



October 14, 2022

To Our Clients & Friends:

This letter is arriving a bit later than usual, but many of our clients got to hear from us at our investor meeting on October 7<sup>th</sup> in New York. Francois Rochon and I enjoyed being with you, whether in person or online, and taking your questions about the portfolio. As a reminder, I also take part every spring in the investor meeting held by my affiliate firm Giverny Capital Inc. in Montreal.

The year continues to be challenging. For the third quarter ended September 30, 2022, the Giverny Capital Asset Management model portfolio, which is a Poppe family account, declined by 4.64%, net of fees.<sup>1</sup> This compares to a decline of 4.88% for the benchmark Standard & Poor's 500 Index.<sup>2</sup> For the year-to-date through September 30, the GCAM model returned -28.71%, net of fees, vs. -23.87%, for the S&P 500 Index. Our firm is now 30 months old, and since inception we have delivered an annualized return of 12.98%, net of fees, vs. 15.80% for the Index.

Our quarterly performance was in line with the market, but the year remains a disappointment. I'll confess to some surprise at the way this year has unfolded. As an owner of a concentrated portfolio of market-leading businesses, I thought we'd fare reasonably well in a severe downturn, as capital might flee speculative stocks in favor of sounder businesses. Instead, it gravitated to oil, utilities and consumer staples, ostensible safe havens in inflationary times. And, truth be told, our beta – a measure of portfolio volatility – is higher than the Index's. That suggested we'd decline more than the market in a downturn (and rise more in a rally).

Whatever our beta (I spend no time thinking about it), I continue to believe we own a higher-quality portfolio of businesses than the Index overall. Why should you believe me? As we discussed at the investor meeting, in recent years our portfolio has grown earnings per share faster than the Index, and the 26 stocks we owned at quarter end generate higher returns on equity (on a weighted basis, accounting for their size in our portfolio) than the Index. Yet with this year's declines, the forward PE multiple on our portfolio is equal to the S&P 500. The market seems to be saying that our companies will not grow in the future the way they have in the past.

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<sup>1</sup> The family account does not pay a management fee. The returns presented herein assume the deduction of an annual management fee of 1% to show what a client account's performance would have been if it had been invested the same as the family account during the period. Past performance is not necessarily indicative of future results.

<sup>2</sup> The S&P 500 Index returns include the reinvestment of dividends and other earnings. The Index is an unmanaged, capitalization-weighted index of common stocks of 500 major US corporations. The Index does not incur expenses and is not available for investment.

A simple chart tells the story of 2022 quite well. The market craves stability, but I'd rather own our three beaten-up growers than the staples companies listed.

<b>Company (As of Sep 30 th)</b>	<b>Growth (11-21)</b>	<b>P/E 2022</b>	<b>PERF. 2022</b>
Coca-Cola Co.	2%	23	-5%
McDonald's	6%	23	-14%
Colgate	0%	23	-18%
<b>Average (3 "stable" stocks)</b>	<b>3%</b>	<b>23</b>	<b>-12%</b>
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Ametek Inc.	11%	20	-23%
Carmax Inc.	15%	15	-49%
First Republic Bank	13%	16	-37%
<b>Average (3 port. holdings)</b>	<b>13%</b>	<b>17</b>	<b>-36%</b>

This is not intended in any way as a criticism of Coke, McDonald's or Colgate. They're exceptional franchises that have generated good results for their owners over generations. They will probably grow earnings modestly this year while some of our companies won't. But our Giverny conglomerate consists of a basket of strong franchises we've identified as having years of growth ahead of them. Right now, our basket is out of favor. Over time, stock prices reflect long-term corporate earnings power. We're investing for 10 years, not one, and I'll go out on a limb and say our three listed companies are going to grow their sales and earnings faster than the three staples over the rest of the decade.

We don't always get it right, especially when we try to anticipate short-term market movements. We entered the year believing interest rates would rise, and that we were well positioned to benefit from that rise. We own a collection of strong insurance companies – Progressive Corp., Markel and several inside Berkshire Hathaway – that invest heavily in fixed income securities and figured to benefit from higher interest rates (in addition to benefiting from rising insurance premiums). That has worked out. Progressive is our best performing stock this year and Markel and Berkshire have outperformed the Index. Importantly, all three continue to benefit from a strong environment for premium rate increases as well as higher returns on fixed income investments.

We own three good banks – JP Morgan, M&T Bank and First Republic – that have low costs of deposits and figured to benefit from collecting deposits cheaply and lending more dearly. M&T Bank is up quite a bit this year, while JP Morgan and First Republic Bank were down 35% to 40% through September 30<sup>th</sup>. The market has become concerned recently about First Republic's ability to keep gathering low-cost deposits to fund torrid loan growth, and the stock has weakened more in October even as it grows loans and customer relationships at accelerating rates.

We also own Charles Schwab, which earns nearly all its income from the spread it earns between the minuscule rate it pays on cash balances held in brokerage accounts and the yield it can earn investing that cash in fixed income securities or lending those balances via Schwab Bank. Schwab is down about 12% through September. That is better than the market but not great, especially considering the consensus of Wall Street analysts says Schwab should earn \$4 per share this year and nearly \$5 next

year. The stock trades for \$75. This is a dominant franchise with consumer trust – Schwab grows brokerage accounts by about 6% per year – and a low-cost expense structure, trading attractively.

Altogether, we have not gotten the benefit I expected from our exposure to higher rates. However, we own these franchises because we think they're going to perform well over many years, and I've seen nothing this year that would change my mind about their respective competitive positions.

Our worst performers for the year-to-date have been painful. Meta Platforms is down roughly 60%, and Carmax, Eurofins Scientific, Coherent and Ciena have lost about half their value. I'm wearing a dunce cap for Meta, as the changes Apple made to privacy tracking severely impacted Meta's effectiveness at targeting ads to the right consumers. However, despite being compared recently to AOL by one analyst, Meta continues to capture enormous amounts of consumer attention: roughly 2.9 billion people use one of its sites every day. I believe it has a very long runway on monetizing those eyeballs, especially outside North America. For all its problems with ad tracking, and despite heavy investment in the so-called metaverse, Meta should earn about \$10 per share in 2022 and more next year. The stock, at \$136 on September 30, reflects pessimism that Meta will ever recover. We're holding because we think that Meta has the resources to improve its advertising efficiency, and that it eventually will.

Other holdings enduring difficult years include Carmax, the largest used car retailer in the country. Demand for used cars can be cyclical, and right now sales are off as cars become less affordable. The current soft patch comes as Carmax has ramped up investment in its ability to sell more cars online. So, we have a double whammy of lower sales and higher investment in future growth. Earnings may fall in half this year, which succinctly explains the stock falling in half. I am positive, however, that Carmax continues to have, by far, the best business model for selling used cars. The success of its Instant Offer program means it has an efficient system to acquire inventory from consumers. It has the lowest costs for refurbishing those cars for resale and the lowest freight costs for moving cars to the markets where they'll sell most profitably. It has the lowest costs in percentage-of-revenue terms of national advertising, because of its scale. The TV ads build the brand. It turns inventory faster than peers, and because used cars lose value at a rate of about \$10 per day, a 15-day advantage in inventory turn amounts to \$150 per car of higher profit.

Add it all up, and this is a highly advantaged company. I see no compromise to its long-term competitive position. Indeed, Carmax is gaining share in a weak market. I continue to believe Carmax could earn \$10 per share in a few years, while still only commanding a mid-single digit percentage of all used car sales. The stock has been as low as \$60 recently.

Coherent and Ciena are quite different companies, but both manufacture and sell optical-electronic components and hardware that carry traffic on communications networks. Demand for bandwidth grows and grows; both companies have large order books and backlogs. The market may believe customers will cancel these orders as the economy weakens. The market also seems particularly skeptical about Ciena's ability to deliver on its backlog, as the company has suffered supply chain problems all year. I think we'll probably end up being happy to have the exposure to the structural growth in wireless communications, cloud computing, industrial automation and related markets. But I am watching closely to see if these two make progress delivering on their extended backlogs of orders.

Eurofins Scientific is a leader in a variety of scientific testing fields: food safety, water quality, pharmaceutical efficacy and, yes, Covid tests. The stock boomed with the rise of Covid testing, and as

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that demand has begun to wane, Eurofins has plunged. I've been a little surprised, mainly because it was always clear the Covid boom would end at some point. While Eurofins' earnings will be lower this year and possibly next, the company's testing businesses outside of Covid continue to grow faster than the economy and remain highly profitable. Pre-Covid, Eurofins tended to trade for high multiples of earnings, reflecting the quality and durability of its market positions. Now, if we strip out Covid earnings entirely, the business trades for about the same multiple as the S&P 500 Index. We think Eurofins, led by founder-CEO Dr. Gilles Martin, remains one of the highest quality businesses we own.

Importantly, when I look at the five worst performers – Meta, Carmax, Coherent, Ciena and Eurofins – with the exception of Meta, I don't see them losing market share to competitors, nor losing pricing power. Meta's Instagram is losing market share to TikTok, the Chinese social media site.

I'd like to make one more point about the current environment. The pain we are feeling now is not only normal, it's part of market cycles. Over the past 65 years, there have been 15 corrections of at least 20%. The average decline in these 15 corrections has been 32%. We don't know how or when the current downturn will end, but in 13 prior cases, the market ended up higher five years later. The two most recent corrections happened recently, so we don't know how their five-year recovery will look.

<u>Year</u>	<u>Crisis</u>	<u>Correction</u>	<u>5 years +</u>
1956-1957	<u>Recession (and "Asian Flu")</u>	-21%	<b>100%</b>
1962	Flash crash / Cuba missile crisis	-29%	<b>112%</b>
1966	<u>Vietnam war escalation</u>	-23%	<b>70%</b>
1970	<u>Recession</u>	-32%	<b>55%</b>
1973-74	<u>Oil shock</u>	-50%	<b>111%</b>
1979-1980	<u>Second oil shock</u>	-21%	<b>138%</b>
1982	<u>Recession (&amp; 15% interest rates)</u>	-28%	<b>274%</b>
1987	Black Monday Crash	-36%	<b>127%</b>
1990	S&L crisis/Iraq war	-20%	<b>127%</b>
1997-98	<u>Asian crisis</u>	-22%	<b>28%</b>
2000-2002	<u>Dot.com bubble bursts</u>	-50%	<b>122%</b>
2008-2009	Great Financial Crisis	-56%	<b>207%</b>
2011	<u>Europe crisis</u>	-22%	<b>124%</b>
2020	<u>Coronavirus pandemic</u>	-35%	<b>118% in two years</b>
2022	<u>War in Ukraine / Inflation</u>	-24%	<b>?</b>
<b><u>Average</u></b>		<b>-32%</b>	<b>123%</b>

It may sound like a cop out for me to tell you that the best strategy for weathering a downturn is to weather it. That doesn't make it less true. Mr. Market is a manic depressive, and stock market highs

tend to be too high and the lows too low relative to the overall health of corporate America. But over decades, the market grinds higher. That's because people with vision, energy and ambition tend to create good products and services that make our lives better and add value to the economy. When we own stocks, we are betting on human ingenuity and managerial discipline to create value, and on the ability of markets to properly assess the worth of profitable enterprises.

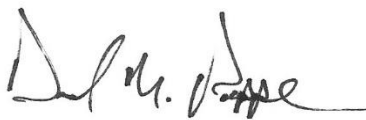
Another factor to consider is that because Mr. Market overreacts, when the current downward spiral reverses, it probably won't happen slowly. At our investor meeting, I talked about how the 10 best up days of the 20-year period from 2001 thru 2020 contributed half of the total return from stocks. If you missed those 10 days in a 20-year cycle, you didn't just underperform, you got clobbered, earning a 3.4% annual return rather than a 7.5% return over two decades. A majority of those 10 days happened literally the day after the market hit its ultimate bottom. Better to own stocks and tolerate volatility than to try to guess when the collective national psyche will improve.

Could it be different this time? Sure. I hear economists, smart investors, foreign policy experts and retired senior military officers speak from time to time and most of these pooh-bahs are profoundly pessimistic. The brilliant investor Stan Druckenmiller opined recently that the US stock market could be flat for a decade. The policy experts say the US is not prepared for nuclear attacks in Ukraine, or for a possible Chinese blockade of Taiwan. The US has so much debt that we require low interest rates to maintain federal spending. If rates keep rising, the US budget deficit could become crushing, quickly. Others decry what they perceive as our country's unmotivated workforce. But I am a news junkie old enough to remember well the reporting on market crises from 1980 forward, and I don't recall the pundit class ever commenting enthusiastically about the country's prospects. Their job is to point out risks and warn of what could go wrong. And it is human nature to expect what happened last to happen next, even though it rarely works that way. Look at that chart again and register where the market tends to be five years after a correction.

This year hurts. Luckily, we don't have to sell stocks at the quoted prices. As it happens, we had no transactions during the third quarter. If we do sell a security at these prices, it will be because we found something to buy at an even better value, thus strengthening the overall portfolio. I'd encourage you to remember that we invest in capable management teams and competitively advantaged businesses. I believe 100% of our companies will earn a profit this year and most have modest debt levels relative to their cash flows.

Finally, my partner Francois reminded me recently that over the past 50 years, the underlying earnings of the S&P 500 Index have risen 33-fold. And guess what? Over that same period, the Index rose in price from 111 to 3660, exactly 33-fold. I am focused on earnings growth because over time, stock prices invariably follow earnings performance.

With every good wish,



David M. Poppe

**Giverny Capital Asset  
Management**

*Top 10 holdings*

*September 30, 2022*

Alphabet A&C	8.1%
Progressive Corp.	7.2%
Arista Networks	6.8%
Charles Schwab	6.6%
Constellation Software	6.0%
Heico Class A	5.5%
Carmax	5.2%
Credit Acceptance Corp.	4.4%
Berkshire Hathaway	4.3%
<u>Five Below</u>	<u>4.2%</u>
<b>Total</b>	<b>58.3%</b>