices are readjusted in this segment of the Canadian economy.

Our Companies

“Character: the virtue of hard times.”

- Charles de Gaulle

This section is for Giverny Capital's partners only !

Five-year Post-mortem: 2004

Like we do every year, we go through a five-year port-mortem analysis. We believe that studying our decisions in a systematic manner, and with some hindsight, enables us to learn from both our achievements and our errors.

In the beginning of 2004, we bought shares in Knight Transportation at around \$10 per share. With the stock at \$19 today, this investment turned out to be a good one. Knight has performed better than just about everyone in the trucking industry, including Heartland Express (the company closest to Knight in terms of productivity). It seems that our competitive analysis of the industry was accurate.

Yet, we are still a bit disappointed with this investment since the company's growth rate, which was around 26% at the time of our purchase, dropped sharply during the recession. This is normal given the circumstances but we would have liked to see the company be more opportunistic about their growth given the numerous expansion opportunities available these days. We are nonetheless confident that the next economic cycle will offer us a better litmus test to judge the quality of this investment.

In a completely different line of reasoning, in our “Mistake du jour” section for 2004, we awarded ourselves a gold medal for selling Yahoo! at \$8 when it subsequently climbed to \$38. There are some interesting conclusions to be drawn, given that the stock is currently trading at \$15 and that the company seems to have lost much of the competitive advantages I had mentioned back in 2004.

The first observation is that competitive advantages in the technological world are rare and often not durable. The rapid progress in technology, while delightful to consumers, is rarely a source of riches for shareholders. Yahoo! lost a good portion of its competitive advantage in 2004 to another business that went public that year: Google.

We learned to consider it dangerous to judge the merits of an investment too quickly. Years, many years, are often necessary to reach a valid conclusion. Even the most patient investors can reach a hasty conclusion. In the business world, as in the world of art, time remains the most objective (and often the most merciless) judge in regards to the durability of one's work.

Nothing gives more wisdom than perspective.

Mistake “du jour”

"Anyone who has never made a mistake has never tried anything new."

- Albert Einstein

Following in the “Givernian” tradition, here are our three annual medals for the “best” errors of 2009. It is with a constructive attitude, in order to always become better investors, that we provide this detailed analysis. As is often the case with stocks, errors from omission (non-purchases) are often more costly than errors from commission (purchases).

Bronze Medal: BYD

During the Berkshire Hathaway shareholder meeting last May, I listened attentively to Charlie Munger's discussion of BYD, a Chinese company led by Wang Chuan-Fu. Charlie said with great admiration that “Chuan-Fu is a combination of Thomas Edison and Jack Welch: I have never met such a businessman.” When we consider that Charlie is 86 years old and that he has probably met the greatest businessmen of the last two generations, it's an extraordinary comment. His words didn't fall on deaf ears and I was instantly interested in BYD.

The company manufactures an array of products but the most important is a revolutionary battery used in electric cars. Based on this invention, BYD launched itself fearlessly into the car manufacturing business. As a fervent believer in the future of the electric car, I became enthralled with this high-potential company. Keep in mind that, with revenues of over \$5 billion in 2009, BYD wasn't exactly the new kid on the block.

My enthusiasm was cooled when I saw the company's valuation on the market. The stock was trading at \$15 on the Hong Kong market while the company only had EPS of \$0.50 in 2008. A P/E ratio of 30 times seemed exaggerated in my mind. So being a persistent man, I woke up each morning to look at BYD's closing price in Asia hoping that the stock had dropped so I could buy a stake in the company at a more reasonable valuation. This was in vain.

The company had an exceptional year in 2009. After nine months, BYD's revenues climbed 39% and their new car division grew 50%. The company's EPS has yet to be announced but it's likely to have doubled to \$1.06 for 2009 and analysts expect \$1.84 in EPS for 2010.

The stock has soared 400% in a year, reaching its current level of \$65. Sometimes, the artistic side of investing is to know when to let go, in a rare and exceptional moment, of market valuations and simply make a leap of faith based on an exceptional human being.

Silver Medal: TJX Companies

TJX owns chains of retail clothing stores. Its sweet spot in the marketplace is selling branded clothing at discount prices by buying discontinued apparel lines, surplus inventory, etc. In the US, the company's brands include T.J. Maxx, HomeGoods and Marshalls. In Canada, it owns Winners and HomeSense. TJX is highly profitable and its returns on capital are unmatched by competitors. I have known this company for a decade or so. In 2000, the stock had fallen to \$10 per share and was trading at 10 times earnings. I thought of buying shares at the time but decided to pass on the idea—with great regret.

The company grew its EPS at 12% annually during the decade. This rise in earnings seemed surprisingly high since sales were only growing at 5-7% per year and, with 2743 stores, this retail concept seemed quite mature.

The key to success at TJX is in the management of its capital. Through opportunistic buyback of its stock and continuous margin improvement, the company was able to create enormous wealth for its shareholders.

I knew two things when the stock lost half of its value at the end of 2008: that the company's business model was well suited for a recession (subsequently proven by the company's EPS soaring 48% in 2009), and that the company would buy back some its shares at these attractive valuations. The P/E ratio was once again at 10, and once again, I remained motionless.

The stock doubled in a year and is now trading at four times its price from 2000. Despite this rise, TJX is still only trading at 12 times its 2010 estimated earnings. When a stock doubles in a year and is still undervalued, it shows how much undervalued it was before.

Gold Medal: Cabela's

Cabela's became publicly traded in 2004. Since 1961, the company has been the leader in catalog sales (and now on the Internet) for products related to hunting, fishing, camping and scuba diving. The company more recently began operating "big box" retail stores. Michael Shearn, our friend from Austin (Texas), had spoken to us with great enthusiasm about this business based out of Sidney, Nebraska. Though the stock didn't seem attractively priced at the time of its IPO at \$24 per share, we knew that this company's competitive advantage merited that we pay particular attention.

In the summer of 2004, I visited one of the company's new (and very impressive) stores in Kansas City. I was highly impressed with this retail concept.

Two years later, Michael and Jean-Philippe visited the company and spent the afternoon in Sidney meeting with upper management. They returned persuaded that the company had compelling competitive advantages and an able management team.

Still, we all shared some reservations about the high level of capital required to open the company's extremely large stores (and their low return on capital). We were also concerned that a substantial portion of the company's profits were from its financial division which issued credit cards to customers of Cabela's.

On the other hand, we also believed that the company could eventually realize certain economies of scale with a larger network of stores and that this should improve the company's returns on equity over time. We decided to buy a few shares, if anything to simply follow the company more closely.

The stock of Cabela's fell sharply in 2008, from a high of \$28 in 2007 to a bottom of \$4. The retail sector was practically torn apart by the drop in consumer spending. On top of that, everyone on Wall Street avoided companies with financial divisions like the plague, regardless of the quality of a company's loan portfolio. Cabela's was different, with its loyal (if not fanatical) customers. The company's customers were also wealthier than average and had higher credit scores.

It's not surprising then that EPS dropped relatively little, from \$1.31 in 2007 to \$1.14 in 2008. When it was trading between \$4 and \$5, the P/E ratio on Cabela's shares was only four times. Without any future growth, such a valuation corresponds to an annual return of 25%!!

To find a high-quality business that is dominant in its industry and is trading on the market for four times its earnings is a rare event in the life of an investor. I could have used the excuse that we were fully invested and that all our stocks were undervalued. But I certainly could have sold another stock in our portfolio that was trading at half of its intrinsic value to buy Cabela's that was trading at one fifth of its value. Selling a 50-cent dollar to buy a 20-cent dollar makes a lot of sense.

The company's earnings rose 18% to \$1.35 per share in 2009. The company has performed extremely well despite the tremendously challenging economic headwinds. Wall Street regained its wits about the value of this business and the stock has risen to \$16 in just a few months. This error of omission, with a price tag of 300%, merits a gold medal.

Conclusion: Warren Buffett's Big Wager

One of the most significant events of 2009 for our portfolio was the acquisition, through a tender offer, of Burlington Northern Santa Fe (BNSF). We had owned stock in BNSF since 2007-08 and, in November of 2009, Berkshire Hathaway offered \$100 per share for Burlington—a 27% premium to the current price of the company's stock.



Warren Buffett and BNSF Chairman Matthew Rose (Source : CNBC.com)

This \$34 billion acquisition is by far the largest over the course of Warren Buffett's long and illustrious career. In his press release, Buffett makes this pertinent comment:

“Our country's future prosperity depends on its having an efficient and well-maintained rail system. Conversely, America must grow and prosper for railroads to do well. Berkshire's \$34 billion investment in BNSF is a huge bet on that company, CEO Matt Rose and his team, and the railroad industry. Most important of all, however, it's an ALL-IN wager on the economic future of the United States. I love these bets.”

M. Buffett, regardless of the metaphor used in the press release, is no gambler. In fact, the master of intelligent investing is faithful to a rule he laid out some 50 years ago: “To succeed in the stock market, be fearful when the others are greedy and greedy when the others are fearful”.

We are, as M. Buffett, very optimistic about the future of our companies. Despite a satisfactory year in 2009 as far as our returns, we believe that the next few years will be quite rewarding for our businesses and their shareholders.

We also want you to know that we are fully aware and grateful for your vote of confidence. It is imperative for us to not only select outstanding companies for our portfolios, but to also remain outstanding stewards of your capital.

We wish a great 2010 to all our partners.

A handwritten signature in blue ink that reads "François Rochon". The signature is written in a cursive, flowing style.

François Rochon and the Giverny Capital team