# Compilation of Reads, Volume 2

In the first compilation of reads, I shared three articles which represent different verticals for analytical thought. Namely, a conceptual hard-to-read piece, a shareholder letter, and a profoundly abstract essay. These compose the triad I suspect should yield the highest results, were one to master it.

The approach to the second compilation differs from the aforementioned, but the essence remains the same. Letters and articles included still portray these elements. However, individually, none can be distinguished for maximizing a single one. If I had to guess, perhaps portfolio management is the trait that's most exhibited.

Notwithstanding the prior remark, my intention hereby is to expand the scope of exposure for the reader. Finding the territories that deserve exploration seems implausible if one doesn't count with a superficial mapping of what's known. Hereafter, I'll briefly expand on the reasoning behind the inclusion of each piece.

**François Rochon 2008 Shareholder Letter**

Rochon's methodology for business selection and portfolio management is systematic and methodical. He was nonetheless capable of finding an intersection between rigidness and flexibility. Rochon has been very vocal in stating that investing resembles art. Ever after 2005, all of François' letters begin with a work of art from Giverny Capital's collection.

Particularly, the 2008 annual report highlights the attitude a great investor had when the world was crumbling. It's fundamental to note that courage is a trait I noticed many outperformers have. Not blind, however. It originates from knowledge and understanding. Emulating courage turns very rapidly into recklessness if the premises under which one is operating are not sound.

## Terry Smith 2021 Shareholder Letter

Great investors are generally great teachers as well. Terry Smith is the person whom I think has best articulated how a strategy for fundamental equity investing could look like. Furthermore, his 2021 letter shines among them all due to the number of brilliant insights included. This might be the single piece that has helped me advance the farthest in business analysis.

## Jeff Bezos 1997 Shareholder Letter

Bezos' letters contain thoughtful advice for business managers. At the end of every issue, he used to attach the 1997 letter. In the latter, Jeff went over his philosophy in an attempt to attract shareholders aligned with it and warn those against it. My sense is that this letter best represents Bezos' core values as well as the areas wherein Amazon would thereafter focus. It is the articulation of the basis for later success.

## Nick Sleep mid-2009 Letter

Nicholas Sleep is the most brilliant investor I've read, and I suspect you'll get a taste of this with the selected letter. Nick taught me a fundamental element I had been missing for investing: *we can compete in the market with intellectual theses.* There are patterns that repeat themselves among successful businesses that are not to be found in financial statements. Nick noticed that 'Scale Economies Shared' had produced immense benefits to the practitioners and their respective shareholders. As a final note, coupling this with Bezos letter might help better grasp where the concept comes from.

## RV Capital, 15-year Anniversary Letter

Plenty of meditations have flooded the investing field, as happens wherever humans gather experience and observations. Yet the incremental value that's generated by 'new' reflections tends to decline after a certain point. It therefore becomes crucial to detect which of these new meditations might cause intellectual breakthroughs for oneself. I suspect Robert Vinall's letter falls in this category.

## The Whistle

I read Benjamin Franklin's autobiography in February and was struck by how little joy I found in his book. However, the sample I acquired included Franklin's other writings as well, ranging from essays to letters. In these is where I strongly recognized the man's brilliance.

For the first compilation, I selected The Way to Wealth, in which Franklin expresses how industry, frugality and hard work lead to a wealthy life. The Whistle narrates an anecdote concerning Benjamin's childhood and the impact it had on the rest of his life. The thesis for this writing goes over Man's misunderstanding of the value of things and the misery this brings upon.

## Extract from the conclusion of The Origin of Species

The Origin of Species is a fascinating and wide endeavor. It explores all intricacies regarding Natural Selection. One of Darwin's traits that caught me by surprise was his humility. On numerous occasions, he states the ignorance surrounding his findings and ideas. Additionally, he explicitly manifests the pushback he received from peers. Everyone believed in the independent creation of species.

What's remarkable about Charles and why I selected this specific extract is because it shows the power in finding comfort in solitude. Consensus is not the truth. It's only the current belief. The Origin of Species might be the piece that has had the largest scientific impact in history. It vividly entails that extraordinary returns are rooted in rational contrarianism.

# Giverny Capital 2008 Letter to their Partners

Dil Hildebrand
Untitled (dusk), 2008
Collection Giverny Capital Inc.

If you don't have time to read the complete letter, please read this:

The opportunity of a generation

To Giverny Capital's partners,

2008 was a difficult year in the stock market, to say the least. We believe that the market drop – and the high level of pessimism – has created great investment opportunities, to a degree we have seldom seen in the modern history of financial markets.

From these depressed levels, we believe that the potential rewards for stocks are very high. We believe that the potential returns for stocks in general have not been that promising since 1979:

- Valuation for stocks in general are very low. The price-earnings ratio to normalized profits is around 9 times for the S&P 500.
- Consumer confidence in the US is at an all-time low of 25 (1985=100). The lowest it had reached before was 42 in 1974.
- Just in the US, there are around 7000 billions of dollars in cash (waiting to get back in the market). This is a sufficient amount to acquire all the S&P 500 companies.
- Interest rates on treasury bills are almost zero. The bond alternative is far from attractive.
- Most investors are pessimistic. Institutions have a very low asset allocation for stocks. Historically, these were signs of future great returns for stocks.
- We can purchase shares of outstanding companies at a third of their intrinsic value, a situation we have rarely seen.

- Finally, the legendary investor Warren Buffett is very optimistic toward stocks: he urged investors to invest for the first time since 1979. He wrote: “A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors.”

At Giverny Capital, we’re ready for the next bull market!

François Rochon

François Rochon and the Giverny Capital team

# Giverny Capital Inc. – Annual letter to partners 2008

For the year ending December 31st 2008, the return of our portfolio was -5.5% compared to approximately -22.0% for our weighted benchmark. It is an added value of +16.5%. These returns both include a gain of 16% related to the fluctuation of the Canadian currency.

Since our beginning on July 1st1993, our annual compounded return is +14.0% compared to +6.4% for our comparative index group. If we exclude the increase of the Canadian currency, our portfolio would have generated an annual return of +14.4% compared to +6.7% for the indexes.

Our long-term (and ambitious) goal is to maintain an annual return of 5% higher than the indexes.

<u>The art work on the cover of our letter</u>

Since 2004, we illustrate our letter with an art work from our corporate collection. This year, we choose a work on paper by the Quebec artist Dil Hildebrand titled "Dusk". We do believe that the bear market could be near its end and we could soon see the lights of the next bull market.

**The Giverny portfolio (in Canadian currency): Our returns since July 1st 1993.**

| Returns * | 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% | 1.5% | 10.0% | 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% | 2.4% | -2.7% |
| 2008 | -5.5% | -22.0% | 16.5% | 23.1% | -21.7% | 16.2% | -21.5% | -35.4% | 13.9% |
| Total | 654.7% | 159.4% | 496.8% | -4.5% | 157.4% | 500.1% | 701.9% | 175.2% | 526.7% |
| Annualized | 13.9% | 6.3% | 7.6% | -0.3% | 6.3% | 7.7% | 14.4% | 6.7% | 7.6% |

* Green section: All the returns are adjusted in Canadian dollars
** Indexes are a hybrid index (S&P/TSX, S&P 500, Russel 2000) which reflects the asset class weight
*** Estimated without the effect of the currency.

Note: the returns in Canadian dollars were audited by Price Waterhouse Coopers.

## The US Giverny portfolio

Since 2003, we also publish the Giverny portfolio returns in US dollars. It mostly corresponds to the American part of the Giverny portfolio. In 2008, the US Giverny portfolio returned -24.3% compared to -35.7% for the S&P 500. Since the beginning of the portfolio, our return is 600.7% which is 13.4% on a annualized basis. During the same period, the S&P 500 returned 171.4%, which is 6.7% annualized. Our annual added value is therefore +6.7%.

| 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% | 36.6% | 18.2% |
| 1996 | 27.0% | 22.3% | 4.8% |
| 1997 | 32.9% | 31.0% | 1.9% |
| 1998 | 11.0% | 28.5% | -17.5% |
| 1999 | 15.9% | 21.0% | -5.1% |
| 2000 | 11.3% | -8.2% | 19.5% |
| 2001 | 8.1% | -11.2% | 19.3% |
| 2002 | -4.4% | -21.4% | 16.9% |
| 2003 | 31.6% | 28.6% | 3.0% |
| 2004 | 9.3% | 10.7% | -1.4% |
| 2005 | 12.5% | 4.9% | 7.6% |
| 2006 | 3.3% | 15.4% | -12.1% |
| 2007 | -1.7% | 5.5% | -7.2% |
| 2008 | -24.3% | -35.7% | 11.4% |
| Total (en $US) | 600.7% | 171.4% | 429.3% |
| Annualized (en $US) | 13.4% | 6.7% | 6.7% |

Note: these returns were audited by Price Waterhouse Coopers.

### Portefeuille Giverny Canada

In 2007, we started the Giverny Canada portfolio. It mostly corresponds to the Canadian part of the Giverny portfolio. In 2008, the Giverny Canada portfolio returned -24.6% compared to -32.9% for the S&P/TSX. Since the beginning of the portfolio, our return is -9.7% which is -5.0% on a annualized basis. During the same period, the S&P/TSX returned -26.3%, which is -14.2% annualized. Our annual added value is therefore +9.2%.

| Year | Giverny Canada | S&P/TSX | +/- |
|---|---|---|---|
| 2007 | 19.7% | 9.8% | 9.9% |
| 2008 | -24.6% | -32.9% | 8.3% |
| Total | -9.7% | -26.3% | 16.6% |
| Annualized | -5.0% | -14.2% | 9.2% |

Note: these returns were audited by Price Waterhouse Coopers.

## The year 2008 in review

Last year, we ended our letter with these words : "If there is a recession in 2008, we are ready". We did enter into a recession last year. Here is a review of some of the main news of a year that was far from ordinary:

- From their peak, World markets were down by more than 50%. Even those that were considered (wrongly it seens) “decouple” from the US economy went down. Markets in China, Brasil, Russia and India were down form 50 to 75%.
- Most industrialised country went into recessions.
- Housing prices were down by 20% in most industrialised countries.
- Three of the top five stock brokers in the US have vanished or have been forced to merge into a new entity (Bear Stearns, Lehman Brothers and Merrill Lynch).
- The three financial titans AIG, Freddie Mac and Fannie Mae collapsed.
- Short term Interest rates in Canada and US are almost zero.
- The S&P 500 dividend yield is higher than 10 year treasury bonds by more than 1%, something that last happened in the mid 1950s.
- It is estimated that around one of three hedge funds could close because of the crisis.
- Oil prices went from a peak of 147$US in July to a low of 35$US in December.
- The Canadian dollar dropped 23% compared to its US countepart.
- The Canadian stock market was not immuned : from its peak, the S&P/TSX dropped 50%, the small-cap index by 60% and the TSX Venture by 75%.

We are always psychologically ready for recessions or market corrections. At the same time, we share the same agnosticism as Warren Buffett’s as for the capacity to predict them (we leave that to astrologists, market strategist and other fortune-tellers). We have accepted since the start that market and economic cycles are parts of our capitalist systems and manage our assets accordingly.

Since 1945, there have been 11 recessions. Four times, the stock market dropped by more than 40%. And crisis have one thing in common: they all ended !

The recent economic crisis originated from the drop in real-estate prices and in the huge consequences on the financial institutions, worldwide. Afterward, the crisis spread to all industries. The market correction was then amplified by the huge number of speculators that crowded the investment world in the years 2006-2007. For example, we wrote to you last year that at some point, there were $200 billions of oil contracts owned by investors. These were not destined to utilisation. Speculators were hoping to find “other” buyers to purchase their contracts before the delivery date. Forced to sell, losses were tremendous for most of them. There was also, the private equity firms (a new name for LBOs) that acquire companies by leveraging them to a dangerous levels. Many of them were forced to sell securities to improve their balance sheet. All this deleveraging process is still hurting the economy.

And as always, market drops created by the selling of speculators have created more fears for many other investors (even those that don’t need to sell). It is hard for many investors to keep a long term view during market corrections, especially when it lasts many months. But they have to. It is impossible to know when but this crisis will pass too we can be certain of that. Our civilization have went through tougher times! A wise man once said that history doesn’t repeat itself exactly the same way but it rimes!

Our portfolio did pretty well in the circumstances. We always have focussed our capital in solid companies with great balance sheets and good profit margins. They also share an important ingredient: honest and accountable people at the helm. Our companies are not immuned to recessions. But we believe that they have what it takes to pass through them. Some of them will emerge even stronger! Finally, we are prudent in the price we pay for stocks. That helps in bear markets.

Some of our companies were quite hurt by the recession but in general our investment philosophy has helped us this year to beat the market, the same way we have done it since 1993. And we are taking advantage of the market crash to purchase great bargains. As Warren Buffett would say: “be greedy when others are fearful”

**The level of undervaluation of stocks in general**

Although we’re stock pickers (not investors in the market per se), we do closely follow the general valuation level of the S&P 500 (in our opinion, the most important index in the World).

To value the S&P 500, we take into consideration three parameters: operating earnings, normalized earnings to smooth out the economical ups and downs and long term interest rates in the US. The last parameter is used to compare price-earnings ratio (P/E) to bond alternatives. Over a long period of time, the market P/E tends to follow the inverted yield of interest rates. Of course, in periods of optimism, the normalized P/E of the S&P 500 can be way higher than interest rates would justify. And in periods of pessimism (like right now!), P/Es can be way lower than their intrinsic value.

If we look at the following chart, the S&P 500 seems to us undervalued by more than 50%, a discount rarely seen (note: in 2008 we use a 4% level for the 10 years bond although it was 2.5% at year end).

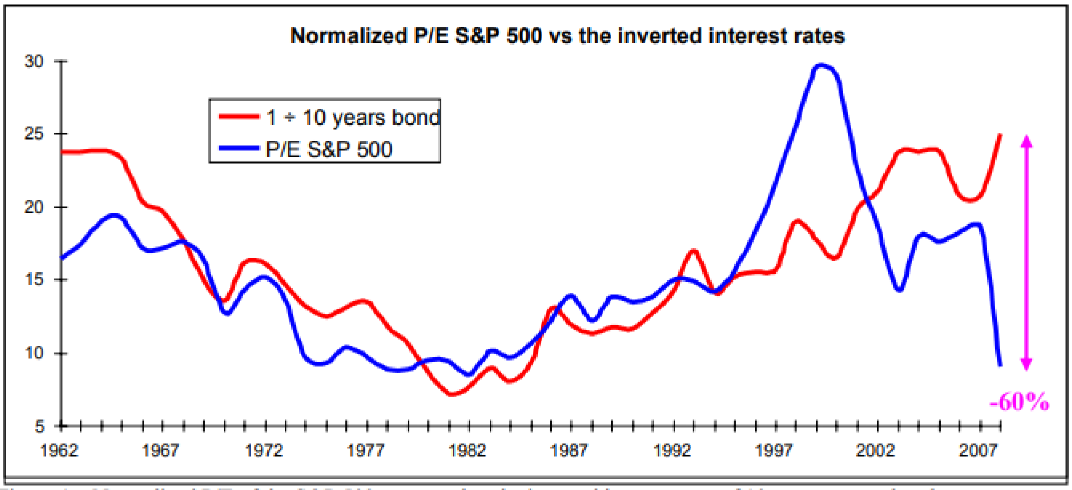


Figure 1 : Normalized P/E of the S&P 500 compared to the inverted interest rates of 10 year treasury bonds.

Such a level of undervaluation for stocks – and a huge potential of future appreciation attached to it – usually happens once per generation. So we are quite optimistic for the years to come. We don't know what the market will do in the next few quarters, but over the next 5 years or so, the potential returns seems to us way higher than the historical norms.

## Historical returns and their fluctuations

There is one reason – and only one – that stocks have created so much wealth to their owners in the last century: on average, companies have maintained a 12% return on equity (ROE). After dividends, this ROE has translated into a 7% annual increase in corporate earnings. This annual increase, combined with the average dividend of 3%, have yielded a total annual return for stocks of 10%. This is better than any other asset class. All equity owners should then have been rewarded at such a rate over time. In reality, this is far from the case.

The stock market is an entity created and composed by human beings. So it has some of its qualities and flaws. The market has periods of huge optimism followed by periods of huge pessimism (although not in a linear fashion). For example, the S&P 500 increased by three fold in 5 years from 1995 to 1999. And it has dropped by 50% in 2008. Usually, the patern of behavior is more or less similar : in periods of increases, investors tend to forget that stocks can also go down and buy them at any level without consideration of their intrinsic values. And then, after a big drop, they sell believing that never again stocks will be a rewarding source of wealth (or they wait for a “better” time to buy time, meaning when they will have gone up a lot). They make the same mistake as in bull markets: they do not focus on intrinsic value.

We believe that the nature of financial markets do not favor such timing investment strategies. In fact, historically, 90% of stock returns happened during 1.5% of trading days. Statistics are way against those that think they can outsmart the market over a long period of time.

We do realize that the last 10 years have been quite difficult for investors in general. It even gives them the impression that stocks ownership is not a rewarding activity (and enjoyable even less). We can look at the following graphic to realize how tough were the last 10 years:

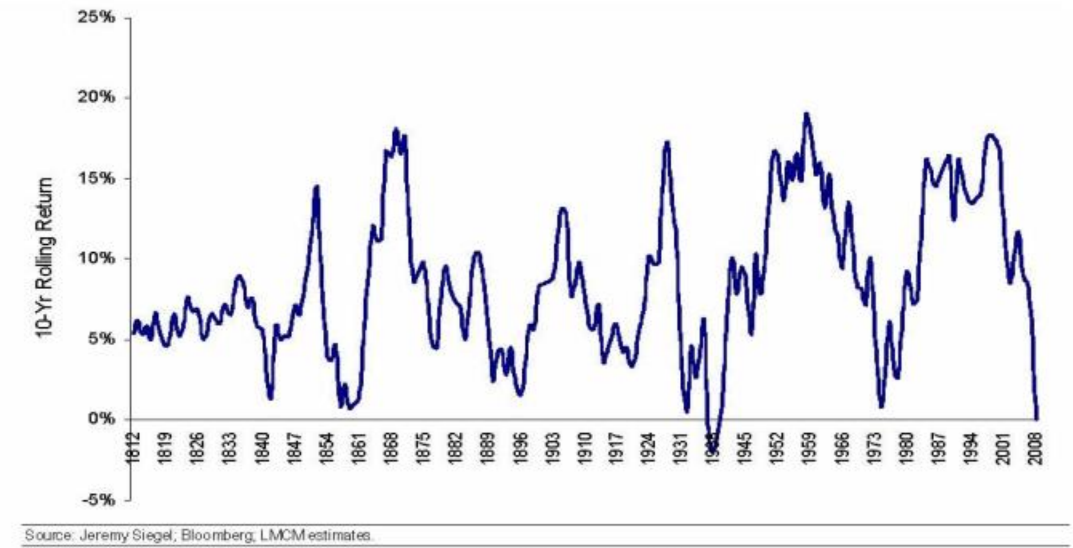



Figure 2 : The S&P 500 annual returns for the previous 10 years since 1812.

In 2008, the rolling 10 years average returns of the S&P 500 was less than -1%. It was only the second time in the last 200 years that this return was bellow 0% (the other time was for the 1929-

1939 period). In 10 years, the market has gone from overvalued to undervalued.

But in the end, the only way to lose money in the stock market over the long run is to sell during corrections or recessions. So the emotional goal of the typical investor is not to fall into the “trap” of bear markets. This “trap” awaits those that can not be impervious to stock market fluctuations. Although it is far from easy, the key to attain such wisdom is to consider stocks as parts of businesses. And – big news ! – that’s what they are. Nothing else!

**Owner’s earnings**

If the vast majority of investors perceive the daily market quotes as an ultimate judge of value, we have a different view. At Giverny Capital, we do not evaluate the quality of an investment this way. In our mind, we are owners of the businesses we invest in. Consequently, we study the growth in underlying earnings of our companies and their long-term perspectives. Every year, we submit a table showing the growth of the intrinsic value of our businesses that we measure using the term invented by Warren Buffett: owner’s earnings.

We therefore come to an estimate of the intrinsic value increase of our portfolio by adding to the growth in owner’s earnings, our average dividend yield. In 2008, our owner’s earnings decreased by 3%. It is not a great accomplishment but it was way better than the 30% drop in the S&P 500 operating earnings (note: earnings in 2008 for the S&P 500 varies a lot depending on how we account for them. We have used the one calculated by the firm Standard & Poor’s)

| | Giverny | | | S&P 500 | | |
|---|---|---|---|---|---|---|
| Year *** | Intrisic Value * | Market ** | + / - | Intrinsic Value * | Market ** | + / - |
| 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% |
| Total | 386% | 247% | -140% | 73% | 82% | 9% |
| Annualisé | 13% | 10% | -3% | 4% | 5% | 0% |

* Owner's earnings growth (approximately) plus dividends
** Stock Market performance, including dividends
*** All the results are estimated without currency fluctuations

According to this calculation, our companies have increased their intrinsic value by 386% (almost 5 fold) but their stocks – in aggregate – increased by 247%. The main difference can be explained by the median P/E contraction from 16x to 11x. We must add that this year's corporate earnings – ours and those of the companies making up the S&P 500 – are depressed because of the recession. In some way, they distort the calculation of intrinsic value. Only time will tell to which degree.

Besides ups and downs in the economy, over the long run, market quotes will follow the increase in the earnings of the underlying companies.

### The flavour of the day in 208: guaranteed impoverishment

Regularly, we try to assess what is the flavour of the day, in other words what needs to be avoided. The stock market tends to get excited from time to time by all sorts of financial assets: it could be a sector, a country, an asset class, a new major "trend", etc. In 1999-2000, it was all about tech stocks. In 2006-2008 (first six months), it was all about commodity and resources stocks. Today, what looks to us very dangerous are – ironically – the treasury bills.

Today, there are around $7000 billions in liquid assets in the US alone. This is enough money to purchase all the companies of the S&P 500 (or 5 times the complete Canadian stock market). At year's end, the interest rate on those liquid asset was 0.07%. The interest rate on 10 years government bonds was 2.2% and the 30 years bonds 2.7%. Those that purchase those assets – in a some sort of collective delusion – believe that they are acting in a prudent way while in fact it could be the riskiest! It is so because it guarantees yearly impoverishment because the yield that they receive will be lower than the inflation rate.

Historically, the inflation rate has been around 3% per year. Although, in 2009 it will probably be lower, investors have to realize that the politic of many governments to inject huge sums of money in the banking system will probably create inflation. In the next 10 years, it could even be a little higher than historical norms, perhaps around 4% a year on average. If we use 3.5%, it means that the bonds yielding 2% will in fact be creating a LOSS of 1.5% per year in real terms. Over 10 years, this is total loss of 14%. Moreover, if that 2% is taxed, the total loss climbs to 21% (not bad for a riskless asset). For 30 years bonds, it's even worse: a non-taxable account will lose 26% of its purchasing power and in a taxable one, 45% !!

That is why we believe that the risk of owning treasury bills has rarely been so high. Impoverishment is guaranteed !

**<u>Our companies: 2008 in review and their future potential</u>**

In 2008, many of our companies saw their earnings reduced or stagnated. In some cases, the reduction was significant. Some of our businesses, we must add, did increase their earnings and some other made important acquisitions while their competitors were paralysed with fear.

**Nitori Co.**

Our best stock in 2008 was Nitori, a Japanese company we acquired last year. Nitori is a retailer of household products (furniture and accessories). It has an everyday low price strategy so it has been 10 gaining market shares in these difficult times. In 2008, earnings were up 13%. The stock went up 30% (to 7000 yens) and we got a little bonus because the yen gained 40% against the Canadian dollar.

**Wal-Mart**

Wal-Mart increased its profits by 6% in 2008. Its same store sales (SSS) were up 3%. In this very tough environment, it was quite an accomplishment. For example, Target saw its SSS decreased by 3%. Wal-Mart is one of the rare retailers that increased its traffic and SSS in 2008.

The top management's decision to reduce the level of new store openings and instead buy back shares looks to us like a wise decision. The stock has been quite resilient this year as it increased by 18% compared to last January.

**Bank of the Ozarks**

Our little bank of Little Rock (Arkansas) accomplished what very few of the 4000 or so banks in the US did this year : increase profits. Assets were up 19% and earnings were up 9% (even after a large increase in loan reserves). The efficiency ratio was down to 42.3%, an exceptional performance. Return on assets was a solid 1.14%.

I've met with the management of Bank of the Ozarks in 2006. I came back from Little Rock quite enthusiastic. Its CEO, George Gleason, acquired the bank for $10 000 at age 25 some 29 years ago. Bank of the Ozarks had then 28 employees et $28 millions in assets. In 2008, assets were $3 billions (an increase of 10 000%) and the bank was worth $500 millions. Mr. Gleason still owns some 22% of the outstanding shares and is paid a very reasonable salary. The culture he has impregnated onto the bank is based on conservatism and a long term horizon. Ozarks did not participate in the “sub-prime” madness and was prudent with its real-estate loan portfolio (there was few speculation in Little Rock considering that the median price of a home is $130 000).

Mr. Gleason is our kind of businessman and we’re happy to be partners with him!

**Well-Fargo**

Wells-Fargo (WFC) made a bold acquisition in 2008 by acquiring Wachovia at a very good price. They paid around $15 billions. This was the equivalent of 17% of its own market cap. In return, WFC doubled its assets. Moreover, we believe that with the charges that they will make to Wachovia books, they could save billions in future income taxes, that could prove to be almost the level of the purchase price.

WFC is so big, it could hardly escape the recession linked problems in 2008. It increased its level of reserves but still was profitable. Earnings were down 25% and we believe they will be lower by as much – at the very least – in 2009.

As always, we look beyond the next few quarters. We believe that once the economy gets back on the growth track, WFC will be able to double its earnings. So we believe that in next cycle, WFC could earn $4 a share. The stock could then reach the $60 level. This is many times the current level of the stock so the potential of appreciation is quite high.

**Allied Irish Bank**

In 2008, we had acquired a small weight in the largest bank in Ireland: Allied Irish Bank (AIB). At its average price of $25 in 2008, the stock was trading at 3 times earnings! AIB had two large investments: $3 per share in a minority holding of M&T Bank and $4 per share in Zachodni WBK, one of the most important bank of Poland. So in fact, we were paying $18 for $6 of EPS. And the dividend was 10%. It looked to us as a very rewarding opportunity.

But it did not turned out the way we had hoped. The economy of Ireland went down in turmoil and its three banks collapsed in the stock market. AIB ended the year at $5. At this price, we were paid $2 to own the most important bank in Ireland (with 41% market share it is the Irish equivalent of a combined Bank of Montreal and Royal bank of Canada).

In the beginning of 2009, there was an incredible event: the Irish government nationalized the third most important bank, Anglo Irish Bank, something very unimaginable just a year ago. Ireland is not a socialist country or a third-world country. Its GDP per capita is 15% higher than in Canada! But political interference makes our analysis futile and predicting the outcome quite impossible. Clearly, at today's price, investors believe that AIB will be almost totally diluted. We follow the situation closely but for the moment, we decided to just keep our shares.

**Disney**

Walt Disney Co. had a good year in 2008. EPS were similar to those of 2007. The recession should impact 2009 EPS but in the long run, this is one of the best companies we own. Moreover, it is brilliantly managed by its current CEO Robert Iger. The stock was a bargain at $30 at the beginning of the year but that did not prevent it from going down to $20. Obviously, in times of great pessimism, a stock trading at half its intrinsic value can go down to a third of its value.

At today's level, Disney trades at 10 times earnings, a level not seen since the mid 1960s. We are still buyers of the stock.

**American Express**

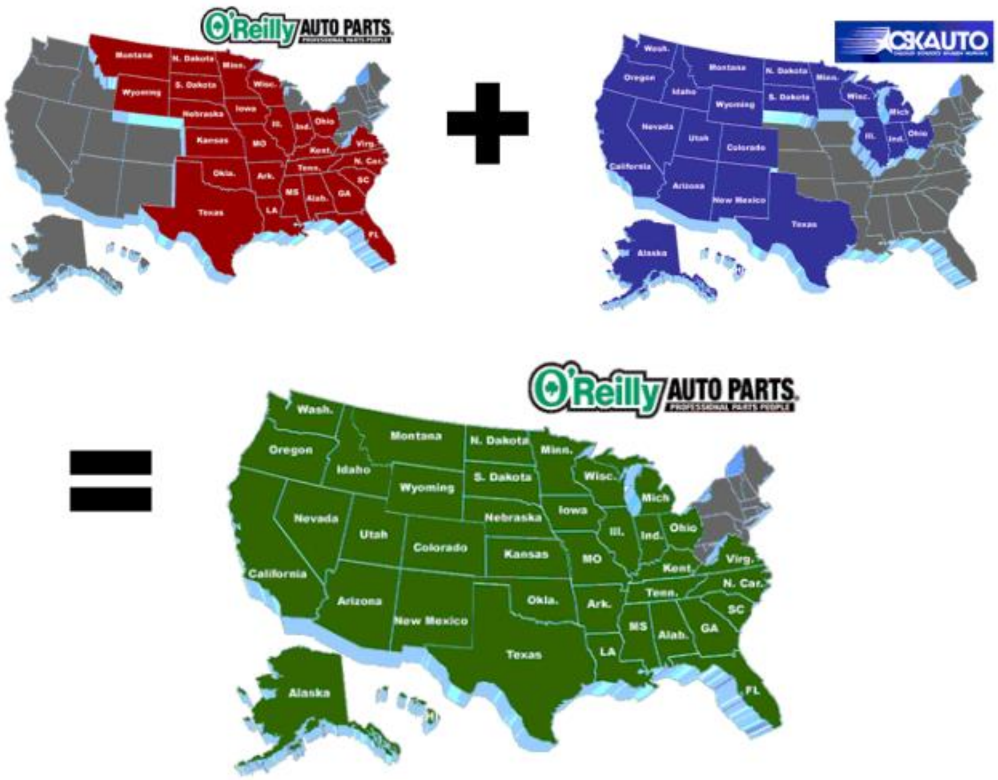
AMEX owns a solid brand name, probably one of the best in the financial sector. But the year 2008 was very difficult for the company. Reserves had to be increased and EPS went down by 28%. The year 2009 doesn't look better. The stock went down to $19. At this level, it trades at around 7 times earnings.

It is difficult to know how hard AMEX will be hurt by the recession. We do believe that the company's brand is intact and that in the next cycle, earnings should rebound. If it earns $4.25 and the P/E gets back to normal levels, this stock could reach $65, more than four times the current level.

**O'Reilly Automotive**

Four years ago, we acquired shares in O'Reilly Automotive, one of the most important retailers of auto parts in the US. We had paid around $20 and the company was earning $1.12 per share at that time. O'Reilly had grown by 20% a year since its IPO in 1993. Future prospects looked good to us. We had visited its headquarters in Springfield (Missouri) and were impressed by its top people. They built a strong culture and had a very long term horizon in their investment process.

In 2008, EPS reached $1.64. Even though it's 46% higher than in 2004, we believe that these earnings are not totally reflective of their true earning power. The store number has increased from 1200 to 3200 during those four years. The stock has been quite rewarding in this down market since it ended the year at $30. Of the 2000 stores increase, a large part of it came from this year's acquisition of CSK Auto (1342 stores). It expanded the reach of O'Reilly to the whole country. And the price paid for CSK seems to us to be very reasonable. So the future of O’Reilly continues to look quite promising.




## Fastenal

We are shareholders of Fastenal since 1998. So far, we have been rewarded to a large degree by this superb company from Winona (Minnesota). In the movie “Other People’s Money”, Lawrence Garfield (interpreted by Danny DeVito) likes businesses that are “Dull but making a decent buck!”. At Giverny Capital, we share this admiration for such businesses. And Fastenal is making more than “decent” returns with its capital!

Fastenal started by selling fasteners but its CEO for many years, Robert Kierlin, diversified the company into many other lines of products as it expanded to around 2000 retail sites. My personal favorite line of products is the janitorial one.


We first purchased shares of Fastenal during the Asian crisis in October of 1998 at around $5 a share (adjusted for splits). In 1998, Fastenal earned $0.35 per share. In 2008, EPS reached $1.91, an increase of 450% in 10 years (18% annualized).

The stock – as it should – has gone up by 500%. The stock has been weak lately: the first few months of 2009 are difficult. But we do believe that in the next cycle, Fastenal will be able to again double sales and profits. And the stock should, at the very least, follow its underlying growth rate.

**MTY Food**

The Quebec based enterprise MTY Food had a good year in 2008. Its sales increased by 12% and EPS by 8%. MTY acquired two franchises: Tutti Frutti et Taco Time. The number of restaurants under the umbrella of MTY has crossed the 1000 level this year. The stock had a tough year as it went down from $12.6 to $7.3, a 42% drop. The company still has a great balance sheet. It shoud help to make other acquisitions in 2009 as the opportunities arise.

**Pason Systems**

Our Calgary oil services company, purchased four years ago, had a good year in 2008. Its US division is doing extremely well and helped the company earned record profits. EPS were up 25% in

2008 but 2009 looks much more difficult (the number of oil rigs are way down as of this writing). We admire Pason's CEO, Jim Hill, tremendously and we talk to him on a regular basis. We are optimistic about the long term prospects of this very impressive Canadian company.

**5N Plus**

5N Plus, a young and dynamic Quebec based company, is a World leader in metal purification. Their products are mostly used in photovoltaic cells for solar panels. For their last fiscal year (ending in May), revenues were up 41% and EPS 83%. After two quarters into 2009, revenues and profits are up 120%. The company has successfully completed its German plant and it's doing very well so far.

The stock was very volatile in the stock market. It started the year by going up from $8 to $13 and then went down the $4.6. The company – with some wisdom – issued more shares at $11 so it has a reserve of $1.2 per share in cash. So in fact, we're paying $3.4 for the company or around 10 times estimated profits for 2009. Such a low P/E for a fast growing company looks very attractive to us. Moreover, we know its founder and CEO very well and have great faith in his managerial skills.

**Resmed**

We purchased shares of Resmed in 2003, an Australian company that is the World leader in sleep disorder medical products. This segment is growing rapidly as more and more people are getting aware of the dangers of apnea. Resmed not only sells products, it helps the medical World and the population get more acquainted with the problem.

In 2008, sales were up 16% and EPS up 13%. Few companies had such a good performance in this economic environment. More importantly, it gained back some market shares from Respironics (now a division of the Dutch company Philips). The stock has over performed the indexes by going down only 29% (!). We believe that the company warrants its premium to the average company. So we are hanging on to ours shares even though they do not look as undervalued as some of our other holdings.

**Knight Transportation**

The trucking industry had to surf through a wave of problems in 2008: retail sales in constant descent, increase competition from railroads and high fuel prices (for a good part of the year). But that did not prevent Knight to continue to earn great returns: revenues were up 8% and EPS were down only 9%. Its efficiency ratio (the most important measure of competitive advantage) was maintained at 84%, more than 10% better than competitors. Its balance sheet is still without debt and with an excess cash level of $54 millions, even after having paid a dividend and repurchased shares.

This is why Knight Transportation was one of the few stocks to increase this year, ending up 9% compared to last year. When we first acquired shares of Knight in late 2003, we labeled it “an oasis in the desert” as it was a great company in a lousy industry. And it’s in great drought that we recognize the best sources!

**Walgreen’s**

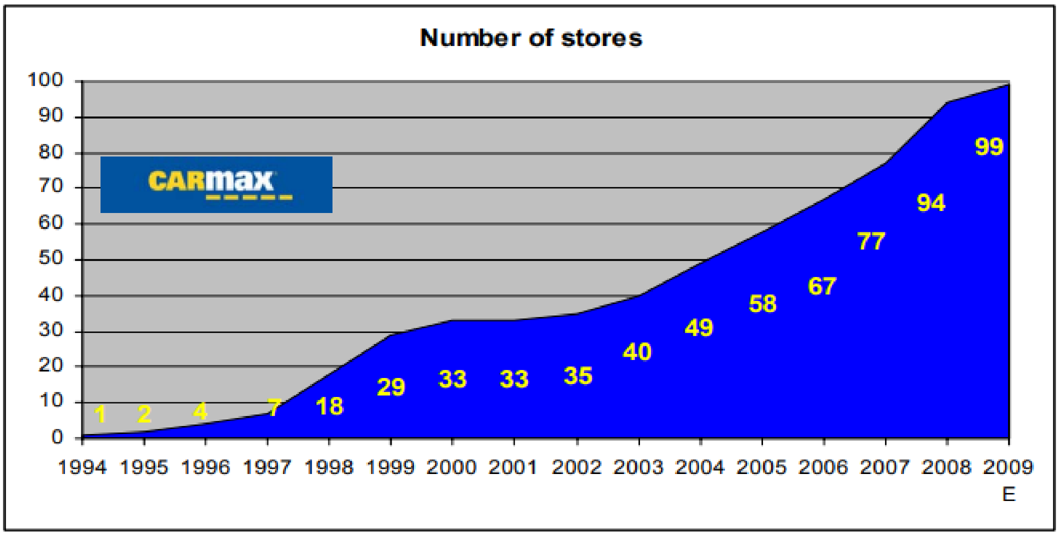
It was a tough year for Walgreen’s, the leading pharmacy chain in the US. SSS went up but at a lower growth rate than the company had accustomed its shareholders. EPS were similar to those of 2007. The stock should have done well in the stock market because of its “defensive” status. But there were few of those in 2008 in Wall Street: the stock went down 34% to $25, doing as poorly as the index.

As always, what counts is the increase in intrinsic value not what the stock does in the short run. It seems to us that long term fundamentals are not as good as they used to be. The company has reduced its long term target of store openings and decided to focus on increasing margins. Although it might be the wisest choice, this is not good news. When we purchase the stock some 6 years ago, the company was growing at a 16-17% growth rate and had maintained that rate for the previous 30 years. Very very few companies had such a track record!

A look at the industry leads us to believe that competition has increased lately. And from a larger base, Walgreen's growth rate should be lower going forward (probably 7-10%). The stock looks incredibly cheap (at a P/E of 11x) and has discounted even worse growth perspectives that we envision. But we are reconsidering this investment as we are finding even better opportunities in other stocks.

**Carmax**

Carmax is the US largest retailer of used cars. Headquartered in Richmond (Virginia), it currently operates 99 used car superstores in 46 markets. In addition, Carmax offers financing to most of its clients (through its CAF division). Loans from clients with good credit scores are pooled and sold on the securitization market. When FICO scores are low, they are sent to Bank of America. Carmax has been growing since its founding some 15 years ago. It went from one store to 99 stores as revenues reached $8 billions in 2007.




It is hard to imagine a worst economic flood for the auto industry than the year 2008 (although it looks like 2009 is going for the record). Sales of cars (both new and used) have gone down by 25%, a decrease rarely seen since its entry into our civilisation. In addition, Carmax had to cope with a terrible securitization market for most of the year and had to accept much lower margins. They also had to increase reserves for delinquencies. So the financial arm lost money in 2008. So in two years, EPS went from $0.92 to $0.11.

We had purchased a starting participation in 2007. As bad news were coming out, we decided to wait to purchase more shares. That does not change our view that the long term fundamentals of Carmax are great. Few companies have so much growth potential. The used car market is highly fragmented and the consumer can gain better services (and less problems) by purchasing at Carmax instead of the local dealer. In just a few years, Carmax has built an impressive brand name that is without equivalent in the industry. With only 2% of market shares, it could grow by 15-20% per year for the next decade and still own less than 10% of the market.

So we believe that we should be patient with that investment and even perhaps considering increasing our holding at some point in the future.

**Mohawk Industries**

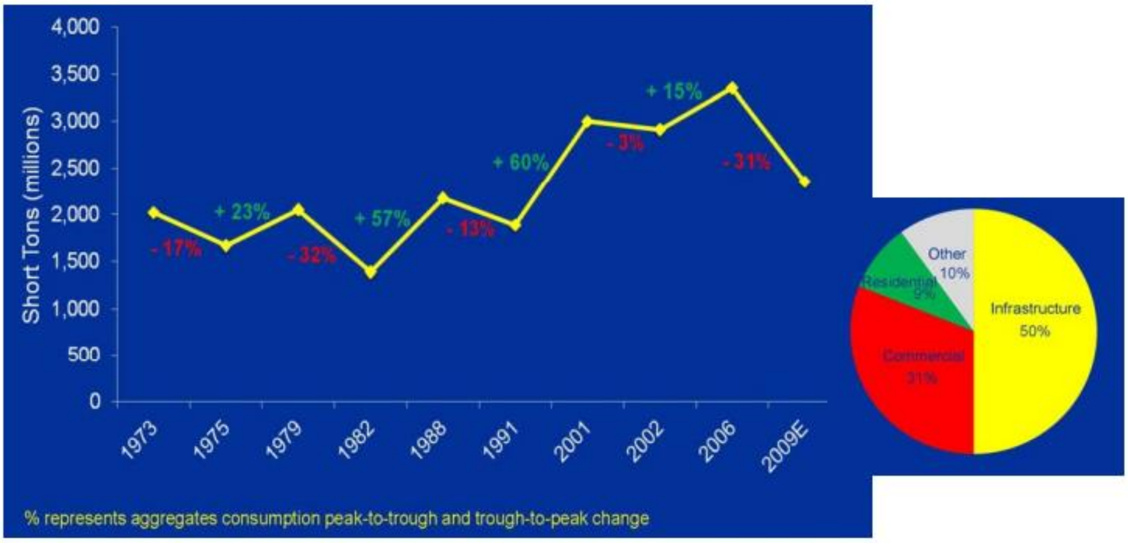
Mohawk Industries is one of the two main players in the flooring industry in the US. It is also an important player worldwide. The year 2008 was very difficult for the industry and for Mohawk. EPS went down 50%. Sales of carpets, tiles and hardwood floors we're down across all segments (commercial, residential and new home construction). Moreover, the increase in oil prices (until August) had a huge impact on gross margins (carpets are made from oil based products). Margins should improve later in 2009 as the company goes through its FIFO inventory. It is worth noting that its main US competitor, Shaw industries (a division of Berkshire Hathaway) had a similar drop in profits. So, it seems that Mohawk has not lost market shares. The other important ingredient is its CEO, Jeff Lorberbaum, who we admire greatly.

The stock had a volatile year. It fluctuated between $83 and $24, ending the year at $43. At its low, it traded at 3 times the earnings of the last cycle peak (2006). If in 5 years, the company returns to a more normal profitability level and trades at a P/E more in line with its historical norm, this stock could reach $120. So Mohawk stock looks to us as being quite undervalued.

<u>**New purchases in 2008**</u>

**Martin Marietta Materials**

We acquired shares of Martin Marietta Materials (MMM), the leading US aggregate producer. The company has strong competitive advantages and long life reserves (84 years). Because of the recession – including the drop in new home sales – aggregates consumption has its worst drop since 1982 as shown in the following chart. So we believe that there is a strong recovery potential.



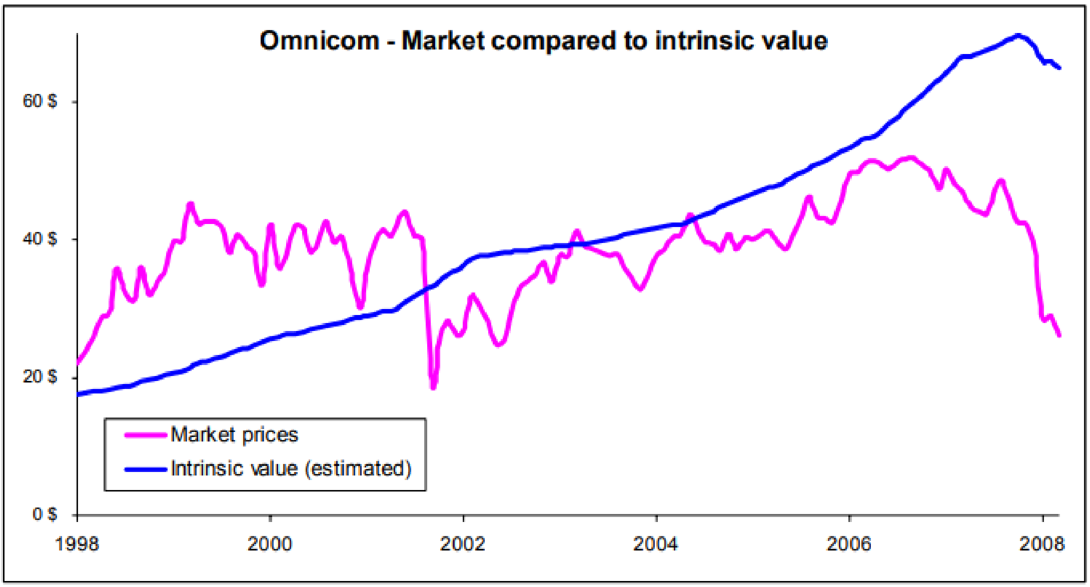

Moreover, according to our analysis, the mid and long term economics of this company are very promising. Around 50% of revenues come from infrastructure projects. This division should rebound in the next few quarters in light of the fact that the newly elected president Barack Obama has announced a major program of investments in that area. And, at some point, new home sales will go back up. So we believe that within the next 5 years or so, MMM earnings could more than double.

**Omnicom**

We have been following Omnicom since 1998. In fact, in 2006, the stock was in the "mistake du jour" section of our annual letter to partners. I explained that in 2002, the stock went from $49 to $18 on rumors of a financial scandal (that turned out to be unfunded). The stock had afterward rebounded to $53 in 2006. So I had lots of regrets to have stayed on the sideline four years earlier.

But in the stock market, we shall never lose patience. In 2008, the stock lost more than half its quoted value and was at $27 at year's end. The recession will have an impact on Omnicom's profitability but we believe that over the long term, its intrinsic value is intact.

It is interesting to note that in 2002, Omnicom realized EPS of $1.72 . In 2008, EPS reached $3.17. So the stock today is even more undervalued (at a P/E of 8x) than it was in 2002 at its low (P/E of 10x). Historically, Omnicom has traded at around 22 times earnings. So at its current level, we believe it is trading at a third of its underlying intrinsic value.




If you believe that decrease in stock value is bad for shareholders, we would tend to think otherwise. Since 2002, the company has bought back 60 millions of its own shares (or 16% of outstanding). It is way better for Omnicom to buy back its stock at 8 times earnings than at 16 times. So we think we will be rewarded from that investment in two ways: First by acquiring shares well bellow intrinsic value. Secondly, Omnicom increases shareholder's wealth by repurchasing its own shares at cheaper level.

**Five years post-mortem: 2003**

We try, on a regular basis, to do a post-mortem of our investment process when sufficient time has gone by. We believe that by studying our past decisions, we can learn from them.

In 2003, we had acquired shares of Factset Reseach, Expeditors International, Harley Davidson, Walgreen's, Fifth Third Bank, Resmed and bought back some First Data. Four of these companies were still in our portfolio at year's end (Factset, Expeditors, Walgreen's and Resmed).

Although we believe its brand to be solid, we sold Harley-Davidson a few months after our purchase. We were not comfortable with their finance division. Our fears were justified. Although it took a few years to materialize, the year 2008 was difficult for Harley. In addition to slower sales, the financial division is worrisome. And its stock went from a peak of $70 to $12 lately. This summer, I went to Milwaukee and visited the newly constructed Harley-Davidson museum. We can realize the strength of the company and of its brand. There are very few brands that people are ready to get tattooed on their body. Harley-Davidson is one of them!

First Data turned out ok. We sold our investment in 2005. The company was then split in two with the spin-off of Western Union. The other part was acquired by a private equity fund afterwards.

Finally, Fifth Third Bank was a poor investment. We sold our shares at around $40, two years after their purchase with a loss of 20%. The Cincinnati bank had a great history of outstanding returns for its shareholders. But sometimes, in capitalism, success creates its own anchor. When we look at today's price of $2 (I have to clean up my screen to be certain that there is not another digit in front of the "2"), we have no regrets that we sold our shares.

## Mistakes du jour

> *Success is a lousy teacher. It seduces smart people into thinking they can't lose.*
>
> *-Bill Gates*

As we do every year, here are our three modals for "best" mistake of the year just passed. As usual, it is with a constructive attitude that we share them with our partners and go into detailed analysis. In the hope to always improve ourselves as investors.

**Bronze Medal: First Cash Financial**

We owned shares of First Cash Financial Services (FCFS) for a few months in 2007. We had purchased them at around $17 and sold them under $10. It was not a good transaction. FCFS had two divisions. The first one was a chain of pawn shops, in the US and in Mexico. This division is highly profitable and almost immune to recessions. But FCFS had a second division, much smaller, that sold used cars with "easy" payments. I was not a fan of that business but since it was a modest part of the profits, we decided to invest a small weight. As usual, we started with a small weight to slowly learn to know management a little better (there nothing like implication to learn about something).

In 2007, the car division turned out to be losing money. The stock fell in half on the news of the December quarter of that year. We believed that FCFS had to sell that division (even give it away, liabilities included). To my great disappointment, FCFS top management decided to keep the trouble division believing that they could solve its problems.

For a few days, I reflected on the situation. I believed that it is was a mistake to continue holding on to the car division. One important criteria when we acquire shares in a company is to have confidence in its top people. Once we are shareholders, if we do not agree with them, we are faced with a tough decision. Obviously, we have no chance on making them change their mind. We either have to accept their decisions or sell our participation. We decided to sell.

The car division continued to lose money in 2008 (and profits to increase in the pawn shops division). But after a few quarters into 2008, FCFS' management decided to depart from that business. The stock promptly rebounded to $17. It was hard to predict such a turnaround in a management decisions (ego sometimes block wisdom in many human beings in powerful positions). It was frustrating since FCFS did chose the path we believe was best.

Was it a mistake to sell? I don't think so. Our reasons were valid. Could we have been more patient with the management of the company? I believe the answer to that question is yes.

**Silver Medal: Ritchie Brothers Auctioneers**

Ten years ago, a fellow money manager recommended to me Ritchie Brothers Auctionneers (RBA), a Canadian company specialized in farm and industrial equipment auctions. A dull business if there is one! RBA gets a percentage on every transaction so their capital needs is quite low. The difficulty lies in the ability to built a strong reputation to attract a critical mass of buyers and sellers. Once that difficulty is surmounted, auctioneers can be a great business (we just have to think of the solidity of Christie's and Sotheby's).

I knew in 1998 that RBA a built a strong nice but I was worried that the farm and industrial equipment auctions would be a cyclical activity. So RBA's P/E of 15x seemed a little high at that time. During the recession of 2001-2002, the company did well and after that the stock continued to trade at high P/Es (sometimes in the high 20s). So far this year, RBA has held up fine.

So after 10 years of following from the stands – for a better price – we can look at the numbers since 1998: sales and earnings have increased three fold and the stock has quadrupled.

**Gold Medal: Mastercard**

In May 2006, Mastecard went public at $45 a share. I knew the company pretty well since we were shareholders of American Express since 1995 (although we have bought and sold the stock at a few occasions over the 14 year period). Mastercard is not as solid as Visa or AMEX but it is a good business that would do well as a newly independent entity. I knew that momentum was pretty good (because of their "priceless" ad campaign). And that margin expansion potential was high.

The stock looked a little high considering that the company earned $1.98 in 2005. But since I knew that margins could be improved, I should not have been too influenced by its high P/E. 20 I took the time to compare market shares, spending per card and profitabilites of all three most important card companies. I believed that AMEX had the best brand. But I also knew that Mastercard and Visa did not lend to consumers, as AMEX was. Mastercard and Visa were just transaction processors and that it was the banks that carried the loans on their books. The two companies just received a fee for their work. It is a pretty good economic model.

I considered reducing AMEX by half and acquire some shares of Mastercard. But I finally decided to keep all our shares of AMEX, believing the long term growth perspectives were better even if the sensibility to recessions was higher.

As noted above, today's recession has hurt AMEX a lot and the company had to increase its reserves for bad loans. Mastercard was immune to such charges. EPS in 2008 for Mastercard reached

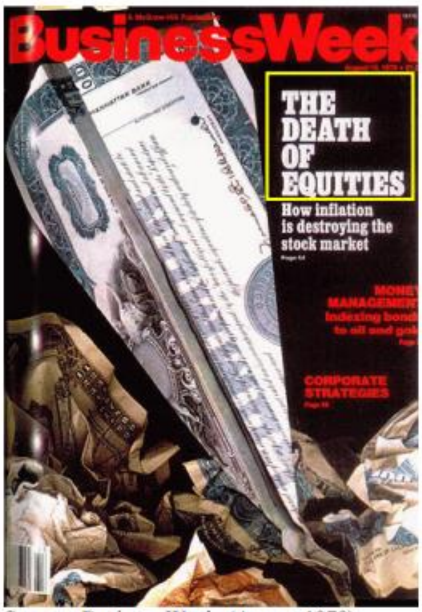
$9, a four and a half fold increase in three years. And the stock is up 200%.

Owning this stock in our portfolio would have been quite rewarding.

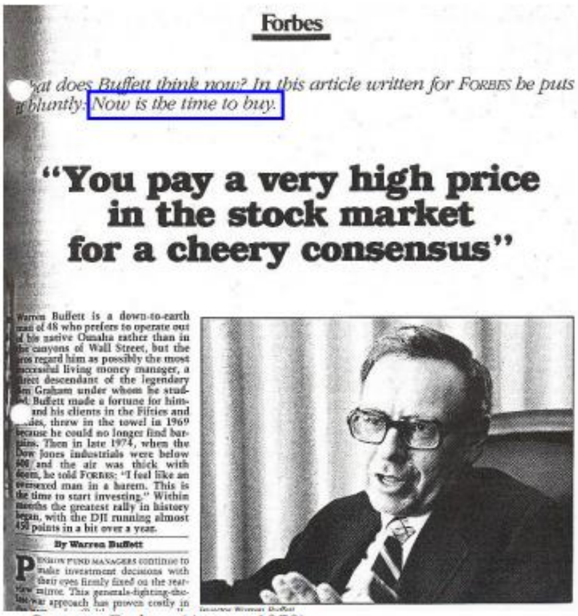
**Conclusion: Warren Buffett recommends to buy stocks for the first time since 1979**

By far, the best investor of all time is Warren Buffett. I have read everything I could find (past and present) about him. In only two instances in the past, Mr. Buffett had recommended to invest, with enthusiasm, in the stock market: in 1974 and 1979. Until this year.

In 1979, the stock market was depressed to a point that Business Week published its now famous edition entitled: “The Death of Equities”. At about the same time, Warren Buffett published an article in Forbes entitled: “You pay a very high price in the stock market for a cheery consensus”.



Source : Business Week (August 1979)



Forbes

...at does Buffett think now? In this article written for FORBES he puts ...bluntly: Now is the time to buy.

**“You pay a very high price in the stock market for a cheery consensus”**

Warren Buffett is a down-to-earth man of 48 who prefers to operate out of his native Omaha rather than in the canyons of Wall Street, but the pros regard him as possibly the most successful living money manager, a direct descendant of the legendary Ben Graham under whom he studied. Buffett made a fortune for him... and his clients in the Fifties and ...ties, threw in the towel in 1969 because he could no longer find bargains. Then in late 1974, when the Dow Jones industrials were below 600 and the air was thick with doom, he told FORBES: “I feel like an oversexed man in a harem. This is the time to start investing.” Within months the greatest rally in history began, with the DJI running almost 450 points in a bit over a year.

By Warren Buffett

PENSION FUND MANAGERS continue to make investment decisions with their eyes firmly fixed on the rear-view mirror. This generals-fighting-the-last-war approach has proven costly in ...

Source : Forbes (August 1979)

In its 1979 article, Warren Buffett explained that it was not optimism but pessimism that was the friend of the true long term investor. That it is pessimism that creates the bargains in the stock market that lead to enrichment in the years to follow.

What has that market done in the following 10 years of these two articles (from 1979 to 1989)? A total return of 400% or 17% on an annual basis, one of the best decade in market's history!

Almost 30 years later, Warren Buffett wrote a similar article in the New York Times edition of October 17th 2008. He strongly urged investors that take advantage of the recession and the high level of fears that were (and still are) present in the stock market.

He was once again an aggressive buyer of stocks when others were selling!

**To our partners**

We are deeply aware of your vote of confidence in us and look forward to reward it in the years to come. It is imperative for us to not only select outstanding companies but also to have great stewardship in the managing of your capital. So we never let our emotions dictate our decisions, particularly during financial crisis.

We wish all of our partners a great year 2009.

François Rochon

François Rochon and the Giverny Capital team

# Terry Smith 2021 Letter

Dear Fellow Investor,

This is the twelfth annual letter to owners of the Fundsmith Equity Fund ('Fund').

The table below shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1st November 2010 and various comparators.

| % Total Return | 1st Jan to 31st Dec 2021 | Inception to 31st Dec 2021 Cumulative | Annualised | Sharpe ratio[5] | Sortino ratio[5] |
|---|---|---|---|---|---|
| Fundsmith Equity Fund[1] | +22.1 | +570.7 | +18.6 | 1.31 | 1.25 |
| Equities[2] | +22.9 | +287.1 | +12.9 | 0.78 | 0.74 |
| UK Bonds[3] | -4.5 | +40.9 | +3.1 | n/a | n/a |
| Cash[4] | +0.1 | +6.4 | +0.6 | n/a | n/a |

The Fund is not managed with reference to any benchmark, the above comparators are provided for information purposes only.
[1] T Class Accumulation shares, net of fees, priced at noon UK time, source: Bloomberg
[2] MSCI World Index, £ net, priced at US market close, source: Bloomberg
[3] Bloomberg/Barclays Bond Indices UK Gov. 5–10 year, source: Bloomberg
[4] £ Interest Rate, source: Bloomberg
[5] Sharpe & Sortino ratios are since inception to 31.12.21, 1.5% risk free rate, source: Financial Express Analytics

The table shows the performance of the T Class Accumulation shares, the most commonly held share class and one in which I am invested, which rose by +22.1% in 2021 and compares with a rise of +22.9% for the MSCI World Index in sterling with dividends reinvested. The Fund therefore marginally underperformed this comparator in 2021 but is still the best performer since its inception in November 2010 in the Investment Association Global sector with a return 357 percentage points above the sector average which has delivered just +213.9% over the same timeframe.

However, I realise that many or indeed most of our investors do not use these as natural comparators for their investments. Those of you who are based in the UK may look to the FTSE 100 Index ('FTSE 100') as the yardstick for measuring your investments and may hold funds which are benchmarked to this index and often hug it. The FTSE 100 delivered a total return of +18.4% in 2021 so our Fund outperformed this by a margin of 3.7 percentage points.

Whilst a period of underperformance against the MSCI World Index is never welcome it is nonetheless inevitable. No investment strategy will outperform in every reporting period and every type of market condition. So, as much as we may not like it, we can expect some periods of underperformance.

This is particularly so when we have a period like 2020–21 which was obviously heavily influenced by the pandemic. Our Fund outperformed the market by 6% in 2020 when the economic effects of the pandemic were at their height and most of the businesses we are invested in proved to be highly resilient. However, last year was more of a year of recovery and our companies had relatively little to recover from.

We find it difficult to outperform in particularly bullish periods where the market has a strong rise — 22.9% in 2021 — as a rising tide floats all ships, including some which might otherwise have remained stranded and that we would not wish to own.

In investment, as in life, you cannot have your cake and eat it, so it is difficult if not impossible to find companies which are resilient in a downturn but which also benefit fully from the subsequent recovery. Of course, you could try to trade out of the former and into the latter at an appropriate time but it is not what we seek to do as the vast majority of the returns which our Fund generates come from the ability of the companies we own to invest their retained earnings at a high rate of return because they own businesses with good returns and growth opportunities. In our view it would be a mistake to sell some of these good businesses in order to invest temporarily in companies which are much worse but which have greater recovery potential.

For the year the top five contributors to the Fund's performance were:

| | |
|---|---|
| Microsoft | +3.9% |
| Intuit | +3.1% |
| Novo Nordisk | +2.3% |
| Estée Lauder | +2.0% |
| IDEXX | +1.9% |

Microsoft makes its seventh appearance on this list, IDEXX its fourth, Intuit its third, Novo Nordisk and Estée Lauder their second. Someone once said that no one ever got poor by taking profits. This may be true but I doubt they got very rich by this approach either, as I've observed before. We continue to pursue a policy of trying to run our winners.

The bottom five were:

| | |
|---|---|
| PayPal | -0.7% |
| Amadeus | -0.2% |
| Kone | -0.2% |
| Unilever | -0.2% |
| Brown-Forman | -0.1% |

PayPal's performance last year was a clear exception to the benefits of running winners. The shares performed poorly amid concerns that its ambitions to construct a 'super app' to drive users to its payment systems might involve some value destruction, brought home by its apparent interest in acquiring social media operator Pinterest. We may be wrong but we would prefer if PayPal stuck to its knitting.

Amadeus is clearly still suffering from the effects of the pandemic on travel which is hardly surprising given that airline reservations are its largest business segment. However, we remain convinced that Amadeus will both survive this downturn and emerge in a stronger market position.

Kone was affected by the travails of the Chinese construction sector which represents its largest market.

Unilever seems to be labouring under the weight of a management which is obsessed with publicly displaying sustainability credentials at the expense of focusing on the fundamentals of the business. The most obvious manifestation of this is the public spat it has become embroiled in over the refusal to supply Ben & Jerry's ice cream in the West Bank. However, we think there are far more ludicrous examples which illustrate the problem. A company which feels it has to define the purpose of Hellmann's mayonnaise has in our view clearly lost the plot. The Hellmann's brand has existed since 1913 so we would guess that by now consumers have figured out its purpose (spoiler alert — salads and sandwiches). Although Unilever had by far the worst performance of our consumer staples stocks during the pandemic we continue to hold the shares because we think that its strong brands and distribution will triumph in the end.

Brown-Forman struggled under the twin impacts of the on trade shutdowns caused by the pandemic and EU tariffs on American sprits which gave us the opportunity to increase our stake. We expect both these headwinds to dissipate.

We sold our stakes in Intertek, Sage, Becton Dickinson, InterContinental Hotels and purchased a stake in Amazon and an as yet undisclosed position during the year.

sure some will see this as some clue that we are selling out of the UK, or that we have some view on the prospects for the FTSE 100 versus the S&P 500 Index (S&P 500) or some other market or macro view. This is not the case. We invest in companies not indices or countries and in our view the country where a company is listed is largely irrelevant, if of course it has a well regulated stock market, and certainly does not provide a good guide to where the company generates its revenues. For example, InterContinental Hotels is listed in the UK but its largest market is the United States, hence why it reports in US dollars.

I don't intend to go into the reasoning on every sale and purchase transaction but the purchase of Amazon has attracted a lot of attention as we had previously declined to purchase its shares. Rather than give a lengthy rationale I would rather summarise it with a quote from the economist (and successful fund manager) John Maynard Keynes who said, 'When the facts change, I change my mind.' Although it could be explained by the simpler aphorism 'Better late than never' or at least it will be if our purchase delivers the performance we expect.

We continue to apply a simple three step investment strategy:

- Buy good companies
- Don't overpay
- Do nothing

I will review how we are doing against each of those in turn.

As usual we seek to give some insight into the first and most important of these — whether we own good companies — by giving you the following table which shows what Fundsmith would be like if instead of being a fund it was a company and accounted for the stakes which it owns in the portfolio on a 'look-through' basis, and compares this with the market, in this case the FTSE 100 and the S&P 500. This shows you how the portfolio compares with the major indices and how it has evolved over time.

| | **Fundsmith Equity Fund Portfolio** | | | | | | | | **S&P 500** | **FTSE 100** |
|---|---|---|---|---|---|---|---|---|---|---|
| **Year ended** | **2014** | **2015** | **2016** | **2017** | **2018** | **2019** | **2020** | **2021** | **2021** | **2021** |
| ROCE | 29% | 26% | 27% | 28% | 29% | 29% | 25% | 28% | 16% | 14% |
| Gross margin | 60% | 61% | 62% | 63% | 65% | 66% | 65% | 64% | 45% | 45% |
| Operating margin | 25% | 25% | 26% | 26% | 28% | 27% | 23% | 26% | 17% | 15% |
| Cash conversion | 102% | 98% | 99% | 102% | 95% | 97% | 101% | 95% | 106% | 124% |
| Interest cover | 15x | 16x | 17x | 17x | 17x | 16x | 16x | 23x | 9x | 8x |

Source: Fundsmith LLP/Bloomberg. ROCE, Gross Margin, Operating Profit Margin and Cash Conversion are the weighted mean of the underlying companies invested in by the Fundsmith Equity Fund and mean for the FTSE 100 and S&P 500 Indices. The FTSE 100 and S&P 500 numbers exclude financial stocks. Interest Cover is median. 2013-2019 ratios are based on last reported fiscal year accounts as at 31st December and for 2020-21 are Trailing Twelve Months and as defined by Bloomberg. Cash Conversion compares Free Cash Flow per Share with Net Income per Share. Percentage change is not calculated if the TTM period contains a net loss.

Returns on capital and profit margins were higher in the portfolio companies in 2021 recovering from the downturn in 2020.

As a group our stocks still have excellent returns, profit margins and cash generation even in poor economic conditions. As you can see the same cannot be said for the major indices — with the exception of their current cash conversion which I suspect is a temporary phenomenon — if you can't get the stock you need because of supply chain problems, cash tied up in working capital is likely to be low. It's also worth remembering that the index numbers have the benefit of including our good companies.

The average year of foundation of our portfolio companies at the year-end was 1926. They are just under a century old collectively.

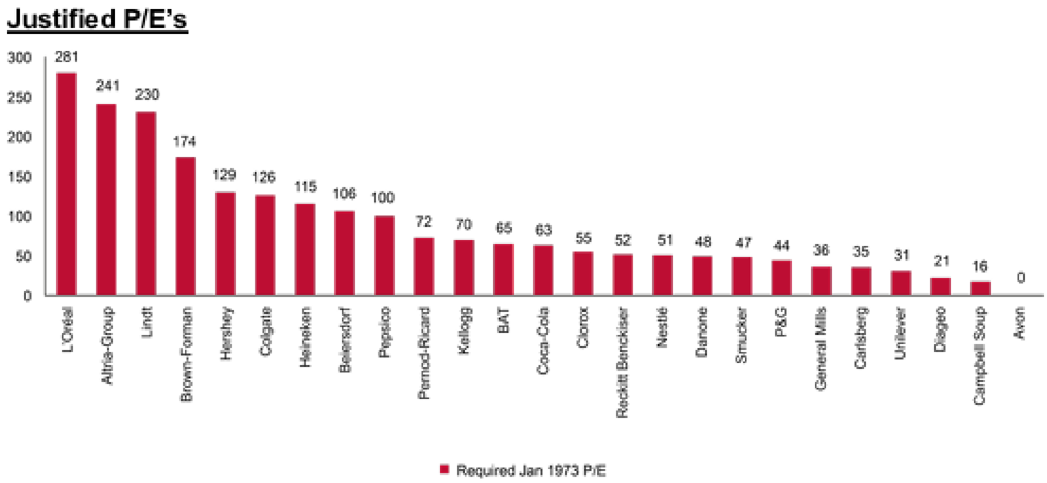
Consistently high returns on capital are one sign we look for when seeking companies to invest in. Another is a source of growth — high returns are not much use if the business is not able to grow and deploy more capital at these high rates. So how did our companies fare in that respect in 2021? The weighted average free cash flow (the cash the companies generate after paying for everything except the dividend, and our preferred measure) grew by 20% in 2021.

This leads onto the question of valuation. The weighted average free cash flow ('FCF') yield (the free cash flow generated as a percentage of the market value) of the portfolio at the outset of the year was 2.8% and ended it at 2.7%.

The year-end median FCF yield on the S&P 500 was 3.6%. The year end median FCF yield on the FTSE 100 was 5.4%.

Our portfolio consists of companies that are fundamentally a lot better than the average of those in either index and are valued higher than the average S&P 500 company and much higher than the average FTSE 100 company. However, it is wise to bear in mind that despite the rather sloppy shorthand used by many commentators, highly rated does not equate to expensive any more than lowly rated equates to cheap.

The bar chart below may help to illustrate this point. It shows the 'Justified P/Es' of a number of stocks of the kind we invest in. What it shows is the Price/Earnings ratio (P/E) you could have paid for these stocks in 1973 and achieved a 7% compound annual growth rate (CAGR) over the next 46 years (to 2019), versus the 6.2% CAGR the MSCI World Index (USD) returned over the same period. In other words, you could have paid these prices for the stocks and beaten the index — something the perfect markets theorists would maintain you can't do.



Source: Ash Park Capital and Refinitiv Datastream, excludes dividends, in USD.

You could have paid a P/E of 281x for L'Oréal, 174x for Brown Forman, 100x for PepsiCo, 44x for Procter & Gamble and a mere 31x for Unilever.

I am not suggesting we will pay those multiples but it puts the sloppy shorthand of high P/Es equating to expensive stocks into perspective.

Turning to the third leg of our strategy, which we succinctly describe as 'Do nothing', minimising portfolio turnover remains one of our objectives and this was again achieved with a portfolio turnover of 5.6% during the period. It is perhaps more helpful to know that we spent a total of just 0.009% (just under one basis point) of the Fund's average value over the year on voluntary dealing (which excludes dealing costs associated with subscriptions and redemptions as these are involuntary). We have held seven of our portfolio companies since inception in 2010.

Why is this important? It helps to minimise costs and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on, or in some cases obsess about, the Annual Management Charge ('AMC') or the Ongoing Charges Figure ('OCF'), which includes some costs over and above the AMC, which are charged to the Fund. The OCF for 2021 for the T Class Accumulation shares was 1.04%. The trouble is that the OCF does not include an important element of costs — the costs of dealing. When a fund manager deals by buying or selling, the fund typically incurs the cost of commission paid to a broker, the bid-offer spread on the stocks dealt in and, in some cases, transaction taxes such as stamp duty in the UK. This can add significantly to the costs of a fund, yet it is not included in the OCF.

We provide our own version of this total cost including dealing costs, which we have termed the Total Cost of Investment ('TCI'). For the T Class Accumulation shares in 2021 this amounted to a TCI of 1.05%, including all costs of dealing for flows into and out of the Fund, not just our voluntary dealing. We are pleased that our TCI is just 0.01% (1 basis point) above our OCF when transaction costs are taken into account. However, we would again caution against becoming obsessed with charges to such an extent that you lose focus on the performance of funds. Some commentators state that an investor's primary focus should be on fees. To quote Charlie Munger (albeit in another context) this is 'Twaddle'. It is worth pointing out that the performance of our

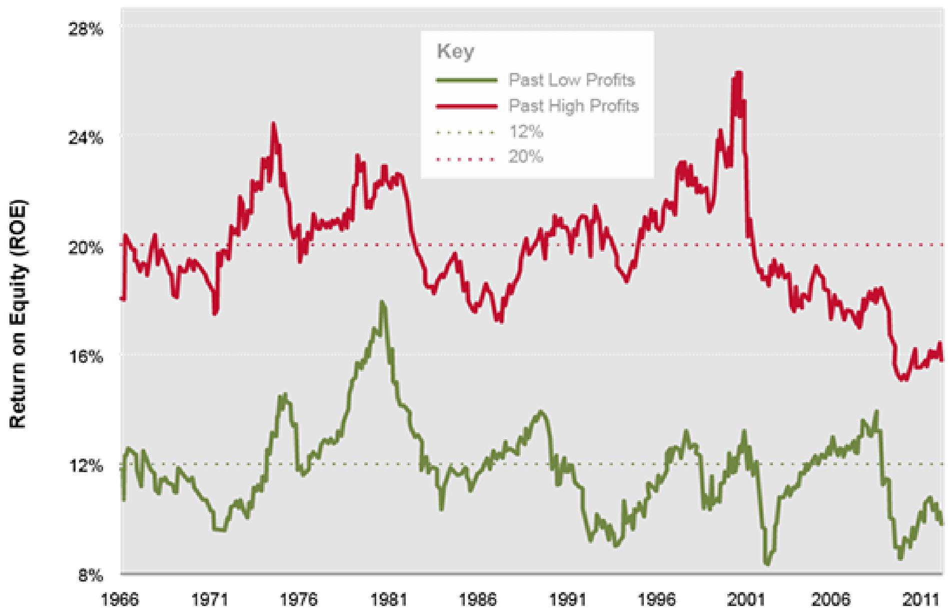
Fund tabled at the beginning of this letter is after charging all fees which should surely be the main focus.

Turning to the themes which dominated 2021, you may have heard a lot talked about the so-called ‘rotation’ from quality stocks of the sort we seek to own to so-called value stocks, which in many cases is simply taken as equating to lowly rated companies. Somewhat related to this there was periodic excitement over so-called reopening stocks which could be expected to benefit as and when we emerge from the pandemic — airlines and the hospitality industry, for example.

There are multiple problems with an approach which involves pursuing an investment in these stocks. Timing is obviously an issue. Another is that their share prices may already over anticipate the benefits of the so-called reopening. As Jim Chanos, the renowned short seller, observed ‘The worst thing that can happen to reopening stocks is that we reopen.’ It is often better to travel hopefully than to arrive.

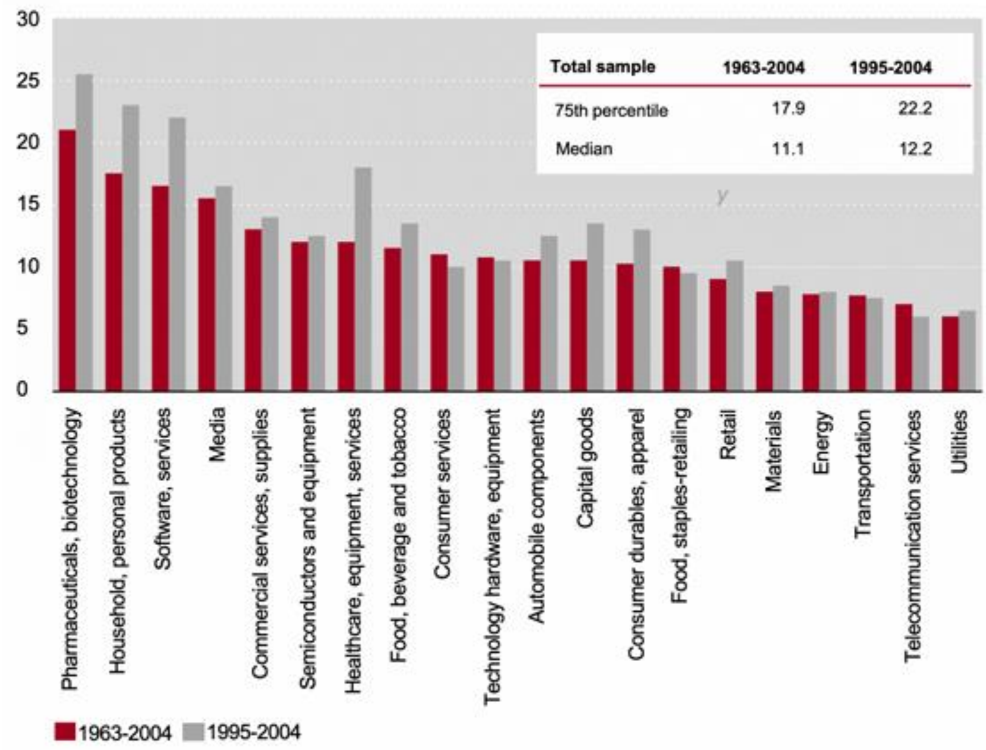
In our view, the biggest problem with any investment in low quality businesses is that on the whole the return characteristics of businesses persist. Good sectors and businesses remain good and poor return businesses also have persistently poor returns as the charts below show:

**Persistence in Profitability**




Source: GMO. The 1000 largest companies in the U.S. were sorted for each point in the graph into quartiles based on return on equity (ROE). Past Low Profits consists of those companies in the quartile with the lowest ROE. Past High Profits consists of those companies in the quartile with the greatest ROE.

**Median and annual ROIC, excluding goodwill %**




Source: McKinsey

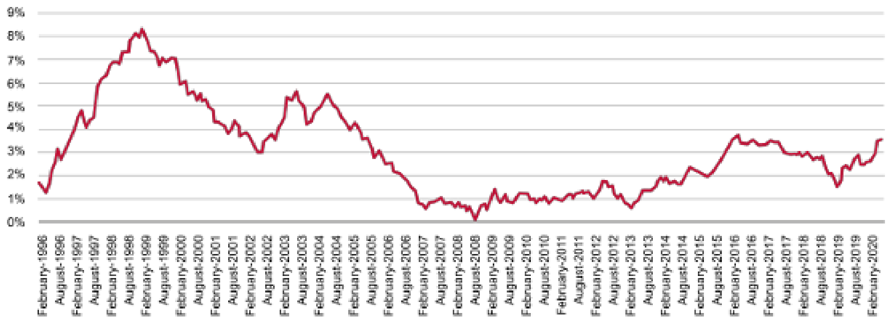
These return characteristics persist because good businesses find ways to fend off the competition — what Warren Buffett calls 'The Moat' — strong brands; control of distribution; high spend on product development, innovation, marketing and promotion; patents and installed bases of equipment and/or software which are troublesome to change for example.

Poor returns also persist because companies which have many competitors, no control over pricing and/or input costs, and an ability for consumers to prolong the life of the product in a downturn (like cars) cannot suddenly throw off these poor characteristics just because they are lowly rated and/or benefit from an economic recovery.

Contrary to the mantra that every fund has to recite, past returns of companies are a good guide to future returns.

Even if you manage to identify a truly cheap value or reopening stock and time the rotation into that stock correctly so as to make a profit, this will not transform it into a good long term investment. You need to sell it at a good moment — presumably when some of your fellow punters investors will also be doing so because its cheapness will not transform it into a good business and in the long run it is the quality of the business that you invest in which determines your returns.

The chart below shows the excess returns — the amount by which it beats the index — of the MSCI World Quality Index (which I am taking as a surrogate for our strategy). Over the last 25 years there has never been a rolling 120 month (ten year) period when quality has not performed as well as or better than the MSCI World Index.




Source: MSCI

I know 10 years is a long time and well beyond the time horizon of most investors, but we are long term investors and aim to capture this inevitable outperformance by good companies. If this investment time horizon is too long for you then you may be invested in the wrong fund. Moreover, if anything this chart flatters the outcome of investing in low quality, cyclical, value or recovery stocks as the index with which the quality stocks are being compared includes those quality stocks. If they were taken out of the index, the relative outperformance would be even more pronounced.

You may have heard a lot about inflation over the past year and I suspect you will continue to hear more about it in 2022.

In some respects, we needn't discuss whether or not we have inflation — German wholesale prices were up 16.6% year on year in November but were easily trumped by Spain whose producer price index (PPI) rose 33.1% in the same period. However, that eye catching statistic is far from the whole story.

It is not difficult to see potential causes of inflation. The expansion of central bank balance sheets with Quantitative Easing after the Credit Crisis has been followed by huge monetary and fiscal stimuli put in place to counter the economic effects of the pandemic. One might reason that given the growth in the money supply has vastly outstripped the increases in production of goods and services the price of those goods and services was sure to be bid up and ipso facto inflation must follow.

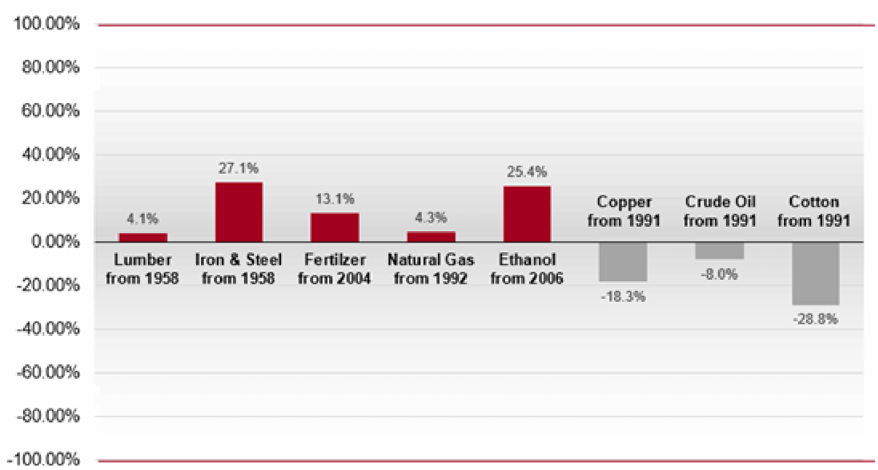
However, this omits another important element of the equation — the velocity of circulation of money. Are people more inclined to save the additional money or to spend it? The savings ratio leapt after the Credit Crisis and again during the pandemic partly no doubt due to caution but also because there were fewer opportunities to spend, for example on travel and vacations.

However, it is now on its way back to pre-crisis levels so maybe we have all the ingredients for inflation to take hold.

You might well be confused at this point (I know I am) particularly considering that the 'authorities' spent most of the decade post the Credit Crisis trying to generate inflation in order to negate the deflationary effects of the Credit Crisis and its causes. The trouble is that with inflation, as with so much else, you need to be careful what you wish for. It is a bit like trying to light a bonfire or a traditional BBQ on a damp day. If you put an accelerant like gasoline on it you can go from no fire to a loud 'Whoosh!' and find that you have also set fire to the garden fence. When inflation takes hold, it too may exceed your expectations.

In terms of how to react, if at all, there are also other factors to consider. Inflation in the cost of commodities does not necessarily equate to retail price inflation or asset inflation. The chart below attempts to correlate the price increases or decreases in a number of commodities with the Consumer Price Index over time.

Correlation of Long Term Commodity Prices With Inflation




Source: Federal Reserve Economic Research. 100% = perfect positive correlation, 0% = no correlation, -100% = perfect negative correlation.

As you can see, there is no correlation. One of the reasons for this is that consumers do not buy commodities. They are bought by companies which make them into the goods which consumers buy. Interestingly, the eye-popping Spanish PPI rise of 33.1% in the year to November included an 88% increase in energy prices, 48% for basic metals and 16% for paper products but only 8.3% for food. Consumers don't buy basic metals.

So the initial impact of input cost inflation is not on consumer prices but on company profits. All companies are not equal in this regard. The higher a company's gross margin — the difference between its sales revenues and cost of goods sold — the better its profitability is protected from inflation.

The table below shows the impact of input cost inflation on two companies in the consumer sector — L'Oréal which we own and Campbell's Soup, which we do not own. L'Oréal has gross margins of 73% and Campbell's has 35%. A 5% rise in input cost inflation would cut L'Oréal's profits by 7% if it took no other action, whereas Campbell's profits would fall by 22%.

**Impact of 5% Inflation**

| L'Oreal | Before | After |
|---|---|---|
| **% of revenues** | | |
| Revenue | 100% | 100% |
| COGs | 27% | 28% |
| Gross profit | 73% | 72% |
| SG&A | 55% | 55% |
| Operating profit | 18% | 17% |
| **Decline in profit** | | **-7%** |

| Campbell's | Before | After |
|---|---|---|
| **% of revenues** | | |
| Revenue | 100% | 100% |
| COGs | 65% | 68% |
| Gross profit | 35% | 32% |
| SG&A | 20% | 20% |
| Operating profit | 15% | 12% |
| **Decline in profit** | | **-22%** |

Source: Fundsmith Research

You will recall from the look-through table earlier that our portfolio companies have gross margins of over 60%, versus about 40% for the average company in the index. So, from a fundamental respect our companies are likely to be better able to weather inflation.

However, inflation also affects valuations. Rises in inflation and interest rates also do not affect the valuation of all companies equally. In the bond market, the longer the maturity of a bond, the more sensitive its valuation is to rate changes. A short-dated bond soon matures and the proceeds can be reinvested at whatever the new rate is. The same is not true of a 10 or 30 year bond.

The equivalent to the duration of a bond in terms of equities is the valuation multiple whether it is expressed in terms of earnings or, as we would prefer, cash flows. The higher rated a company's shares are, the more it will be affected by changes in inflation or interest rates. This is one reason why the shares of the new wave of unprofitable tech companies have performed so poorly latterly. As they are loss-making more than 100% of their expected value is in the future (there are probably other reasons like the growing realisation that you are often being invited to invest in a business plan rather than a business).

So in brief, if inflation is seen to have taken hold rather more than some people, including the Federal Reserve Bank expects, then we are probably in for an uncomfortably bumpy ride in terms of valuations but we can be relatively sanguine in terms of the effect on the fundamental performance of our portfolio businesses which is our primary focus.

The good news is that we do not invest on the basis of our ability to forecast inflation or any other macroeconomic factor. We invest in companies not countries, indices or macroeconomic forecasts. I would like to leave you with this thought: our Fund has prospered during the pandemic. The companies it invests in have endured much more — the Great Depression, World War II, the Great Inflation of 1965–82, the Dotcom meltdown and the Credit Crisis. They will probably survive whatever comes next and so will we if we stick to our principles and we have every intention of doing so.

Finally, may I wish you a happy New Year and thank you for your continued support for our Fund.

Yours sincerely,

Terry Smith

Terry Smith
CEO
Fundsmith LLP

# Jeff Bezos 1997 Shareholder Letter

To our shareholders:

Amazon.com passed many milestones in 1997: by year-end, we had served more than 1.5 million customers, yielding 838% revenue growth to $147.8 million, and extended our market leadership despite aggressive competitive entry.

But this is Day 1 for the Internet and, if we execute well, for Amazon.com. Today, online commerce saves customers money and precious time. Tomorrow, through personalization, online commerce will accelerate the very process of discovery. Amazon.com uses the Internet to create real value for its customers and, by doing so, hopes to create an enduring franchise, even in established and large markets.

We have a window of opportunity as larger players marshal the resources to pursue the online opportunity and as customers, new to purchasing online, are receptive to forming new relationships. The competitive landscape has continued to evolve at a fast pace. Many large players have moved online with credible offerings and have devoted substantial energy and resources to building awareness, traffic, and sales. Our goal is to move quickly to solidify and extend our current position while we begin to pursue the online commerce opportunities in other areas. We see substantial opportunity in the large markets we are targeting. This strategy is not without risk: it requires serious investment and crisp execution against established franchise leaders.

*It's All About the Long Term*

We believe that a fundamental measure of our success will be the shareholder value we create over the long term. This value will be a direct result of our ability to extend and solidify our current market leadership position. The stronger our market leadership, the more powerful our economic model. Market leadership can translate directly to higher revenue, higher profitability, greater capital velocity, and correspondingly stronger returns on invested capital.

Our decisions have consistently reflected this focus. We first measure ourselves in terms of the metrics most indicative of our market leadership: customer and revenue growth, the degree to which our customers continue to purchase from us on a repeat basis, and the strength of our brand. We have invested and will continue to invest aggressively to expand and leverage our customer base, brand, and infrastructure as we move to establish an enduring franchise.

Because of our emphasis on the long term, we may make decisions and weigh tradeoffs differently than some companies. Accordingly, we want to share with you our fundamental management and decision-making approach so that you, our shareholders, may confirm that it is consistent with your investment philosophy:

We will continue to focus relentlessly on our customers.

- We will continue to make investment decisions in light of long-term market leadership considerations rather than short-term profitability considerations or short-term Wall Street reactions.
- We will continue to measure our programs and the effectiveness of our investments analytically, to jettison those that do not provide acceptable returns, and to step up our investment in those that work best. We will continue to learn from both our successes and our failures.
- We will make bold rather than timid investment decisions where we see a sufficient probability of gaining market leadership advantages. Some of these investments will pay

off, others will not, and we will have learned another valuable lesson in either case.

- When forced to choose between optimizing the appearance of our GAAP accounting and maximizing the present value of future cash flows, we'll take the cash flows.
- We will share our strategic thought processes with you when we make bold choices (to the extent competitive pressures allow), so that you may evaluate for yourselves whether we are making rational long-term leadership investments.
- We will work hard to spend wisely and maintain our lean culture. We understand the importance of continually reinforcing a cost-conscious culture, particularly in a business incurring net losses.
- We will balance our focus on growth with emphasis on long-term profitability and capital management. At this stage, we choose to prioritize growth because we believe that scale is central to achieving the potential of our business model.
- We will continue to focus on hiring and retaining versatile and talented employees, and continue to weight their compensation to stock options rather than cash. We know our success will be largely affected by our ability to attract and retain a motivated employee base, each of whom must think like, and therefore must actually be, an owner.

We aren't so bold as to claim that the above is the "right" investment philosophy, but it's ours, and we would be remiss if we weren't clear in the approach we have taken and will continue to take.

With this foundation, we would like to turn to a review of our business focus, our progress in 1997, and our outlook for the future.

*Obsess Over Customers*

From the beginning, our focus has been on offering our customers compelling value. We realized that the Web was, and still is, the World Wide Wait. Therefore, we set out to offer customers something they simply could not get any other way, and began serving them with books. We brought them much more selection than was possible in a physical store (our store would now occupy 6 football fields), and presented it in a useful, easy-to search, and easy-to-browse format in a store open 365 days a year, 24 hours a day. We maintained a dogged focus on improving the shopping experience, and in 1997 substantially enhanced our store. We now offer customers gift certificates, 1-Click(SM) shopping, and vastly more reviews, content, browsing options, and recommendation features. We dramatically lowered prices, further increasing customer value. Word of mouth remains the most powerful customer acquisition tool we have, and we are grateful for the trust our customers have placed in us. Repeat purchases and word of mouth have combined to make Amazon.com the market leader in online bookselling.

By many measures, Amazon.com came a long way in 1997:

- Sales grew from $15.7 million in 1996 to $147.8 million -- an 838% increase.
- Cumulative customer accounts grew from 180,000 to 1,510,000 -- a 738% increase.
- The percentage of orders from repeat customers grew from over 46% in the fourth quarter of 1996 to over 58% in the same period in 1997.
- In terms of audience reach, per Media Metrix, our Web site went from a rank of 90th to within the top 20.
- We established long-term relationships with many important strategic partners, including America Online,

Yahoo!, Excite, Netscape, GeoCities, AltaVista, @Home, and Prodigy.

*Infrastructure*

During 1997, we worked hard to expand our business infrastructure to support these greatly increased traffic, sales, and service levels:

- Amazon.com's employee base grew from 158 to 614, and we significantly strengthened our management team.
- Distribution center capacity grew from 50,000 to 285,000 square feet, including a 70% expansion of our Seattle facilities and the launch of our second distribution center in Delaware in November.
- Inventories rose to over 200,000 titles at year-end, enabling us to improve availability for our customers.
- Our cash and investment balances at year-end were $125 million, thanks to our initial public offering in May 1997 and our $75 million loan, affording us substantial strategic flexibility.

*Our Employees*

The past year's success is the product of a talented, smart, hard-working group, and I take great pride in being a part of this team. Setting the bar high in our approach to hiring has been, and will continue to be, the single most important element of Amazon.com's success.

It's not easy to work here (when I interview people I tell them, “You can work long, hard, or smart, but at Amazon.com you can't choose two out of three”), but we are working to build something important, something that matters to our customers, something that we can all tell our grandchildren about. Such things aren't meant to be easy. We are incredibly fortunate to have this group of dedicated employees whose sacrifices and passion build Amazon.com.

*Goals for 1998*

We are still in the early stages of learning how to bring new value to our customers through Internet commerce and merchandising. Our goal remains to continue to solidify and extend our brand and customer base. This requires sustained investment in systems and infrastructure to support outstanding customer convenience, selection, and service while we grow. We are planning to add music to our product offering, and over time we believe that other products may be prudent investments. We also believe there are significant opportunities to better serve our customers overseas, such as reducing delivery times and better tailoring the customer experience. To be certain, a big part of the challenge for us will lie not in finding new ways to expand our business, but in prioritizing our investments.

We now know vastly more about online commerce than when Amazon.com was founded, but we still have so much to learn. Though we are optimistic, we must remain vigilant and maintain a sense of urgency. The challenges and hurdles we will face to make our long-term vision for Amazon.com a reality are several: aggressive, capable, well-funded competition; considerable growth challenges and execution risk; the risks of product and geographic expansion; and the need for large continuing investments to meet an expanding market opportunity. However, as we've long said, online bookselling, and online commerce in general, should prove to be a very large market, and it's likely that a number of companies will see significant benefit. We feel good about what we've done, and even more excited about what we want to do.

1997 was indeed an incredible year. We at Amazon.com are grateful to our customers for their business and trust, to each other for our hard work, and to our shareholders for their support and encouragement.

/s/ JEFFREY P. BEZOS
Jeffrey P. Bezos
Founder and Chief Executive Officer
Amazon.com, Inc.

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# Nomad Investment Partnership

# Interim Letter

### For the period ended June 30th, 2009

| To June 30th, 2009 | Nomad Investment Partnership * | MSCI World Index (net) US$ |
|---|---|---|
| Trailing: | | |
| Year to date | +20.9% | +6.4 |
| One year | -16.5 | -29.5 |
| Two years | -31.7 | -37.0 |
| Three years | -11.5 | -22.2 |
| Four years | -2.5 | -9.0 |
| Five years | +23.1 | +0.2 |
| Six years | +73.6 | +24.2 |
| Seven years | +113.5 | +21.2 |
| Since inception (Sept 10th 2001) | +144.8 | +14.6 |
| | | |
| Annualized since inception: | | |
| Before performance fees | +12.1% | +1.8% |
| After performance fees including performance fees reimbursed | +9.6 | |

The figures above are unaudited, presented on a cumulative basis and, as ever, are before performance fees. Below the same results are presented in discrete annual increments. In our opinion it is the upper table that is most useful in assessing long- term investment performance.

| To June 30th, 2009: | Nomad Investment Partnership | MSCI World Index (net) US$ |
|---|---|---|
| Calendar Year Results: | | |
| 2009 (year to date) | +20.9% | +6.4% |
| 2008 | -45.3 | -40.7 |
| 2007 | +21.2 | + 9.0 |
| 2006 | +13.6 | +20.1 |
| 2005 | +9.2 | +9.5 |
| 2004 | +22.1 | +14.7 |
| 2003 | +79.6 | +33.1 |
| 2002 | +1.3 | -19.9 |
| 2001 | +10.1 | +3.6 |

*"This Abstract, which I now publish, must necessarily be imperfect. I cannot here give references and authorities for my several statements; and I must trust to the reader reposing some confidence in my accuracy. No doubt errors will have crept in, though I hope I have always been cautious in trusting to good authorities alone. I can here give only the general conclusions at which I have arrived, with a few facts in illustration, but which, I hope, in most cases will suffice. No one can feel more sensible than I do of the necessity of hereafter publishing in detail all the facts, with references, on which my conclusions have been grounded; and I hope in a future work to do this. For I am well aware that scarcely a single point is discussed in this volume on which facts cannot be adduced, often apparently leading to conclusions directly opposite to those at which I have arrived. A fair result can be obtained only by fully stating and balancing the facts and arguments on both sides of each question; and this cannot possibly be here done."*

So begins paragraph three of "On the Origin of Species by Means of Natural Selection" by Charles Darwin, the bicentenary of whose birth falls this year. The book took Darwin twenty years to write and may have done more than any, with the exception of the Bible, to shape man's self-perception. But just look, if you will, at the language of the introduction:

*"This Abstract must necessarily be imperfect…no doubt errors have crept in… I can here only give the general conclusions…I am well aware that scarcely a single point is discussed on which facts cannot be adduced, often apparently leading to conclusions directly opposite to those at which I have arrived…A fair result can only be obtained by fully stating and balancing the facts on both sides".*

One can hardly accuse the man of promotion! Darwin knew he was right but his findings troubled him personally. He was a Christian, in a Christian society, indeed he had considered studying theology before setting sail on HMS Beagle, and his new ideas challenged the church, his countrymen and his conscience. At major turning points in society, such as he was suggesting, how many of us, we wonder, would be modest about what we had discovered? Darwin's humility is an attractive human quality, perhaps because such understatement recognizes that the ideas were bigger than the man. Which, of course, they were. It is an interesting subconscious psychological tendency that truths are often spoken with a whispered voice whilst shaky suppositions are shouted for all to hear. It is not so much us that the shouters are convincing, as the need to convince themselves. We all shout to some extent, with agents usually shouting louder than principals: and that should tell us something. In the Nomad ecosystem we do try to keep the volume down somewhat. Like Darwin, perhaps, but on a very different scale, we recognize a few simple truths and we are conscious that our views, in the eyes of our peers, may not be very popular.

Empty Vessels and a Quieter Approach.

Upon reflection, it is curious that this quiet attitude extends, in its own way, to the companies in which we have entrusted your dollars: Amazon and Costco do not advertise (no shouting here); Berkshire Hathaway and Games Workshop do not provide earnings guidance (popular with baying fund managers and stockbrokers); Amazon, Costco, AirAsia, Carpetright, and parts of Berkshire give back margin to the customer, we would argue that is a pretty humble strategy too. In other words, around two thirds of the portfolio is invested in firms that in some major way shun commonplace promotional activity and they are no less successful as a result.

If one steps outside of stock market listed companies to instead observe private firms run by proprietors and founders, it is the quiet approach that is far closer to the norm. Let's invert: why are publicly listed companies so promotional about their affairs? Are these companies shouting to inform shareholders and customers or convince themselves?

Nomad's investments may be in publicly listed firms but these firms are also overwhelmingly run by proprietors who think and behave as if they ran private firms. Amazon for example struggles with institutional investor relations so much so that the good people that man the IR department do so knowing that the firm's founder, Jeff Bezos, thinks their role is all but a waste of time! Poor souls. Bezos was also quite forthright on the subject of product promotion and advertising at this year's annual general meeting:

*"Advertising is the price you pay for having an unremarkable product or service".*

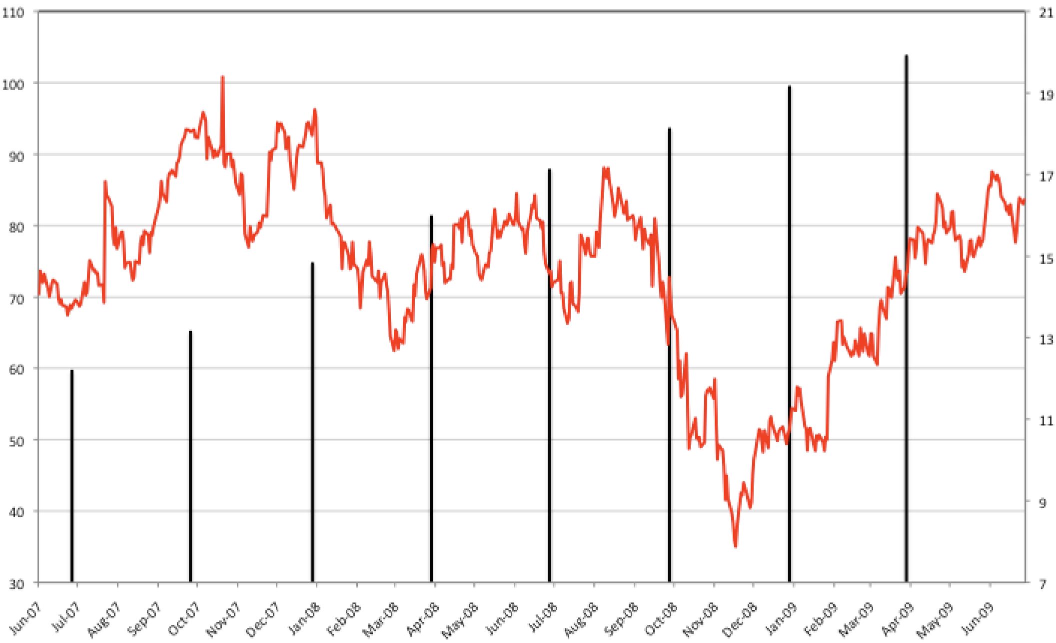
It is interesting to note that the other end of the promotional scale is exemplified by the pop star razzle of General Motors which had the largest advertising budget of any company whose annual report we read this year (actually that title went to GM last year, and the year before, and the year before…). The advertising spend was U$5.3bn in 2008, or U$630 per car delivered. It is fun to muse that had the company made cars that required little advertising support, then the firm's last five-years' advertising spend may have been sufficient to retire half of the company's debt, at par, instead! But, it seems, it was easier to call Madison Avenue than build cars that sold themselves. In our opinion, GM is very much the empty vessel making the most noise, in this regard. Our portfolio takes a different path. The whispered voice of price givebacks is economically fruitful but only if the customer reciprocates in the form of more spending, even in the face of more promotional approaches by competitors. For evidence that this is the case with our whisperers look no further than the average revenue growth rate of the largest investments in Nomad (including some of the companies mentioned above, err, not GM!) which, in the most recent reporting period, was in excess of ten percent!

Why? In a word, price. It is in times like these that the hyper-efficient low-cost providers, who share the benefits with their customers, often take permanent market share. This fact rather reminded us of a quip by Wal-Mart founder, Sam Walton, who, when asked about the recession of the early 1990s, stated:

*"I've thought about it and decided not to participate".*

Amazon, for example, is choosing "not to participate" in as much as trailing twelve- month revenues have risen by over sixty percent since the onset of the credit crisis, say mid 2007. Not that the steady growth in revenues has always been apparent in its stock price, as the chart below describes. As a youthful analyst I used to have a notice on my desk that read, "share prices are more volatile than corporate cash flow, which is more volatile than asset replacement cost". It was reminder to concentrate on non-transitory items. Today I would update such a notice to read, "share prices are more volatile than business values", but the gist is the same: a reminder to focus on lasting value, not transitory prices. More on this subject later in this letter.

Chart 1: Make up your mind, U$100 or U$40? Amazon.com trailing twelve month revenues (in billions of dollars, rhs) and share price (lhs).




Source: Company accounts, Bloomberg, Sleep, Zakaria and Company, Ltd.

## The Investment Industry and Over-Diversification, again.

In business, thoughtful whispering works, which makes it all the more remarkable that the investment industry, as well as many economic commentators, spend so much time shouting. So much commentary espouses certainty on a multitude of issues, and so little of what is said is, at least in our opinion, knowable. The absolute certainty in the voice of the proponent so often seeks to mask the weakness of the argument. If Zak and I spot this, we metaphorically tune out. In our opinion, just a few big things in life are knowable. And it is because just a few things are knowable that Nomad has just a few investments.

The church of diversification, in whose pews the professional fund management industry sits, proposes many holdings. They do this not because managers have so many insights, but so few! Diversity, in this context, is seen as insurance against any one idea being wrong. Like Darwin, we find ourselves disagreeing with the theocracy. We would propose that if knowledge is a source of value added, and few things can be known for sure, then it logically follows that owning more stocks does not lower risk but raises it! Real diversification is offered by index funds at a fraction of the price of active management.

Sam Walton did not make his money through diversifying his holdings. Nor did Gates, Carnegie, McMurtry, Rockefeller, Slim, Li Ka-shing or Buffett. Great businesses are not built that way. Indeed, the portfolios of these men were, more or less, one hundred percent in one company and they did not consider it risky! Suggest that to your average mutual fund manager. And it is interesting to note that none of the great fund management organizations got rich on the back of the most successful companies of the modern era either!

This failure goes largely unrecognized, and certainly ignored, perhaps because it is the elephant in the room. (Quick, change the subject). It is ignored because some fund managers are not trying to make clients rich per se, but instead their goal is to beat their peers or a benchmark. Fine, but what strikes us about such a disposition is that, somewhere in that frame of mind, one ceases to be an investor and starts to be a business manager and, to borrow a phrase from a popular UK TV advert, “that’s not what is says on the tin”. When investment skills share a seat with business management, in time, it’s the commercial genes that tend to thrive, and investment skills that are not used end up atrophying. Is that why the fund management industry finds itself, like GM, relying so heavily on marketing?

Back to real investing! The trick, it seems to us, if one is to be a successful long-term investor, is to recognize the sources of enduring business success, get in early and own enough to make a difference. Which raises two questions: what are the sources of success and second, if these are so readily recognized up front why are they not discounted in prices already? We will spend the balance of this letter answering these two questions.

Seeing, but not Understanding.

How might corporate success be predictable? There are some clues in the world around us. Zak and I observe several business models that work in the long run, and scale economics shared is one of these, witness Ryanair, Wal-Mart, Geico, Southeast Airlines, Tesco, Nebraska Furniture Mart, Direct Line et al. And that is why companies that share scale with the customer such as Carpetright, Costco, Berkshire Hathaway, Amazon and AirAsia make up around sixty percent of the Partnership. It works because it turns size, normally an anchor to growth and returns, into an asset. But I also don't think this is a great secret.

Investors are broadly rational people (they all knew that Wal-Mart was a wonderful business) and fund managers operate under healthy profit incentives that ought to foster good outcomes, so why is it that no one but the founding Walton family-owned Wal-Mart all the way through? Zak and I were told a story by one of the industry's most senior fund managers which we enjoyed enormously and might help illustrate the point. In the early 1970s a then, and still today, large successful fund management company analysed its portfolio and discovered that their sale of IBM thirty years earlier had been a huge error of omission. If they had instead kept their IBM shares for the last thirty years, that stake alone would have been larger than total funds under management. No doubt they all agreed to learn from that particular mistake and, as so often happens, went back to their desks and got on with life as before, as if nothing had happened. It is fun to note that, at about the same time, they also made the decision to sell their stake in Wal-Mart, which, thirty years later, would be worth more than their then-to-be funds under management! In terms of dollars of opportunity lost, it is likely to be the biggest single error this firm will make.

We offer the following reasons for this mistake:

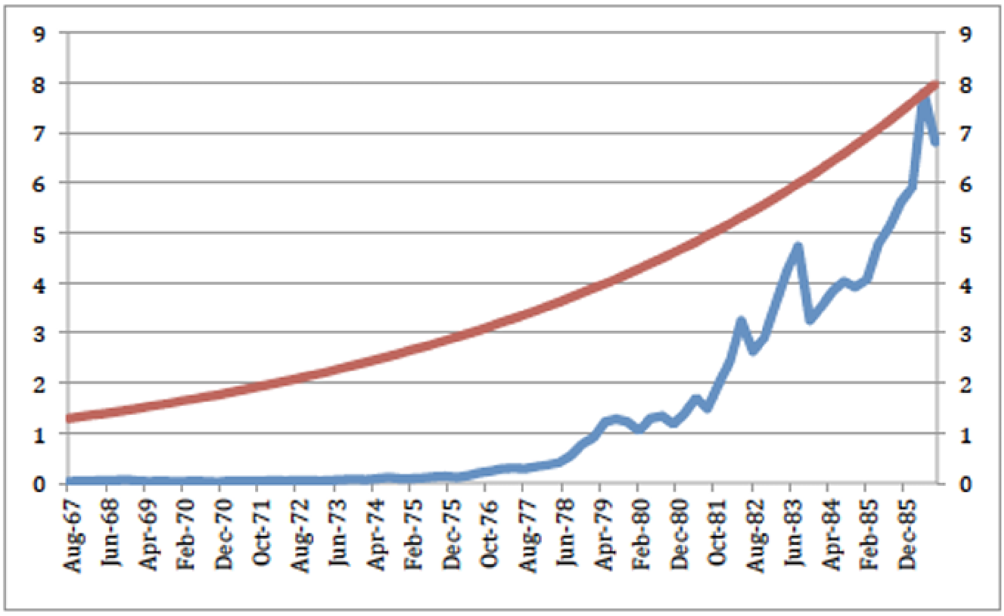
1. Misanalysis, or using the wrong mental model: Investors are used to firms which have one good idea, such as a new product, but then struggle to replicate success and end up diluting returns (Zak and I call this the Barbie problem, as Mattel has struggled to replicate the economics of its famous doll). Taking this model and applying it to Wal-Mart would miss the company's source of success entirely as the strategy of price givebacks did not change from year to year; culture plays a part in the continuity of a successful price giveback strategy and factors such as culture, because they are hard to quantify, often go undervalued by investors; investors presume regression to the mean starts at the time of their analysis or, as CFA students may recognize, in year three or five of a DCF analysis! Investors use valuation heuristics rather than assess the real value of the business.
2. Structural or behavioral: Active fund managers have to look active. One way to do this is to sell Wal-Mart, which appeared expensive (but actually wasn't), to buy something that appeared cheaper (but err, also wasn't); investors are not long-term and did not look further than the next few years or, more recently, few quarters. Evidence for this can be gleaned from the average holding periods for shares which stands at just a few months; fund managers wish to keep their jobs and espousing a ten-year view on a firm risks being a hostage to fortune; marketing folks require new stories to tell and new stocks in the portfolio provide new stories; fund managers sell their winners in order to appear diversified in the eyes of their clients.

3. Odds or incorrectly weighing the bet: In the words of my first boss, investors tend not to believe in "longevity of compound". Conventional thinking has it that good things do not last, and indeed, on average that's right! Empirical Research Partners, an investment research boutique, discovered that the chance of a growth stock keeping its status as a growth stock for five years is one in five, and for ten years just one in ten. On average, companies fail.

The list above is far from exhaustive and we can all pick our favorites. No doubt some combination of these, plus others, acted in the minds of sellers. It matters not particularly. What matters is the effect of this collective mis-cognition. Investors know that in time average companies fail, and so stocks are discounted for that risk.

However, this discount is applied to all stocks even those that, in the end, do not fail. The shares of great companies can therefore be cheap, in some cases, for decades. To illustrate the point, consider the graph below. The blue line represents the share price of Wal-Mart and the red line the price that one could have paid at any time since 1972 (the firm's initial public offering) and then earned a return of ten percent (a proxy for a reasonable equity return) through to today. The red line can be thought of as what the firm was really worth.

Chart 2: Cheap for Decades. Share price of Wal-Mart (blue) and the price one could have paid and still earned a ten percent return (red).




Source: Company accounts, Bloomberg, Sleep, Zakaria and Company, Ltd.

Just look how long the undervaluation persisted! If, in 1972, upon reading that year's twelve page annual report (!) an investor chose to make a purchase of shares, he could have paid over one hundred and fifty times the prevailing share price (a price to earnings ratio of over fifteen-hundred times, a ratio far in excess of what professional fund managers would consider prudent. They would be mistaken, as it turns out) and he would have still earned a ten percent return on his investment through to today. If, instead, the investor thought about it for a while and decided to purchase shares ten years later he could still have paid over two hundred times earnings for his shares (beware heuristics) and still earned ten percent on his investment. And ten years after that could also have paid a premium over the prevailing Wal Mart share price and done well subsequently. The market struggled to appreciate the magnitude and longevity of the business' success. But why?

Weighting the Information

Investors see the information (on conference calls they cheer "great quarter, Wal- Mart") but, in our opinion, they incorrectly weigh the information. It could be argued that lots of things had to go right for Wal-Mart to grow for forty years. That is certainly true but, at its heart, a very few simple things really mattered. In our opinion, the central engine of success at Wal Mart was a thrift orientation fueling growth with the savings shared with the customer. The culture of the firm celebrated this orientation and reinforced the good behaviour. This is the deep reality of the business. This should have had the greatest weighting in the minds of long term investors even if other things looked more important at the time. Instead, investors may place too much emphasis on valuation heuristics, or margin trends, or incremental growth rates in revenues or any of the list above, but these items are transitory and anecdotal in nature.

There are very few business models where growth begets growth. Scale economics turns size into an asset. Companies that follow this path are at a huge advantage compared to those, for example, that suffer from Barbie syndrome. Put simply: average companies do not do scale economics shared. Average companies do not have a healthy culture. After all, average companies are more like GM than Wal-Mart! The removal of a portion of failure risk from the investment equation creates a huge opportunity for those investors that can see the company in its true perspective and act with a bit of patience. It is a huge anomaly that investors recognize success incrementally when the factors that lead to success, such as scale economics shared reinforced by a strong culture, may be constant. If the early investors in Wal-Mart had understood this, they may have retained their holding along with the, now billionaire, Walton family.

The fund management industry has it that owning shares for a long time is futile as the future is unknowable and what is known is discounted. We respectfully disagree. Indeed, the evidence may suggest that investors rarely appropriately value truly great companies. We can hear the howls of derision from the professional cynics “that’s twenty-twenty hindsight, guys!” Dare we whisper it but, in some cases, we think that greatness may be knowable in, shhh, FORSIGHT! This “longevity of compound” opportunity exists precisely because the average fund manager is attending a different church. Thank God!

Simple, but not Easy

When Zak and I trawled through the detritus of the stock market these last eighteen months (around a thousand annual reports read and three hundred companies interviewed) we had four main choices: add to existing holdings, invest in new firms, invest in growth businesses, invest in cigar butts. Overwhelmingly we have preferred our existing businesses to the alternatives. Of course, such a conclusion will only make sense if the businesses in which we have invested have great prospects and the shares are cheap. Like Darwin, perhaps, we are well aware that we live in an ambiguous world. And we are not saying, for example, that Amazon is the next Wal- Mart. Time will tell on this front. But we are asking the question, what if? The portfolio weightings are sizeable in the firms we consider to be the pick of the bunch, and Nomad should do well if our firms grow from acorns to oaks. It is this rational will to believe and be patient that perhaps marks Nomad out from its peers.

What we are doing is investing at its most honest and most simple. But it is not easy. It is hard because one first has to reject industry dogma. The non-thought of received wisdom is shouted from the rooftops and it is safe and comfortable, glamorous, exciting even, being part of the crowd. The road less travelled is hard as there is lots of heavy lifting involved in the homework, although we happen to rather like the workout. As Darwin found, it is hard to let the facts speak for themselves, reject the established way of thinking and to do so in good conscience. And it is a blessing for us that the crowd have rejected something so obviously right as investing at its simplest. Phew, that was just as well! Indeed, such is the lure of, what might be called, professional fund management techniques (!) that we find there is, albeit with a few notable exceptions, almost no competition for the long-term investor who has done his homework. Isn't it exciting that honest, simple, long-term investing is so, well, un-exciting.

The State of our Partnership

Some facts and figures may help paint a useful aggregate picture of the Partnership. Zak and I think of the Partnership in terms of business models deployed by our investee firms. The names we use to describe these models are not that catchy but please bear with us. The largest group making up over half the Partnership are, no drum roll required, scale-economics-shared; next comes discounts-to-replacement- cost-with-pricing-power (I warned you) at around fifteen percent; hated-agencies fifteen percent; super-high-quality-thinkers just under ten percent. The Partnership has twenty investments but a noticeable concentration in ten, which make up around eighty percent of the portfolio, and for those with sharp eyes around thirty percent of the Partnership in one investment. Although the bulk of the Partnership is listed in the United States, look-through revenues are far more diversified: US dollar revenues forty seven percent, Euro and Swiss Franc revenues twenty-one percent, South East Asian currencies sixteen percent, Sterling ten percent, Yen three percent and others three percent. There are perhaps six main industry groups and their weightings are as follows: internet thirty percent, consumer staples sixteen percent, consumer discretionary fourteen, business services thirteen, insurance and finance eleven, and airlines eight percent, with a tail of smaller groupings.

Return on capital in the portfolio is extremely high, as are endemic growth rates. We estimate that around three-quarters of the portfolio is invested in growth businesses, which have the potential to compound for many years, and the balance in more cigar butt like investments (we just could not help it!). In aggregate the portfolio is priced in the market at meaningfully less than half our appraisal of what our firms are really worth. The Partnership will remain open to incremental subscriptions whilst this is the case. Here ends the marketing pitch from the chief marketing officer, who now announces his retirement!

One common psychological trap that agents may fall into is that clients expect action, or to be more accurate, fund managers expect their clients to expect action! The investor Seth Klarman was once challenged on whether Buffett's track record was statistically significant as he traded so little? To which Klarman answered that each day Buffett chose not to do anything was a decision taken too. It is quite possible that we may not change the companies in which we have invested very much over the next few years. Indeed, that is our preference. Zak and I expect that we have built a portfolio not just for the recovery out of recession but for many years after that too. At least, we aim for such a Zen-like state.

<u>Housekeeping</u>

Our cost reimbursement management fees are running at around twenty basis points per annum. We could get it lower, but not by much, and would rather let it fall naturally as the fund grows in size. It is a fair estimate that, if Nomad was a billion dollars in size, the management fee would halve in basis point terms. We target single digit basis points in time. The reimbursable performance fee was, indeed, reimbursed to investors last year. And so it should be.

## Thank You

It is with the greatest delight, and respect, that we report that Nomad has had net subscriptions as a result of the credit crisis. I think that is a fact of which we can all be proud. And we have had nothing but notes of support during a period when the market, and gyrations in Nomad's share price, could have given much cause for concern. That ecosystem is special. Thank you. As always, we thank you for your confidence and most especially your patience. Back to those annual reports.

Yours sincerely,

Nicholas Sleep

** Sleep, Zakaria and Company, Ltd., was appointed as investment advisor to the Nomad Investment Partnership with effect from September 12th 2006, replacing Marathon Asset Management who had been investment advisor to the Partnership since inception. Prior to this transition Nicholas Sleep and Qais Zakaria were responsible for the investment management of Nomad whilst employed by Marathon Asset Management. Partners should note that the very nature of the transition from Marathon to Sleep, Zakaria and Company, Ltd., means that the Partnership does not benefit from the same back office infrastructure support it used to receive. In this letter we use the term "partners" as a generic term referring to all Nomad investors, whether shareholders in the feeder fund (the Nomad Investment Company) or limited partners in the Partnership and not, in the strict, legal sense of the word, to imply the creation of a partnership between* *shareholders in the feeder fund, Nomad and/or Sleep, Zakaria and Company, Ltd.*

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# 15-Year Anniversary of the Business Owner Fund

RV Capital, 2023

You may have missed it, but the Business Owner Fund turned 15 on the 30th of September 2023. I wrote on the occasion of the ten-year anniversary that I had been expecting extensive coverage of the occasion but, regrettably, the FT was having a busy news day. With the 15th anniversary now having also passed without much fanfare, I am starting to think I may be alone in recognising the earth-shattering importance of these historic milestones...

Joking apart, the way I have chosen to celebrate these markers in time has been by publishing a memo on some of the most important lessons that I learned over the previous five years. I am happy to continue the tradition here.

First A Look Back

In my five-year memo, I wrote about how I became an independent fund manager. Five years into a multidecade project may seem a bit premature to start spilling the beans on the secret sauce. However, I felt and feel like I had stumbled upon a wonderful formula. And like any decent person who has had exceptional luck, I was keen to share it. Perhaps, if my setup had been the result of strategic acumen or intellectual brilliance on my part, I would have been inclined to keep my cards closer to my chest. However, as I outline in the memo, many of the decisions I made - such as working alone, keeping costs at a bare minimum and eschewing marketing - were made out of necessity. It was thanks to the positive feedback loop I inadvertently experienced that I kept doing things the same way.

In my ten-year memo, I described my journey as an investor and, in particular, two key transitions. The first transition was from an investor who was narrowly focused on more quantitative metrics around an investment opportunity to an investor who paid much closer attention to the overall quality of a business. The second transition was to an investor who paid closer attention to the quality of the people running a business than just the business itself. Of course, neither of the ideas underpinning these transitions were particularly original. For example, whenever you speak with an entrepreneur, the first thing they will tell you is that "it is all about the people". The application of these ideas to value investing, however, was. They went somewhat against the grain of what many people considered to be value investing then and perhaps, to a certain extent, still do.

## The Present

This brings us bang up to the present and the 15-Year memo. Its topic is how hard it is to beat the market in the long-term, why this is the case, and – you will be relieved to hear – what countermeasures an investor can take. The last five years have been the toughest of my investing career, and this, no doubt, influenced the choice of subject matter. The lessons, though, are relevant in any phase of an investing career.

Let me start the discussion by posing a question. Imagine you had to bet your life on a single investor beating the market over a long period of time. Who would it be? There's a catch, though: you cannot choose Warren Buffett.

I have been investing for over 20 years, have made 100s of investments, and know many if not most of the world's most highly thought-of investors - some intimately. Despite this, I would not accept the bet. And, for the avoidance of doubt, this includes if I were permitted to bet on myself.

It begs the question: What makes investing so difficult that not even a small minority can be certain of beating the market before the fact? Sidenote: obviously plenty of investors will beat the market looking back. It’s an important question as, obviously, whatever the bottleneck is to beating the market is where investors should direct their energy.

In my view, the bottleneck is not that the basic tenets of investing are not well documented and well understood. We are not eagerly waiting for someone finally to publish the definitive book on value investing.

Good investing involves finding a business whose long-term cash flows can be forecast with a reasonable degree of certainty and paying less for it than it is worth. It’s as simple as that. I feel quite certain that in a hundred years’ time, there will be no innovation that somehow undermines or supersedes this simple truth.

“Yes,” you might argue, “but analysing a business' long-term earnings potential is easier said than done. Isn’t it there that investors should focus their energy?”. If investing were a contest in which a limited number of investment opportunities had to be assessed at a single point in time, then that would, no doubt, be the case. However, the choice of investments is unlimited (or at least greater than any single person could ever analyse) and an investor can take as much time as they want before making an investment decision. If an investor feels unable to value a company, they can simply move on to the next one, or wait till such a point in time when they feel they can. In such a contest, the advantage from intellectual acumen alone is unlikely to be decisive.

The Actual Bottleneck

If the wrong mental model or a lack of intellectual acumen is not why people fail to beat the market, what is? In my view, it is the sheer difficulty of remaining rational – i.e., buying businesses for less than they are worth and selling them for more than they are worth – when being constantly bombarded with market gyrations, news flow, social media, expert opinions, and any number of other influences. This is not something that I or, likely, anyone is immune to. Over the last five years, I likely became too optimistic in some of my assumptions as the bull market approached its peak in 2021.

That the emotions interfere with rational thought is not an original idea. The definitive book on psychological biases has already been written - “Thinking, Fast and Slow,” by Israeli-American Nobel Prize winner Daniel Kahneman.

In the book, the author describes many psychological biases including the commitment bias (the tendency to stick with a decision even when it's no longer in one's best interest, likely to remain consistent with previous choices) and the sunk cost fallacy (the tendency to continue to invest in a project based on resources already committed rather than the expected future benefit). The question for us investors is how we apply the lessons from this book in order to improve our chances of beating the market.

The first thing we need to do, in my view, is narrow the list of biases down to the ones most likely to hinder our chances of success. The book lists many biases, some important in an investing context, others less so; some destructive to investment success, others potentially also less so. Sidenote: If investors generally trade too much, is commitment bias such a bad thing?

In practice, there are two main failings resulting from emotional biases that an investor needs to eliminate – turning overly pessimistic when markets or investments are down and turning overly optimistic when they are up. Perhaps it could even be argued that turning overly pessimistic when markets are down is the key risk to be cognizant of. Assuming markets trend upwards over time - albeit in a lumpy fashion - the single most important attribute in an investor is the ability to remain steadfast when the outlook temporarily looks bleak. However, given how damaging to wealth it can be to be caught up in a bubble, I will leave the list at two.

The second thing we need to do is give the topic the attention it deserves. Investors tend to view the study of psychological biases as an adjunct to good investing, not a core component. Despite the extensive body of research in behavioural finance, the pantheon of books on investing is largely made up of books that discuss the nature of markets (spoiler alert: they occasionally do crazy things), what makes a good company (spoiler alert 2: a growing moat), and when to buy it (spoiler alert 3: when it is trading for less than it is worth). These are of course important things to understand but given an abundance of intelligent and motivated investors out there, they are unlikely to provide any competitive differentiation - although you would, of course, be at a competitive disadvantage if you did not understand them.

To overstate my case only slightly, if I were to teach a ten-class course on investing, the first nine classes would be about how the market and other factors mess with your ability to think clearly. In the tenth, I would say: “Oh by the way, this is how you build a DCF model, and this is what constitutes a moat”. Please do not ask me how to teach that course, though. The only way to understand what markets can do to your mental faculties is to experience it. Just because something cannot be taught in a classroom, though, does not mean it is unimportant. This is why my first piece of advice to anyone interested in becoming an investor is to open a brokerage account and start investing. If your employer forbids it, you may want to seek out a new job.

## The Bottom Line

In a nutshell, this is what I am arguing: there are tens of thousands of diligent, talented, and motivated business analysts/investors in the world, but there is only one that I feel completely sure will make better than average investment decisions irrespective of what the market throws at him: Buffett.

## Ten Countermeasures

On this sombre note, let's move on to a more upbeat topic: What can we do to add our names to this list of one? As it happens: a lot. Some of these things I do well, others less so, so this is written as much for my benefit as for yours.

### 1. Recognize the Nature of the Game

It is important to recognise what the nature of competition is and set priorities accordingly. If the challenge is to outsmart all the other investors, then obviously you would want to sharpen your analytical capability. If, on the other hand, the challenge is to keep an even keel when everyone else is losing their head, this calls for a different set of priorities. As you probably guessed, I believe the latter is more important than the former. If so, you need to prioritize thinking clearly over all else.

### 2. Seek Independence

I cannot overstate the importance of being independent. It is far easier to reach a rational conclusion about any topic if your thought process is unclouded by the opinions of others.

In the 1950s, psychologist Solomon Asch conducted a series of psychological experiments known as the Asch conformity experiments. A group of eight participants engaged in a simple perceptual task, whereby all but one of the participants were actors. Each participant was shown a card with one line on it followed by another card with three lines of differing lengths on it. See image:

The task was to state which line was of similar length, a simple task that everyone got right when left to their own devices. The catch is that in some trials, the actors gave the wrong response. When this happened, the study's subject was far more likely to give the wrong response as well. The research suggests people are more likely to conform than they might expect.

Furthermore, the study found that people are more likely to conform when a) more people are present; b) the task is more difficult; and c) the other members of the group are of higher social status. The study found they are less likely to conform when able to respond privately.

This suggests to me four ways to increase your chances of thinking independently: avoid large groups, stick to simple investment opportunities, avoid experts and gurus, and make investment decisions in private, i.e., not in a committee. It is fascinating to me that three of these four measures suggest working alone is better than in a team, and the fourth (keeping it simple) is independent of team size. All the evidence suggests that the smaller the team size, the better the decision-making.

3. Research Ideas Thoroughly

Thorough research is vital. There is nothing too controversial in that statement. The reason, however, perhaps is. It is not to figure out whether an investment makes sense. A good investment idea should be obvious. If hundreds of hours of research are necessary to figure out whether an investment is worthwhile, it likely is not. The purpose of research is to have the emotional fortitude to stay the course when an investment is going against you. When an investment is doing poorly, someone is going to forward you an article saying something along the lines of "the largest customer is about to in-source," or "Amazon with its bottomless pockets is planning on entering the market," or, more simply, "the company is a fraud". If you have not put in the long hours of research, when this happens you will panic and head for the hills.

"Are not several pairs of eyes better than one," you might ask, "when it comes to building a 360-degree view of a company?" Of course. There is no rule that you cannot collaborate with other people when it comes to research. The investment decision, however, needs to be made independently.

4. Kiss Lots of Frogs

Given that a good investment idea should be obvious, but the analysis before investing needs to be detailed, it stands to reason that the optimal approach is to analyse many ideas superficially and a handful (the ones considered for investment) in depth. In other words, it is necessary to kiss lots of frogs until you find a prince.

The investment blog, value and opportunity, occasionally takes an entire stock market and analyses every company in it. I am a big fan of the idea. The blogger's reasons for rejecting an investment sometimes amount to just a single sentence, so these entries will not win any prizes for their intricacy. However, to the end of creating as many free options as possible, it is great.

5. Practice Negative (and Positive) Visualisation

I have derived a lot of benefit from negative visualisation, i.e., visualising how I would feel if there was a negative news story about a company that I am invested in and the share price tanked. If I would feel uncomfortable, then it is probably not a company I should be investing in. As every company experiences negative news flow and stock price declines at some point, it is an exercise that is well worth doing ahead of time. It helps to prepare psychologically for what is likely to be a stressful experience and increases the chances of keeping a cool head.

The most painful investing experiences are when you lose money, so when it comes to visualisation, I tend to practice the negative variant. Positive visualisation is also important though when there is an excess of pessimism. Today, for example, there is lots of pessimism around China for all the reasons you will be familiar with. China though is a country with an educated, hardworking population and lots of catch-up potential to Western living standards. There will be a time (perhaps even in our lifetimes) when there is considerably more optimism than there is today. Visualising such a time helps perhaps to put the current mood in perspective and seize what could be a historic investment opportunity.

## 6. Build a Supportive Capital Base

It is vital to have a loyal and supportive capital base. Without one, it is very difficult to stay the distance no matter how good your intentions. I saw firsthand in the Great Financial Crisis how many funds folded because their investors panicked and redeemed their capital at the bottom of the market. In many cases, the reason the funds folded was not poor investment decisions on the part of the managers. The investments did fine over time. They failed because they had taken capital from the wrong people.

At the other extreme, I have also seen funds fail because they received too much capital at the top of the market. When the inevitable downturn happens, they find themselves in a situation where most of the investors in their fund have had a bad experience even though the long-term track record is perfectly respectable. This leads to potentially catastrophic outflows if the fund has built up a cost base commensurate with the higher level of assets under management.

7. Do Not Post on Social Media

If the name of the game is to keep an even keel despite what is happening around you, I cannot for the life of me imagine how having a prominent social media presence can improve investment returns. Social media tends to amplify whatever emotions are prevalent at the time. When returns are good, you are likely to be celebrated as the next Warren Buffett. When they are bad, you will be pummelled mercilessly. An ideal environment is the exact opposite – one where you receive gentle encouragement when things are going badly and a reality check when things are going well. I realise that building a prominent social media presence is an effective way to raise capital fast. But if you live by the sword, expect to die by the sword.

8. Meditate?

I do not meditate – nothing will more assuredly send me into a coma-like sleep than a comfortable seating position and the sounds of pebbles washing up against a beach. I know a lot of accomplished investors, however, that do (hey Josh!). The mental state of autonomy and equanimity that I understand meditation engenders strikes me as conducive to good investment decisions. Perhaps, I should give it another try. Worst case scenario, I will be well rested before making any new investment decisions 😊.

9. Take A Long-Term View

The single best way I have found to evaluate whether something is important or not is to consider whether I will care about it or even remember it in 10 years' time. Changes in interest rates, disappointing quarters and even recessions are things that people will likely not care about in ten years' time. A customer exodus, the breach of debt covenants, and a disruptive new entrant potentially are. Looking through the lens of how things will appear in the future helps to separate signal from the noise. Note though, it is only possible to practice long-term thinking if you have capital providers who take a similarly long-term perspective.

10. Be Humble

The final point is the importance of humility. Markets occasionally do unexpected things and the best investment strategies ultimately fail as competitors imitate them. Anyone who thinks they have everything figured out is riding for a fall. It is important to be humble.

You have read on two occasions in this memo that it is not clear to me whether I will beat the market in the longterm. This is not false humility. I believe it - not just because of the sobering experience of the last five years, but for the simple reason that so few investors do beat the market over the long-term. Why should I be the chosen one? I hope this is not too disconcerting to my investors. It should not be. Even Buffett is circumspect about Berkshire's ability to continue to beat the market given its enormous scale, though he would no doubt fancy his chances with a smaller capital base. Anyone who is certain they are going to beat the market belongs in the marketing department, not the investment department.

That's it for now – see you in five years' time!

Rob

# François Rochon Investment Philosophy

Giuliano Mana, 2023

François Rochon is the founder and portfolio manager of Giverny Capital, a Canadian money management firm. His academic background is, interestingly, purely in engineering, studying for an Undergraduate Degree in Engineering and a master's in science, with both of them being in Montreal.

After graduating, François worked as a network engineer for a telecom company in Canada. It is unclear how long did he work there, but in1993, Rochon took 180 degrees turn career-wise. The world of investing had always fascinated and finally motivated him to manage family accounts for three years. François then joined Montrusco & Associates as an analyst and was rapidly promoted to portfolio manager. In 1998, he founded Giverny Capital and has been the portfolio manager ever since.

For us to have a proxy of how well Rochon has done, the firm delivered a total return of 5355% since 1993, compared to 1177% to the comparable index. This translates into an annualized return of 14.5% for Giverny Capital vs 9% for the index.

The Rochon Global Portfolio: Returns since July 1st 1993

| Year * | Rochon | Index ** | + / - | $ US/Can *** |
|---|---|---|---|---|
| 1993 (Q3-Q4) | 37.0% | 9.5% | 27.6% | 3.3% |
| 1994 | 16.5% | 3.7% | 12.7% | 6.0% |
| 1995 | 41.2% | 24.0% | 17.2% | -2.7% |
| 1996 | 28.0% | 22.8% | 5.2% | 0.3% |
| 1997 | 37.8% | 28.6% | 9.2% | 4.3% |
| 1998 | 20.6% | 18.8% | 1.8% | 7.1% |
| 1999 | 15.1% | 16.3% | -1.2% | -5.7% |
| 2000 | 13.4% | 3.2% | 10.2% | 3.9% |
| 2001 | 15.1% | -0.4% | 15.5% | 6.2% |
| 2002 | -2.8% | -18.3% | 15.6% | -0.8% |
| 2003 | 13.6% | 14.0% | -0.4% | -17.7% |
| 2004 | 1.6% | 6.2% | -4.5% | -7.3% |
| 2005 | 11.5% | 3.6% | 7.9% | -3.3% |
| 2006 | 3.5% | 17.0% | -13.5% | 0.2% |
| 2007 | -14.4% | -11.6% | -2.8% | -14.9% |
| 2008 | -5.5% | -22.0% | 16.5% | 22.9% |
| 2009 | 11.8% | 12.2% | -0.4% | -13.7% |
| 2010 | 16.1% | 13.8% | 2.3% | -5.3% |
| 2011 | 7.6% | -1.1% | 8.7% | 2.2% |
| 2012 | 21.2% | 12.5% | 8.7% | -2.2% |
| 2013 | 50.2% | 38.9% | 11.3% | 6.9% |
| 2014 | 28.1% | 17.8% | 10.2% | 9.1% |
| 2015 | 20.2% | 13.4% | 6.8% | 19.3% |
| 2016 | 7.3% | 14.3% | -7.0% | -3.0% |
| 2017 | 13.1% | 10.3% | 2.9% | -6.6% |
| 2018 | -0.6% | -1.4% | 0.8% | 8.7% |
| 2019 | 25.6% | 22.3% | 3.3% | -4.8% |
| 2020 | 12.9% | 15.1% | -2.2% | -2.0% |
| 2021 | 27.0% | 21.0% | 5.9% | -0.4% |
| 2022 | -15.2% | -12.3% | -2.9% | 6.8% |
| **Total** | **5355.0%** | **1177.3%** | **4177.7%** | **5.7%** |
| **Annualized** | **14.5%** | **9.0%** | **5.5%** | **0.2%** |

## Business Owner

First and foremost, François has built the entirety of his strategy around the fact that stocks are nothing more than a fraction of a business. Understanding this is what helped him move forward and determine which was the unit of analysis. The underlying business is what he would then focus on for three decades investing. In all of his shareholder letters, Rochon underscores this is the fundamental pillar for Giverny Capital and, in 2018, he clearly revealed what motivated this decision:

> “So I took the time to study the source of their [great investors] outperformance and they all had one thing in common: they considered buying a stock as the purchase of a business and were all trying to buy these businesses at a meaningful discount to their intrinsic values” 2018 Letter

In fact, every year, François includes an analysis of the evolution of the intrinsic value of the portfolio’s companies. He compares it with the evolution of the returns the fund has had in the respective periods. In the same table, a similar analysis is done for the S&P 500, the index Rochon utilizes as a proxy for performance. The concept of “Owner Earnings” was coined by Warren Buffett, and François calculates companies’ increase in intrinsic value “by adding the growth in EPS and the average dividend yield for our portfolio”. He recognizes that, even though it is an ultimately imprecise measurement, the calculation is approximately right.

> “We evaluate the quality of an investment by focusing on the growth in intrinsic value instead on market price. Growth in intrinsic value in one year is based on the growth in EPS andchanges in the long-term perspective of this variable.” 2001 Letter

| | Rochon Global Portfolio | | | S&P 500 | | |
|---|---|---|---|---|---|---|
| Year *** | Value * | Market ** | Difference | Value * | Market ** | Difference |
| 1996 | 14% | 29% | 15% | 13% | 23% | 10% |
| 1997 | 17% | 35% | 18% | 11% | 33% | 22% |
| 1998 | 11% | 12% | 1% | 4% | 29% | 25% |
| 1999 | 16% | 12% | -4% | 12% | 21% | 9% |
| 2000 | 19% | 10% | -9% | 15% | -9% | -24% |
| 2001 | -9% | 10% | 19% | -21% | -12% | 9% |
| 2002 | 19% | -2% | -21% | 13% | -22% | -35% |
| 2003 | 31% | 34% | 3% | 12% | 29% | 16% |
| 2004 | 21% | 8% | -12% | 20% | 11% | -10% |
| 2005 | 14% | 15% | 0% | 15% | 5% | -10% |
| 2006 | 14% | 3% | -11% | 24% | 16% | -8% |
| 2007 | 10% | 0% | -10% | -4% | 5% | 9% |
| 2008 | -3% | -22% | -19% | -31% | -37% | -6% |
| 2009 | 0% | 28% | 28% | 6% | 26% | 20% |
| 2010 | 22% | 22% | 0% | 50% | 15% | -35% |
| 2011 | 17% | 6% | -11% | 18% | 2% | -16% |
| 2012 | 19% | 23% | 4% | 9% | 16% | 7% |
| 2013 | 16% | 42% | 26% | 8% | 32% | 24% |
| 2014 | 13% | 19% | 6% | 10% | 14% | 4% |
| 2015 | 11% | 4% | -7% | 1% | 1% | 0% |
| 2016 | 9% | 10% | 1% | 4% | 12% | 8% |
| 2017 | 14% | 20% | 7% | 14% | 22% | 11% |
| 2018 | 20% | -8% | -28% | 23% | -4% | -26% |
| 2019 | 10% | 31% | 20% | 3% | 31% | 29% |
| 2020 | -2% | 15% | 17% | -9% | 18% | 27% |
| 2021 | 32% | 28% | -4% | 48% | 29% | -19% |
| Total | 2474% | 2817% | 343% | 676% | 1152% | 476% |
| Annualized | 13.3% | 13.9% | 0.5% | 8.2% | 10.2% | 2.0% |

* Estimated growth in earnings plus dividend yield
** Market performance, inclusive of dividends (refer to Appendix B for disclosure statements on our returns)
*** Results estimated without currency effects

The causal factor that inspired such philosophy was acknowledging that, over the long run, stock prices tend towards the fundamentals of the underlying businesses. Therefore, little attention is paid to yearly comparisons between both elements. Rather, it becomes apparent as each of these rows gets added year after year that they converge.

> "Investing is acquiring a participation in a business. If the business does well over many years, all fog tend to disappear and the stock market reflects in all its brightness the true intrinsic performance of the underlying enterprise. Without exception!" 2005 Letter

Based on this, François destines no thoughts towards short-term price action, as there's little "truth" behind it. The latter leads to another fundamental keystone of Giverny Capital investment philosophy.

**Patience**

François Rochon has effectively mastered a personality element that seems to come unnatural to humans. The brevity of life clouds our minds' capacity to think long-term. It knows that, if we engage with such path of thinking, it invariably collides with everyone's destiny, something it tries to avoid thinking about, to protect us. Therefore, I immensely respect individuals that conquer a realm we are not meant to.

> "Patience – from the money manager AND the clients – becomes the supreme quality of investing" 2003 Letter

Patience is a trait that's recurrently praised by the greatest investors of all time, but it is not something that comes up, as far as my readings go, the same way in which this man exercises it, year after year. In line with the convergence between fundamentals and price action, it is only in the long term that such phenomena occur. Notice how, in the table, huge disparities can be observed in single periods, but as time passes, both numbers look more and more alike. What François utilizes to explain long-term differences between the two is a change in the index/portfolio multiple. From Mauboussin's articles, I got that such a change is the reflection of a perceived-as-expanding (or contracting) competitive advantage period of the underlying assets.

Moving forward, patience is leveraged for other core competencies of his PM position. Firstly, François perfectly realizes the importance of the price we pay for stocks and therefore proceeds with caution. Prior to buying, great deals of research are done and, once identified the wonderful businesses he'd like to own, Rochon waits as long as it seems fit for the price of such stock to reach attractive levels. Moreover, time tests hypotheses for which, if after a decade, a business turns out the way he thought it would, some validity can be found in the premises.

> "If you have a good memory, you'll remember that in 1994, I almost bought shares of J&J. In spite of heavy remorse toward J&J, for obvious reasons, I had always continued to follow the company closely. And last summer, we had a chance to acquire shares at a good price when there was an FDA investigation at their Puerto Rico plant" 2002 Letter

> "Long-term partners of the firm will remember that we have already been shareholders in companies within this industry: Cordis (acquired by Johnson & Johnson in 1995) and St-Jude Medical which we owned from 1993 to 1996. I've been following Medtronic for more than 16 years now." 2009 Letter

In the same line of thinking, François describes the perfect investment as one in which he never sells. Nonetheless, there is some turnover of the portfolio every year, which I suspect is caused by the outlook Rochon perceives his holdings have.

> "we estimate that our average turnover during the last several years has been around 15%. In other words, we keep our stocks for 6 to 7 years on average" 2015 Letter

Giverny aims for at least 5pp outperformance over the S&P, which inevitably forces the stock selection process to be aimed at companies that can maintain high growth rates for a long time. The latter is not easy for businesses and, as they saturate their market, François looks to switch boats. However, as long as the future looks bright, selling is not an option, without taking into consideration some trimming due to expensive valuations.

“We sold our remaining shares of Fastenal in early 2016, after having held the company in our portfolio for over 17 years.. The company no longer has the same growth rate as in the past” 2015 Letter

**Non-linearity**

Similar to other successful portfolio managers, François recognizes that we don’t get to future states in a linear fashion. He acknowledges the possibility of a business doing fantastically over several years but with little to no change in the stock’s price. Therefore, patience needs to be exercised so that prices catch up to fundamentals.

*The following example is from BMTC Group.*


In line with business performance and its reflection in the underlying stock, Rochon warns investors, in advance, that the funds’ returns will not be linear. A combination of companies whose stocks do not strictly follow fundamentals simply results in a portfolio that follows the same pattern. This behavior is extensible to that of the general market. Both of these, and another point not directly linked to non-linearity, have led

François to creating his “Rule of Three” (which is also non-linear), based on empiric observations:

- “One year out of three, the stock market will go down at least 10%
- One stock out of three that we buy will be a disappointment
- At least one year out of three, we will underperform the index”

François claims that not trying to escape non-linearity behavior is an immense advantage over his financial peers. In Giverny’s 2004 Letter, he shared his experience at other money management firms. In the latter, as in most across the financial landscape, portfolio managers are pressured to beat the S&P on a yearly and even quarterly basis. This strategy clashes with the unavoidable element of the market’s short-term price action. Not having to deal with this pressure allows François to focus on where true value is created, in the long term, a product of compound interest.

**Patience as a Double-edged Sword**

The trait is an apparent pre-requisite to triumph in this game, but it can definitely backfire. Something that surprised me, but should have come as expected, is how much time François gives investment thesis to play themselves out. Given the confidence he has in the stock selection process, it is almost always a matter of when do investments turn out right, not if. Consequently, a long holding period with “poor” results can occur.

> “We had own Cognex for 10 years. We bought and sold the stock at different prices, but I would say that on average our annual returns was around 4% per year, which is extremely disappointing. In this case, our patience was not rewarded.” 2006 Letter

Similarly, recognizing that, as Nicholas Sleep puts it, 'all businesses will be meaningfully mispriced' eventually, can lead to a long time of waiting before making a purchase. However, there are rare occasions where such a thing never happens, or the mispricing is not considered as such by the investor. In these cases, great opportunities might be missed. The following extract includes not only the mistake, but the lesson to be learned:

> "You might have noticed − given your usual perceptiveness − that the stock's P/E ratio was 29 times in 2002 and is still 28 times at the current moment. The stock has always traded at lofty P/E ratios. I have therefore made an error that I have, unfortunately, made many times: avoiding a high quality enterprise due to a valuation that seemed higher than what I would have liked to pay. I waited in vain for a better price… for a decade. It's very difficult to find a company that can maintain an annual growth rate of more than 20% over a long period of time. When we find one and we have confidence that the future outlook is promising, refusing to pay a slight premium relative to average companies often becomes a very costly mistake. It was an error of almost 500% in this case" 2012 Letter

**Businesses' Characteristics**

In essence, François Rochon looks for the generically known as high quality businesses. To not be overly repetitive, I will not dive into what's included here, but rather delve into some common patterns I believe arise from his investments. Further, there are, I believe, specific components of businesses quality to which Rochon pays special attention. But, prior to this, two general considerations that are a byproduct of the recognized long-term convergence:

> “We focus our capital on businesses that we believe can – in the long run – earn 15% on equity annually” 2003 letter

> “We aim at finding companies that grow their underlying value at around 12-14% per year, twice the market average.” 2004 Letter

I think both characteristics help explain why Giverny’s portfolio turnover is higher than might be expected from a perceived as “hold forever” type of investor. François continuously evaluates what he thinks businesses’ future look like. As they grow, it is natural to start picturing a decline in future returns on invested capital and growth slowdown. The reason behind it is simple: industries’ addressable market is not infinite; they eventually get saturated. Consequently, given Giverny’s high aim for growth and returns, the companies in the portfolio need to rotate.

In general, and explicitly mentioned in all letters, careful consideration of management is in place when deciding whether to invest or not. It is not by the sole statement that I mention this. I found in multiple investors’ philosophies that they acknowledge management’s relevance, but it is rather rare to see consistent high weighing in the decision-making process. François takes the element further than most.

> “Frequently, great achievements are done over many decades. For example, at General Electric, the best performance was realized in the second decade that Jack Welch was CEO. That is why I like to invest with companies that exist for more than 10 years and are still managed by the founder(s)(...) A great garden needs years to become a masterpiece (…) Great entrepreneurs and great gardeners often have similar dreams: building a garden of tall trees that will give shades to many people for generations to come”

The deep understanding of compounding interest invariably leads to the conclusion that most beautiful things require time to flourish. François looks for, therefore, entrepreneurs that are not only long-term oriented, but that love their craft. Only by loving it can it become a sustainable endeavor at high levels of performance. At the same time, only by genuinely being mission-driven can founders envision a version of the final product and transit the unclear path towards it.

Throughout his letters, on many occasions François mentions the fact of him visiting companies' headquarters and speaking to management. Based on how he expresses such situations, it appears as if a huge factor that influences the investment decision is his impression on management.

> "At the start of 2004, we studied a company that we considered well managed and highly profitable: Autozone. Our usual investment process led us to study the company's competitors, which led us to O'Reilly. The latter seemed even more interesting to us than Autozone so I decided to go visit the company in Springfield, Missouri. I was highly impressed by the company's game plan, its extensive distribution network, and the company's management. We decided to invest in O'Reilly despite the fact that the company's P/E ratio was considerably higher than Autozone's" 2014 Letter

> "President George Gleason greeted me with twenty or so vice presidents in the boardroom of the bank's headquarters in Little Rock (his daughter even picked me up at the airport). Mr. Gleason explained the culture of Bank of the Ozarks to me and its history. What struck me most was that he seemed to know almost every loan on the bank's books (…) We decided to buy shares in the bank upon my return to Montreal" 2016 Letter

Likewise, Rochon manifests and explicitly states his complete admiration for specific individuals. When he identifies a founder/manager who is incredibly capable and honest, François simply bets on the person. A great example of this is Disney. Giverny's first investment in the company was in 1995, but it sold its stake in the year 2000. In 2005, François decided to reopen the position due to the following:

> "Disney's market valuation is thereby much more attractive today. It is not for that reason that I decided to repurchase shares lately. It is because of the new CEO: Mr. Eisner left in September and was succeeded by Mr. Robert Iger. I knew Mr. Iger at the time he worked at ABC under Mr. Tom Murphy, one of the best managers of all time. After reading a few interviews with Mr. Iger late in 2005, I decided that he would be the man to put Disney back on the right track." 2005 Letter

On BYD (he didn't build a position): "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." 2009 Letter

> "We bought shares for the second time in M&T Bank in 2009 for about $38 and the stock has performed well since. We had previously been shareholders between 1998 and 2007 for one single reason: we had deep admiration for the bank's CEO, Robert Wilmers. In 2007, Mr. Wilmers decided to retire and we sold. During the crisis of 2008, he decided to return to take back the helm at M&T Bank so we decided to buy again" 2012 Letter

Regarding management, a final characteristic that's often praised by François is one he also reminds investors in Giverny. Investors and François are partners, as he mentions in all of his letters, given the fact that Rochon is also invested in the firm. When it comes to management, a similar feature is very much welcome.

Moving past this crucial feature François looks for in businesses, there is a specific business model that especially seems to capture his attention. It is still unclear to me why, but the franchising business model is one that continuously appears in his portfolio. Perhaps the thesis for investing in these companies lies in analyzing unit economics and management's ability. If the former are correctly in place and management is capable of executing, high bottom line growth should follow. If individual stores operate at profit, the brand is valuable and there is room for geographical expansion, it's just a matter of execution. Among the list, some companies Rochon has owned and spoken about include:

- MTY Food, chain of restaurants
- O'Reilly Auto Parts
- Fastenal, fastener distributor
- Walgreen's, pharmacy and everything chain
- Carmax, retailer of used cars
- TJX Companies, chains of retail clothing stores
- Cabela, catalog sales for hunting, fishing, camping and scuba diving
- Dollarama, dollar stores
- Buffalo Wild Wings, American restaurant chain
- Lumber Liquidators, flooring products
- Alimentation Couche-Tard, convenience store including gas retail
- The Floor & Decor Flooring Company

François recurrently mentions his admiration towards Peter Lynch and speaks about how his books changed his investment philosophy. After reading everything he could find on Lynch, Rochon proceeded to invest in a line very similar to his. Perhaps as a result of this influence is that François got very much attracted towards this type of business model. The simplicity with which growth can come, be explained and perhaps be somewhat foreseeable, might be one of the causes.

> “Mr. Lynch hasn’t been involved in the management of mutual funds for several years now, but he does continue to manage a few portfolios with the same enthusiasm that has always been part of his approach. We talked about our favorite ideas, particularly within the retail and restaurant industries— a sector that Mr. Lynch has always enjoyed following” 2011 Letter

**The Importance of Being Different**

The pricing mechanism acts in such a way that prices throughout the economy encompass all agents’ information. Therefore, it becomes evident that, to escape market-like performance, a reasonable dose of uniqueness is required. From a pragmatic perspective, François mentions in his 2001 letter that Giverny is able to avoid the conventional route by ignoring market fluctuations and industries he knows nothing about. Additionally, as addressed earlier, not having to deal with quarterly pressure provides further ground to escape conventionalism.

> “since our beginning we have known that “being different” is the first ingredient of success (although there are many other ingredients needed!). I was very much influenced by John Templeton’s maxim: “It is impossible to obtain a performance superior to the average unless you do something different from the average”. 2001 Letter

Similar to other great investors, Rochon posits that average results can be indirectly avoided by exercising the act of thought.

Curiously, like Nicholas Sleep and Buffett, though the latter is a product of his writing, Rochon quotes Ayn Rand:

> "Wealth is the product of Man's capacity to think" Ayn Rand, 2011 Letter

However, François takes the contrarianism/differentiation factor to novel corners. In Giverny's 2013 letter, he wrote about a hypothesis he came up with, the tribal gene. Rochon, after decades of observing investors, suspects that there is a genetic element that determines whether a person can go against the crowds or not. Ultimately, going against it acts as a testament of individual thinking, which is the process by which one can improve and that could lead to profitable waters.

Thinking for oneself, being able to detach from conventionalism and taking what one believes to be right, genetic or not, is what builds the ground for acting with conviction in times of chaos. François builds on this in his 2003 letter by quoting Charlie Munger:

> "In the 1996 Wesco Financial's annual report, its CEO, Charlie Munger, wrote this phrase: "…Being prepared, on a few occasions in a lifetime, to act promptly in scale in doing some simple and logical thing will often dramatically improve the financial results of that lifetime. A few major opportunities, clearly recognizable as such, will usually come to one who continuously searches and waits, with a curious mind, loving diagnosis involving multiple variables. And then all that is required is a willingness to bet heavily when the odds are extremely favorable, using resources available as a result of prudence and patience in the past…""

Occasionally, the world takes very dark routes. In these times, the tragedy of the short term obfuscates people's vision. Fog does not allow to see past it. It is very curious for me to read about a person that has consistently managed to sweep fog away, look straight into the end of the tunnel, and proceed accordingly. I am not sure there are many individuals that were capable of taking advantage, in the form of buying, of all crises and the terrifying events that took place these past decades.

> "As you see in the graphics above, when the Stock Exchange reopened, a few days following September 11, it dropped 6% in one day. Unfortunately for those who sold at this moment, the S&P 500 is 40% higher today. To sell in a panic is not a winning strategy. We had decided to make some purchases following this correction." 2001 Letter

> "The opportunity of a generation: 2008 was a difficult year in the stock market, to say the least. We believe that the market drop – and the high level of pessimism – has created great investment opportunities, to a degree we have seldom seen in the modern history of financial markets." 2008 Letter

> "The stock market fell dramatically in mid-March 2020 when the World Health Organization (WHO) announced that we were officially in a pandemic. In just a few weeks, the S&P 500 had fallen 35% from its high and the Russell 2000 had tumbled 40%. The rapidity of the decline was probably only matched by the crash of 1987. Several stocks dropped to very attractive valuations and we took the 6 opportunity to make a new acquisition" 2020 Letter

**A Systematic Approach to Learning and Portfolio Management**

François is an engineer by profession. In careers based on mathematics, algebra and logic, what we learn is methodology; a system we can leverage to solve problems, even complex and unstructured ones. Solutions are never generic, but processes employed and created tend to have the same root. I think that, partly due to this, Rochon developed a very specific model to approach portfolio management and the never-ending task of learning about it. The system consists of three pillars, which I'll address below.

Firstly, and I think the most curious of them, in all letters François has a section destined towards his biggest mistakes. He includes three mistakes and ranks them from bronze to gold. The intention is to identify where did his decision-making went wrong. It is fascinating that a simple, in appearance, habit, can truly lead to exponentially improve one's investment skill as time goes by. The most common origin of mistakes mentioned are: a lack of patience, an inability to execute when he knew he should have, and error of omission. A very specific one I'll emphasize again is the one mentioned above: not paying up for quality.

Moving forward, very aware of the biases that cloud our judgement and the strong existence of social proof, every year François writes about what he thinks is "the flavor of the day". One way to achieve differentiation is to analyze what is the general public doing and carefully avoid it. With high degrees of attention comes high valuations, which, on several occasions, turn irrational and unsustainable. Some of the topics mentioned are: gold and basic material companies (2003), indexes (1998), Canadian Residential Real Estate (2009), gold (2010), bonds (many letters), Bitcoin (2017), some software, cloud and tech sectors (2020), cryptocurrencies (2021).

Finally, Rochon understands that memory is not fixed, but it rather changes. This turns the task of critically analyzing past decisions a very tricky one, more so considering the infinite biases to which we are subject to. With the purpose of dealing with this phenomenon, and improving his decision-making process, in all of his letters François includes a "five years post-mortem" analysis. Throughout his writings, he lays down his thoughts and summarizes theses for his investments. Each year, he goes back 5 years and reads what he wrote down to see how reality played itself out. François then proceeds to share whether he believes that the decision was wrong and, if so, why.

# Terry Smith Genius Letter

Giuliano Mana, 2023

I was thinking on following the path I constructed after reading Buffett's first 30 years of letters. A summary of each investor's philosophy is crucial, which is why I did not omit that part after going through Terry Smith's letters. I was then thinking to, again, write which letters are the most important, perhaps the 2 or 3 most relevant, with the intention of 'saving' you some time.

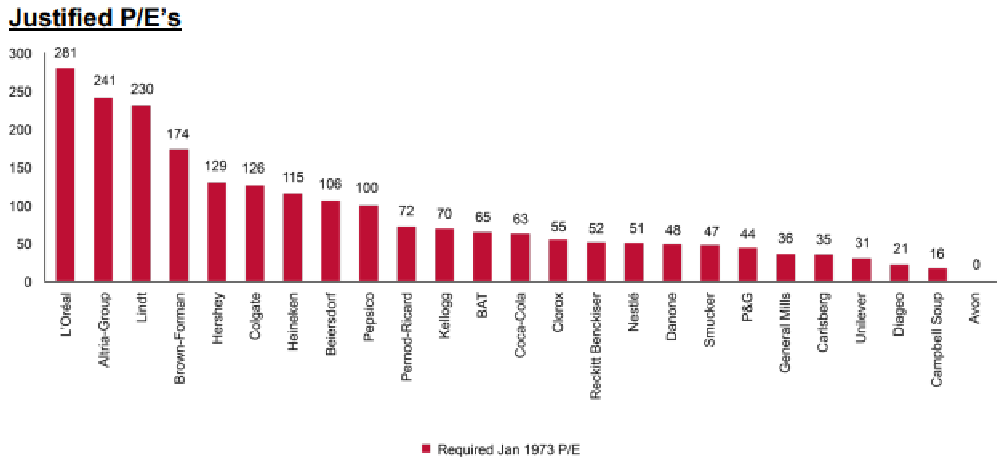
However, I didn't find most of his letters as authentic fountains of wisdom as I had with Buffett's. This allowed me to narrow down the universe of masterpieces to one, which should help save you some time.

I think Warren Buffet letters reach an absurd level of financial philosophy. I think Terry does not get to the level of deep thinking Warren does, but he is for sure as good a teacher as Buffett. Throughout this decade and something of writing, Smith shares an uncountable number of insights and his 2022 letter, in this sense, is absolutely brilliant.

**On valuations and good businesses**

In investing, rules of thumb are intrinsically worth nothing. Even though they may act as guidance, if we isolated and evaluated their core, there's futility. The first point that caught my eye in this letter is when Terry tears apart the idea that paying high PEs for companies invariably leads to underperformance.

Multiples intend to offer some sort of parameters to try infer how expensive is a business trading in respect to its own fundamentals, like earnings or sales. Nonetheless, the number itself is useless and this cannot be taken by granted. Terry computes and interesting chart with this idea (I believe) in mind.




Source: Ash Park Capital and Refinitiv Datastream, excludes dividends, in USD.

This illustrates what PE ratio you could have paid for each of these companies in 1973 and still achieve a 7% CAGR over the next 46 years, outperforming the 6.2% obtained by MSCI's World Index.

One important reminder:

> "I am not suggesting we will pay those multiples but it puts the sloppy shorthand of high P/Es equating to expensive stocks into perspective." January 2022

> "Past returns of companies are a good guide to future returns"

This is a fascinating one. The first time I came across the following concept (in a well-defined manner) was while reading Buffett's 1985 shareholder letter. In it, he states:

> "A textile company that allocates capital brilliantly within its industry is a remarkable textile company—but not a remarkable business"

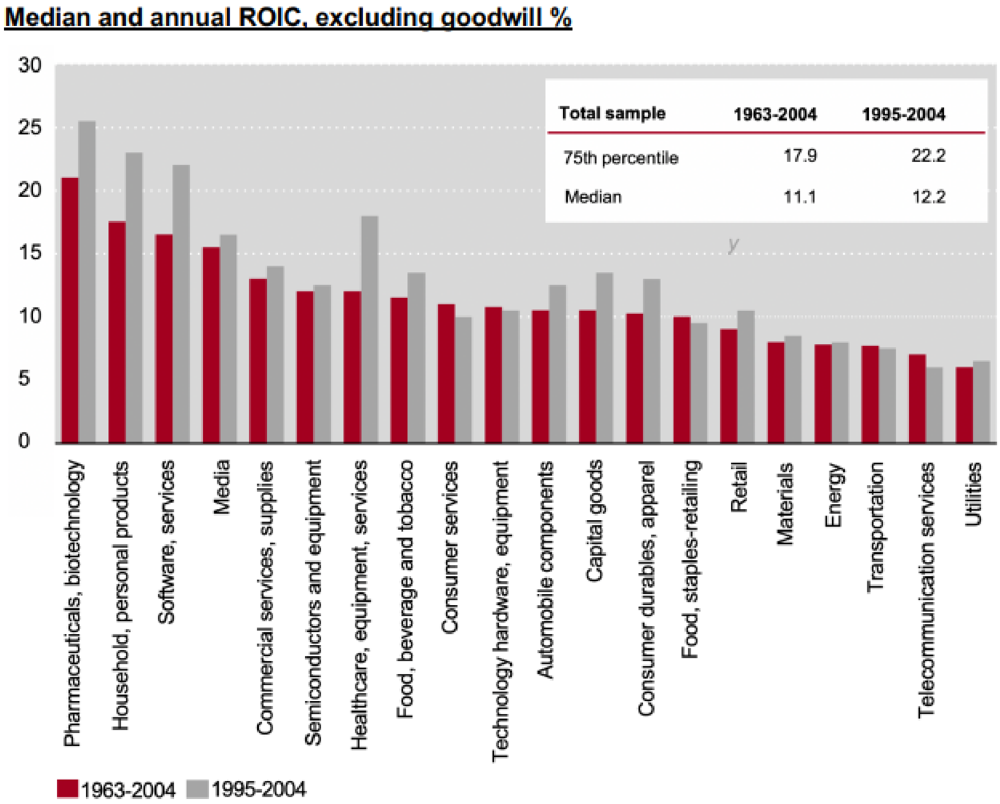
The quote encompasses the idea that good returns on capital are inherent to industries and businesses. Moreover, there's some sort of restrictions or ceiling imposed to the maximum returns a company could earn, based on these intrinsic fundamentals. Terry brings the same idea to the table, but it accompanies it with the following chart:

**Persistence in Profitability**


The chart is composed by the thousand largest companies in the US, which were sorted into quartiles based on their ROE. The green line represents companies in the lowest quartile, while the red one, the opposite group.

It is extremely insightful to observe how there's some sort of mean to which these companies returns tend to. Variation is all across the board from period to period, but it is clear how good companies always tend to return to the 18-20% ROE while the bad ones return to 10-12%.

Terry further addresses the matter with an even clearer illustration:




Source: McKinsey

The chart above shows the achieved annual return on invested capital over two different periods and across industries.

> "These return characteristics persist because good businesses find ways to fend off the competition — what Warren Buffett calls 'The Moat'"

> "Poor returns also persist because companies which have many competitors, no control over pricing and/or input costs, and an ability for consumers to prolong the life of the product in a downturn (like cars) cannot suddenly throw off these poor characteristics just because they are lowly rated and/or benefit from an economic recovery"

## On inflation's impact

Inflation has always been in investors mind, but its appearance and persistent nature started raising some concerns. In this letter, Terry addresses the issue by sharing phenomenal yet simple table regarding inflation's impact on businesses performance:

**Impact of 5% Inflation**

| L'Oreal | Before | After |
|---|---|---|
| **% of revenues** | | |
| Revenue | 100% | 100% |
| COGs | 27% | 28% |
| Gross profit | 73% | 72% |
| SG&A | 55% | 55% |
| Operating profit | 18% | 17% |
| **Decline in profit** | | -7% |

| Campbell's | Before | After |
|---|---|---|
| **% of revenues** | | |
| Revenue | 100% | 100% |
| COGs | 65% | 68% |
| Gross profit | 35% | 32% |
| SG&A | 20% | 20% |
| Operating profit | 15% | 12% |
| **Decline in profit** | | -22% |

Source: Fundsmith Research

The table aims to show that companies with higher gross margins have their profitability far more protected than those with lower gross margins.

Terry also takes the time to expand on another matter that inflation affects, valuations, which are not affected equally to all companies. The longer the maturity of a bond, or the further in time the asset's cash flows, the more sensitive is its valuation to changes in interest rates. The same happens with companies and that's one of the reasons why unprofitable tech have performed so poorly recently. Since all of their value is derived from cash flows that will be produced long time from now, they are more susceptible to changes in interest rates, because the latter is in charge of discounting those future cash flows into "today's dollars".

# Nick Sleep Solved Disruptive Innovation

Giuliano Mana, 2023

I usually try to escape writing about the obvious. There is little incremental value I can add on widely covered topics. Moreover, given they're mostly well-known, it is very likely that you are familiar with them already, which makes reading another article about it, a partly waste of time. That's the reason why 90% of Sunday articles are about subjects I found curious and the approach I take is a purely personal one. It's what I remember or understand. Probabilities of publishing something that's somewhat novel increase dramatically under such conditions.

When I read Nick Sleep's letters, back in March, I only wrote one article about them. His writing is so peculiar and delightful it was very difficult to grasp the essence of his philosophy. Nevertheless, there was a concept I knew many people were familiar with, which should've been a must-share, but, honestly, I didn't really understand it. However, being familiar with the subject allowed me to have some conversations around it and these past weeks I've been talking with a friend that's very well read and is very familiar with Nick's ideas. He explained to me the concept, which almost immediately triggered an unbelievable connection.

**Scale Economies Shared**

Nicholas and Zakaria, at Nomad Investment Partnership, came up with the description of a business model. They noticed a pattern among some very successful companies and were able to put into words what these were doing. Furthermore, their fund was known for its highly concentrated positions, with most capital being allocated within this small universe of companies that had this business model.

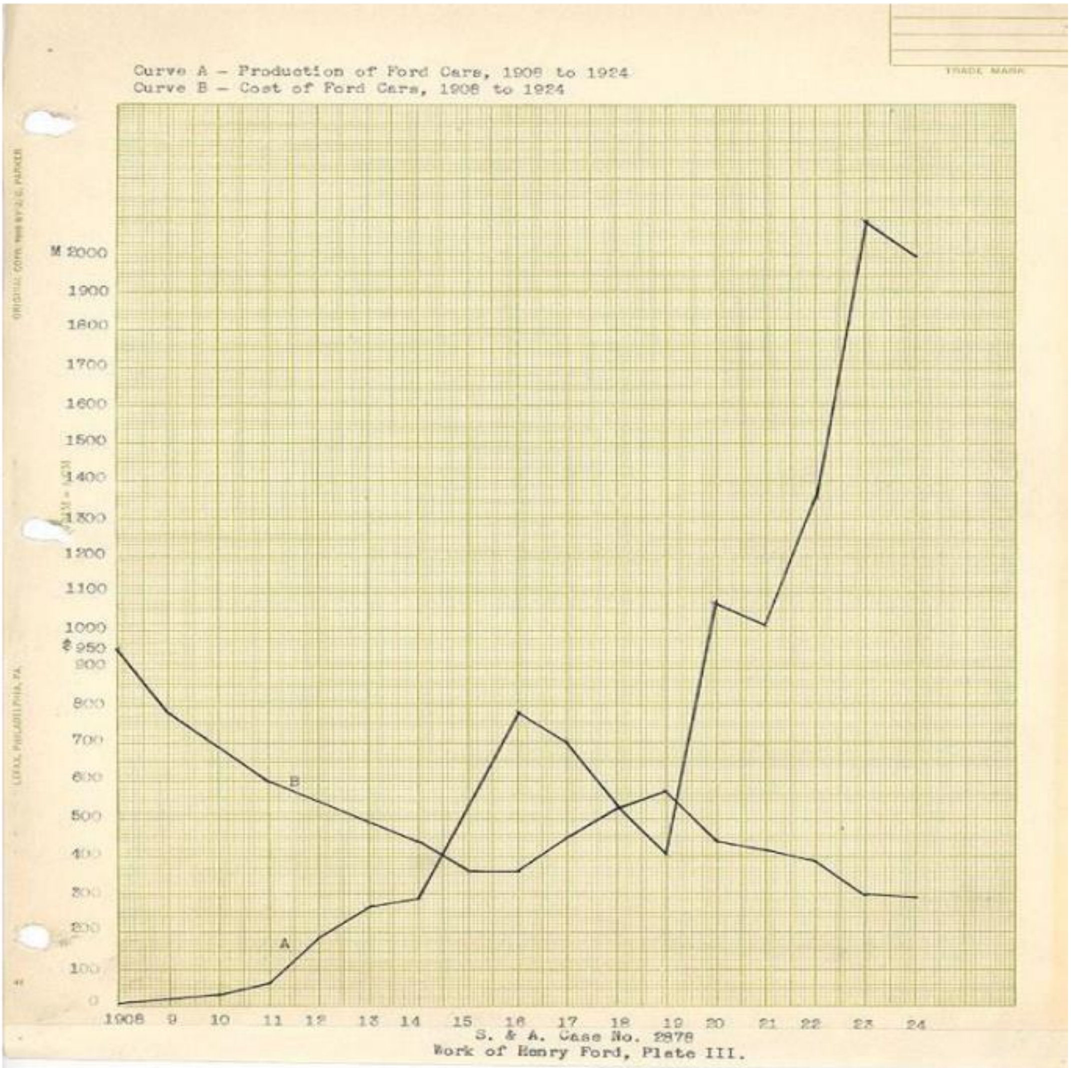
Scale economics shared imply for a company that, firstly, benefits from scale. The latter would be in the form of operating leverage, expanding margins, product of very high upfront investments and not necessarily high variable costs. Then, what these companies do is to pass this scale advantage to its customers. They prefer for their margins to not expand by lowering prices and, instead of making extra profit, it is customers who get to save more.

> “Scale economics shared operations are quite different. As the firm grows in size, scale savings are given back to the customer in the form of lower prices. The customer then reciprocates by purchasing more goods, which provides greater scale for the retailer who passes on the new savings as well” Nick Sleep, 2008 letter

> “Our judgment is that relentlessly returning efficiency improvements and scale economies to customers in the form of lower prices creates a virtuous cycle that leads over the long-term to a much larger dollar amount of free cash flow” 2006 letter

> “For example, it is interesting to note that the business model that built the Ford empire a hundred years ago and is illustrated in the chart below (dated 1927), is the same that built Sam Walton’s (Wal-Mart) in the 1970s, Herb Kelleher’s (Southwest Airlines) in the 1990s or Jeff Bezos’s (Amazon.com) today. And it will build empires in the future too.” 2012 Letter

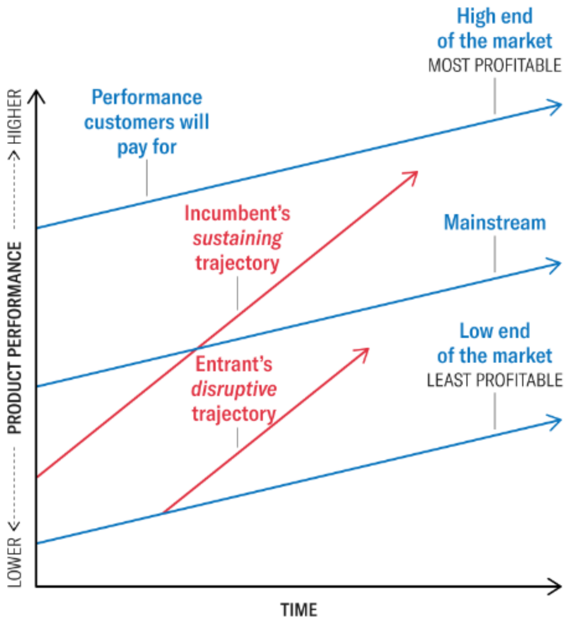
Chart 1: Production Volumes and Cost (to the consumer) of Ford Cars 1908 to 1924.




It was not until after a year of writing about Tesla and 4 months of studying disruptive innovation that I couldn't go further in this line. But I think there is something here.

**Why does it work?**

The Innovator's Dilemma tries to answer why do good firms, led by good managers, fail. Paradoxically, it is the pursuit of profit what makes them fail. Companies begin either at the low end of the market or in a new industry, producing for previously non-consumers. What happens afterwards is that these new companies tend to perform sustaining and efficiency innovations until they perish, under the pressure of a new disruptive company (which could happen after generations). It is the classic upmarket movement we've gone through over and over.




This logical strategy is deeply flawed. By focusing on higher margin products, on higher tiers of the market, companies neglect low end customers. They overshoot them in terms of performance they need, creating a gap that a new disruptor can fill. Nicholas' scale economics shared business model would suppose a change in the disruptive technology's trajectory.

I think this would imply businesses to stay at the low end of the market, which does not necessarily mean there's no profit there, forever, making the trajectory flat. However, it might also be the case that, because these efficiency innovations are being passed on to consumers, the company behind such a process may be continuously altering what the low end of the market represents. Each time it saves customers' money, it brings the low end of the market lower and lower. I'm still not seeing it very clearly, but I would suppose this not only fills all gaps that would give room for disruption, but also discourages new entrants from coming to this market.

Nicholas Sleep is an authentic genius. Along with Zakarias, they might have come up with a business model that’s truly enduring and goes in line with the rules of theory.

# The Whistle

Benjamin Franklin, 1979

When I was a child of seven years old, my friends, on a holiday, filled my pocket with coppers. I went directly to a shop where they sold toys for children; and, being charmed with the sound of a *whistle*, that I met by the way in the hands of another boy, I voluntarily offered and gave all my money for one. I then came home, and went whistling all over the house, much pleased with my *whistle*, but disturbing all the family. My brothers, and sisters, and cousins, understanding the bargain I had made, told me I had given four times as much for it as it was worth; put me in mind what good things I might have bought with the rest of the money; and laughed at me so much for my folly, that I cried with vexation, and the reflection gave me more chagrin than the *whistle* gave me pleasure.

This, however, was afterwards of use to me, the impression continuing on my mind; so that often, when I was tempted to buy some unnecessary thing, I said to myself, *Don't give too much for the whistle;* and I saved my money.

As I grew up, came into the world, and observed the actions of men, I thought I met with many, very many, who *gave too much for the whistle*. When I saw one too ambitious of court favor, sacrificing his time in attendance on levees, his repose, his liberty, his virtue, and perhaps his friends, to attain it, I have said to myself. *This man gives too much for his whistle*.

When I saw another fond of popularity, constantly employing himself in political bustles, neglecting his own affairs, and ruining them by that neglect. He pays, indeed, said I, too much for his whistle.

If I knew a miser, who gave up every kind of comfortable living, all the pleasure of doing good to others, all the esteem of his fellow-citizens, and the joys of benevolent friendship, for the sake of accumulating wealth. Poor man, said I, *you pay too much for your whistle*.

When I met with a man of pleasure, sacrificing every laudable improvement of the mind, or of his fortune, to mere corporeal sensations, and ruining his health in their pursuit. Mistaken man, said I, *you are providing pain for yourself instead of pleasure; you give too much for your whistle.*

If I see one fond of appearance, or fine clothes, fine houses, fine furniture, fine equipages, all above his fortune, for which he contracts debts, and ends his career in a prison, Alas! Say I, he has paid dear, very dear, for his whistle.

When I see a beautiful, sweet-tempered girl married to an ill-natured brute of a husband. What a pity, say I, that she should pay so much for a whistle!

In short, I conceive that great part of the miseries of mankind are brought upon them by the false estimates they have made of the value of things, and by their *giving too much for their whistles.*

# The Origin of Species; Extract from the Recapitulation and Conclusion

Charles Darwin, 1859

I have now recapitulated the facts and considerations which have thoroughly convinced me that species have been modified, during a long course of descent. This has been effected chiefly through the natural selection of numerous successive, slight, favourable variations; aided in an important manner by the inherited effects of the use and dis- use of parts; and in an unimportant manner, that is in relation to adaptive structures, whether past or present, by the direct action of external conditions, and by variations which seem to us in our ignorance to arise spontaneously. It appears that I formerly underrated the frequency and value of these latter forms of variation, as leading to permanent modifications of structure independently of natural selection. But as my conclusions have lately been much misrepresented, and it has been stated that I attribute the modification of species exclusively to natural selection, I may be per- mitted to remark that in the first edition of this work, and subsequently, I placed in a most conspicuous position—namely, at the close of the Introduction the following words : "I am convinced that natural selection has been the main but not the exclusive means of modification." This has been of no avail. Great is the power of steady misrepresentation; but the history of science shows that fortunately this power does not long endure.

It can hardly be supposed that a false theory would explain, in so satisfactory a manner as does the theory of natural selection, the several large classes of facts above specified. It has recently been objected that this is an unsafe method of arguing; but it is a method used in judging of the common events of life, and has often been used by the greatest natural philosophers. The undulatory theory of light has thus been arrived at; and the belief in the revolution of the earth on its own axis was until lately supported by hardly any direct evidence. It is no valid objection that science as yet throws no light on the far higher problem of the essence or origin of life. Who can explain what is the essence of the attraction of gravity? No one now objects to following out the results consequent on this unknown element of attraction; notwithstanding that Leibnitz for merely accused Newton of introducing "occult qualities and miracles into philosophy."

I see no good reason why the views given in this volume should shock the religious feelings of any one. It is satisfactory, as showing how transient such impressions are, to remember that the greatest discovery ever made by man, namely, the law of the attraction of gravity, was also at- tacked by Leibnitz, "as subversive of natural, and inferentially of revealed, religion." A celebrated author and divine has written to me that "he has gradually learnt to see that it is just as noble a conception of the Deity to believe that He created a few original forms capable of self-development into other and needful forms, as to believe that He required a fresh act of creation to supply the voids caused by the action of His laws."

Why, it may be asked, until recently did nearly all the most eminent living naturalists and geologists disbelieve in the mutability of species. It cannot be asserted that organic beings in a state of nature are subject to no variation; it cannot be proved that the amount of variation in the course of long ages is a limited quantity; no clear distinction has been, or can be, drawn between species and well-marked varieties. It cannot be maintained that species when inter- crossed are invariably sterile, and varieties invariably fertile; or that sterility is a special endowment and sign of creation. The belief that species were immutable productions was almost unavoidable as long as the history of the world was thought to be of short duration; and now that we have acquired some idea of the lapse of time, we are too apt to assume, without proof, that the geological record is so perfect that it would have afforded us plain evidence of the mutation of species, if they had undergone mutation.

But the chief cause of our natural unwillingness to admit that one species has given birth to other and distinct species, is that we are always slow in admitting great changes of which we do not see the steps. The difficulty is the same as that felt by so many geologists, when Lyell first insisted that long lines of inland cliffs had been formed, and great valleys excavated, by the agencies which we see still at work. The mind cannot possibly grasp the full meaning of the term of even a million years ; it cannot add up and perceive the full effects of many slight variations, accumulated during an almost infinite number of generations.

Although I am fully convinced of the truth of the views given in this volume under the form of an abstract, I by no means expect to convince experienced naturalists whose minds are stocked with a multitude of facts all viewed, during a long course of years, from a point of view directly opposite to mine. It is so easy to hide our ignorance under such expressions as the "plan of creation," "unity of design," &c., and to think that we give an explanation when we only re-state a fact. Any one whose disposition leader him to attach more weight to unexplained difficulties than to the explanation of a certain number of facts will certainly reject the theory. A few naturalists, endowed with much flexibility of mind, and who have already begun to doubt the immutability of species, may be influenced by this volume; but I look with confidence to the future,—to young and rising naturalists, who will be able to view both sides of the question with impartiality. Whoever is led to believe that species are mutable will do good service by conscientiously expressing his conviction; for thus only can the load of prejudice by which this subject is overwhelmed be removed.

Several eminent naturalists have of late published their belief that a multitude of reputed species in each genus are not real species; but that other species are real, that is, have been independently created. This seems to me a strange conclusion to arrive at. They admit that a multitude of forms, which till lately they themselves thought were special creations, and which are still thus looked at by the majority of naturalists, and which consequently have all the external characteristic features of true species, —they admit that these have been produced by variation, but they refuse to extend the same view to other and slightly different forms. Nevertheless they do not pretend that they can define, or even conjecture, which are the created forms of life, and which are those produced by secondary laws. They admit variation as a vera causa in one case, they arbitrarily reject it in another, without assigning any distinction in the two cases. The day will come when this will be given as a curious illustration of the blindness of preconceived opinion. These authors seem no more startled at a miraculous act of creation than at an ordinary birth. But do they really believe that at innumerable periods in the earth's history certain elemental atoms have been commanded suddenly to flash into living tissues? Do they believe that at each supposed act of creation one individual or many were produced? Were all the infinitely numerous kinds of animals and plants created as eggs or seed, or as full grown? and in the case of mammals, were they created bearing the false marks of nourishment from the mother's womb? Undoubtedly some of these same questions cannot be answered by those who believe in the appearance or creation of only a few forms of life, or of some one form alone. It has been maintained by several authors that it is as easy to believe in the creation of a million beings as of one; but Maupertuis' philosophical axiom "of least action" leads the mind more willingly to admit the smaller number; and certainly we ought not to believe that innumerable beings within each great class have been created with plain, but deceptive, marks of descent from a single parent.

As a record of a former state of things, I have retained in the foregoing paragraphs, and elsewhere, several sentences which imply that naturalists believe in the separate creation of each species; and I have been much censured for having thus expressed myself. But undoubtedly this was the general belief when the first edition of the present work appeared. I formerly spoke to very many naturalists on the subject of evolution, and never once met with any sympathetic agreement. It is probable that some did then believe in evolution, but they were either silent, or expressed themselves so ambiguously that it was not easy to understand their meaning. Now things are wholly changed, and almost every naturalist admits the great principle of evolution. There are, however, some who still think that species have suddenly given birth, through quite unexplained means, to new and totally different forms: but, as I have attempted to show, weighty evidence can be opposed to the admission of great and abrupt modifications. Under a scientific point of view, and as leading to further investigation, but little advantage is gained by believing that new forms are suddenly developed in an inexplicable manner from old and widely different forms, over the old belief in the creation of species from the dust of the earth.

It may be asked how far I extend the doctrine of the modification of species. The question is difficult to answer, because the more distinct the forms are which we consider, by so much the arguments in favor of community of descent become fewer in number and less in force. But some arguments of the greatest weight extend very far. All the members of whole classes are connected together by a chain of affinities, and all can be classed on the same principle, in groups subordinate to groups. Fossil remains sometimes tend to fill up very wide intervals between existing orders. (…)

When the views advanced by me in this volume, and by Mr. Wallace, or when analogous views on the origin of species are generally admitted, we can dimly foresee that there will be a considerable revolution in natural history. Systematists will be able to pursue their labours as at present; but they will not be incessantly haunted by the shadowy doubt whether this or that form be a true species. This, I feel sure and I speak after experience, will be no slight relief. The endless disputes whether or not some fifty species of British brambles are good species will cease. Systematists will have only to decide (not that this will be easy) whether any form be sufficiently constant and distinct from other forms, to be capable of definition; and if definable, whether the differences be sufficiently important to deserve a specific name. This latter point will become a far more essential consideration than it is at present; for differences, however slight, between any two forms, if not blended by intermediate gradations, are looked at by most naturalists as sufficient to raise both forms to the rank of species.

Hereafter we shall be compelled to acknowledge that the only distinction between species and well-marked varieties is, that the latter are known, or believed, to be connected at the present day by intermediate gradations whereas species were formerly thus connected. Hence, without rejecting the consideration of the present existence of intermediate gradations between any two forms, we shall be led to weigh more carefully and to value higher the actual amount of difference between them. It is quite possible that forms now generally acknowledged to be merely varieties may hereafter be thought worthy of specific names; and in this case scientific and common language will come into accordance. In short, we shall have to treat species in the same manner as those naturalists treat genera, who admit that genera are merely artificial combinations made for convenience. This may not be a cheering prospect; but we shall at least be freed from the vain search for the undiscovered and undiscoverable essence of the term species.

The other and more general departments of natural history will rise greatly in interest. The terms used by naturalists, of affinity, relationship, community of type, paternity, morphology, adaptive characters, rudimentary and aborted organs, &c., will cease to be metaphorical, and will have a plain signification. When we no longer look at an organic being as a savage looks at a ship, as something wholly be- yond his comprehension ; when we regard every production of nature as one which has had a long history; when we contemplate every complex structure and instinct as the summing up of many contrivances, each useful to the possessor, in the same way as any great mechanical invention is the summing up of the labour, the experience, the reason, and even the blunders of numerous workmen ; when we thus view each organic being, how far more interesting—I speak from experience—does the study of natural history become!

A grand and almost untrodden field of inquiry will be opened, on the causes and laws of variation, on correlation, on the effects of use and disuse, on the direct action of external conditions, and so forth. The study of domestic pro- ductions will rise immensely in value. A new variety raised by man will be a more important and interesting subject for study than one more species added to the infinitude of already recorded species. Our classifications will come to be, as far as they can be so made, genealogies; and will then truly give what may be called the plan of creation. The rules for classifying will no doubt become simpler when we have a definite object in view. We possess no pedigrees or armorial bearings; and we have to discover and trace the many di- verging lines of descent in our natural genealogies, by characters of any kind which have long been inherited. Rudimentary organs will speak infallibly with respect to the nature of long-lost structures. Species and groups of species which are called aberrant, and which may fancifully be called living fossils, will aid us in forming a picture of the ancient forms of life. Embryology will often reveal to us the structure, in some degree obscured, of the prototypes of each great class.

# Epilogue

The pricing mechanisms forces us to philosophically compete with the financial community. I urge you to acknowledge the importance of this factor. A prerequisite for excess returns is to send signals with unpriced information. The signal could also encapsulate the recognition of a saturated component.

I am strongly getting the feeling that *worldly wisdom* will facilitate thinking in dissonance with the crowds. Only rarely can one get novel, unpriced, insights, if the person operates with widely spread tools. For future editions, I might consider including pertinent extracts from other disciplines that I suspect can get you closer to being an *originator of original ideas.*

This compilation of reads largely entails elements worth mastering. Portfolio management is a skill we must unavoidably learn to generate excess returns. Continuous proper weighing of information appears to be one of the most difficult things to grasp. These types of reads provide different perspectives, all of which have proven to be profitable. It is up to each of us to learn from these brilliant and generous people.