April 15, 2022

"Persistent inflation will require rising interest rates and a massive but necessary shift from quantitative easing to quantitative tightening. It is easy to second-guess complex decisions after the fact. The Federal Reserve (the Fed) and the government did the right thing by taking bold dramatic actions following the misfortune unleashed by the pandemic. In hindsight, it worked. But also in hindsight, the medicine (fiscal spending and QE) was probably too much and lasted too long. I do not envy the Fed for what it must do next: The stronger the recovery, the higher the rates that follow (I believe that this could be significantly higher than the markets expect) and the stronger the quantitative tightening. If the Fed gets it just right, we can have years of growth, and inflation will eventually start to recede. In any event, this process will cause lots of consternation and very volatile markets.

- Jamie Dimon, JP Morgan Chase CEO annual letter to shareholders

To Our Clients and Friends:

For the first quarter of 2022, Giverny Capital Asset Management’s model portfolio declined by 8.21%, net of fees, vs. a decline of 4.60% for the Standard & Poor’s 500 Index. For the trailing twelve-month period, the GCAM model generated a return of 9.63% vs. 15.65% for the Index, also net of fees. Our firm is now two years old and has generated annualized performance of 32.17%, net of fees, vs. 34.47% for the Index since our inception.

It was a rough quarter. I don’t say that because stock prices declined. That happens. Volatility, after all, is what creates the occasional dislocations in the market that allow long-term investors to buy great companies at attractive prices. We took some advantage of the downturn to get more invested in businesses we like, reducing our cash position to below 3%, the lowest level since we started the firm. But I would typically expect this portfolio to perform better during periods of market weakness. In my experience, the best companies tend to weather crises better than average ones, and I believe we own a portfolio of outstanding companies.

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1 The model is a Poppe family account which 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.

2 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.
So, what happened? For one thing, energy-related stocks led the market. The Index’s energy components overall returned 38% during the quarter, while most other stocks lost value. Not coincidentally, the Brent crude oil price also rose 38% during the quarter.

GCAM doesn’t own any energy or materials stocks. That’s intentional. About 15 years ago, I did a fair amount of work on the emerging Canadian oil sands companies. Back then, many people believed in the peak oil theory – that is, all the easily pumped oil in the world had been identified and production had peaked. In the future, incremental barrels of oil would be expensive to produce, driving oil prices higher. If you believed in peak oil, the Canadian oil sands figured to be extremely valuable. The oil sands were (and are) a massive deposit of low-quality oil residing in tarry bogs in northern Alberta. Extracting that oil from the sandy soil is expensive, but in a world of $100/barrel oil, the oil sands companies stood to prosper.

I learned three lessons from this project that inform my investing at GCAM. First, never bet on any kind of Malthusian thesis about scarcity, as this is essentially a bet against human ingenuity. Peak oil was entirely wrong; there was plenty of oil left to extract, via fracking and other technological advances. Second, no one in the oil industry knows what the price of oil will be in a year. Thus, oil companies spend tens of billions of dollars on capital investments with limited visibility into what the future return will be. Third, oil companies are like derivative securities: their success or failure depends more on the price of an underlying asset – oil – than it does on their management teams. For sure, there are better and worse managements in energy, and they all work hard to produce oil at the lowest possible cost. But every major oil company underperformed the S&P 500 over the decade ended March 31, 2022, a period in which the oil price was mostly low.

Here is a chart of seven leading oil companies’ stock performance over the past decade vs. the Index.

<table>
<thead>
<tr>
<th>Company</th>
<th>Total Shareholder Return 10 years thru March 31, 2022 - annualized</th>
</tr>
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<tbody>
<tr>
<td>Exxon Mobil</td>
<td>3.8%</td>
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<tr>
<td>Chevron</td>
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<td>Hess</td>
<td>7.9%</td>
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<tr>
<td>ConocoPhillips</td>
<td>9.3%</td>
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<td>EOG Resources</td>
<td>9.5%</td>
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<tr>
<td>Shell</td>
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<td>Canadian Natural Resources</td>
<td>10.0%</td>
</tr>
<tr>
<td>S&amp;P 500 Index</td>
<td>14.6%</td>
</tr>
</tbody>
</table>

*Source: FactSet Research, Morningstar*

Were these companies all run by subpar management teams? Of course not. But they are all ultimately hostage to the oil price. What I am trying to do at GCAM is align with fantastic managers who control their own destiny. Or, at minimum, have more control of their own destiny. At Five Below, management builds a new store with the confidence that it will receive 100% of the capital investment back in the first year of operation. I would much rather invest in a business that earns predictably high returns and...
has a clear growth trajectory than in a business that could earn a superior return if a commodity price remains elevated.

However, the right thing for me to do today is tip my cap to the benefits of a diversified portfolio and acknowledge that if oil prices remain around $100 per barrel for years, energy companies may lead the market for some time. This is a possibility in part because low oil prices over the past decade led (eventually) to low investment. If Russia’s vicious war in Ukraine leads to Western countries banning Russian oil for years, it won’t be easy to replace that production.

I intend to continue avoiding commodity businesses in favor of investing in exceptional management teams at the helm of competitively advantaged businesses. Further, even if I wanted to hedge geopolitical risk by owning some oil exposure, over the long term, I would expect global oil consumption to decline. My crystal ball is not better than anyone else’s, but I’d rather invest in obvious structural growers than probable structural decliners, even if the decliners are having a moment.

My wife likes to kid me for my tendency to praise essays and other commentary by saying, “It was good because I agreed with it.” I cite Jamie Dimon at the top of this letter because I agree with his comments and, in fact, have been writing to you for some time about the problem of unsustainably low interest rates coupled with high levels of inflation. As you know, we own a significant number of companies that should benefit from higher interest rates, including banks JP Morgan Chase, M&T Bank and First Republic Bank, insurers Progressive Corp., Berkshire Hathaway and Markel, and the brokerage Charles Schwab. This group constitutes more than a quarter of the portfolio, and the three insurers and M&T Bank were the best performers in the portfolio during the first quarter.

The Federal Reserve seems reluctant to do its job, but it is clear (at least to Jamie Dimon and me) that interest rates are going to have to rise at a much faster rate to tame inflation. The economy is humming, despite the war and high gasoline prices. Sales of recreational vehicles – campers – will roughly double over the period from 2019 to 2022. Credit card balances are up, per JP Morgan, as are bank deposits. Airlines, cruise lines and Las Vegas resorts expect their revenue to approach or exceed 2019 levels this year. We’re at nearly full employment even though some two million Americans retired early during the pandemic. I am involved with a non-profit that will raise salaries for all employees by 10% this year just to keep up with the cost of living.

Dimon mentions in his letter to JP Morgan shareholders that rising interest rates will cause market turmoil, but adds stable markets are less important than a stable economy. Again, I agree with him, but market turmoil is where we come in. The next year or two likely will be bumpy. Our GCAM portfolio saw a huge disparity in performance between the top five and bottom five stocks in the first quarter. Put bluntly, our insurers rose a lot, while companies that reported any kind of hiccup in their results got punished severely. I suspect those kinds of strong reactions will continue.

Our top five performers for the quarter were Markel (+19.5%); Berkshire Hathaway (+18.0%); Progressive Corp. (+11.2%); M&T Bank (+11.1%) and II-VI (+6.1%). The top three are insurers, although Berkshire has diverse businesses contributing to results. Property & Casualty insurers broadly speaking enjoy a lot of pricing power right now, but they also benefit from rising interest rates in their large portfolios of fixed income investments.
Our bottom five performers were a more eclectic bunch and boy, did they get clobbered. Meta Platforms declined 33.9%, followed by Installed Building Products (-29.2%); Carmax (-25.9%); Five Below (-23.5%) and Eurofins Scientific (-21.6%). Credit Acceptance also declined 20%.

If there is any good news, I don’t believe this group suffered material impairments to their long-term earnings trajectory. Rather, relatively small earnings misses or reductions to short-term guidance led to large stock declines. I added to several of these positions during the quarter.

However, our holding Meta Platforms, the detested social media business formerly known as Facebook, deserves some attention. It suffered an earnings miss in the fourth quarter of 2021 and provided sobering future guidance. While this qualifies as disappointing news, I think the market reaction was more of a primal scream than a considered response.

As a person who manages other people’s money for a living, I can tell you with confidence that clients don’t like Meta. A few of you won’t own it, restricting me from buying it for you. Others defer to me, grudgingly. There is no other security in our portfolio like this. When a company is so widely disliked, the main reason to hold it is because it is “working,” to use the horrible Wall Street parlance. In other words, your manager owns it because it keeps going up. Once it stops going up, professional money managers happily accept the chance to sell it. No more cranky calls from clients questioning their ethical compass.

The rub, however, is that despite the bad earnings news the economics of Meta’s social media businesses remain exceptionally good. In 2021, for every dollar of revenue generated Meta spent 63 cents on expenses and reported 37 cents of pretax profit. That was considered disappointing, even though very few businesses generate 37% profit margins. On top of that, fully one-third of expenses, or 21 cents on the dollar of revenue, is spent on research & development, which is investment in future growth. In Meta’s case, this amounts to about $25 billion a year invested in various new projects, the most important of which is the metaverse. R&D is not completely discretionary as companies have to invest in innovation or stagnate. But management certainly has flexibility as to the pace of spending.

In addition to its huge R&D budget, Meta spent about $19 billion last year on capital expenditures – investment in physical assets like computer data centers – that also fuel future growth. It intends to spend much more on property and equipment in 2022 and 2023. Add together the rising R&D and capital spending, and Meta could spend more than $50 billion a year on growth initiatives.

I can’t say yet that these investments will pay off, but sales of Meta’s Oculus headsets are healthy and reviews are enthusiastic. I feel certain that Meta CEO Mark Zuckerberg won’t continue to spend so heavily on R&D if it produces no results.

Further, Wall Street may loathe Meta but the consensus of analysts who follow the company is that revenue should grow from $118 billion in 2021 to more than $170 billion in 2024. Call it 45% revenue growth in three years. How can this be, you may wonder, given that everyone ostensibly is moving on to other social media sites?

Well, the truth is that American users now spend about 16 hours a month on Facebook – a half-hour every day, roughly – and this is slightly down from a year ago. But users everywhere else in the world spend closer to 20 hours per month on Facebook, and this number is going up. And advertising markets are much less developed outside the US, meaning there is a lot of room to grow ad revenue. Facebook’s revenue per hour of usage in North America is more than 10 times higher than it is in Asia, but Asia has
many more users. Instagram usage also grows both in the US and the rest of the world. Changes by Apple’s and Alphabet’s phone operating systems have damaged Facebook’s utility as an advertising platform by making it harder to track people’s habits on the internet, but Facebook’s investments in machine learning should mitigate that harm. Also, this is a known problem and factored into long-term growth expectations. I’ve heard comments from two large advertising agencies recently that their budgets for Meta Platforms’ properties are growing by double digit percentages this year, a signal that Meta remains an important advertising vehicle.

As a thought exercise, if Meta grew revenue to $170 billion by 2024 and held the R&D spend flat at $25 billion or so per year, while letting all other operating expenses rise at the same rate as revenue, its operating profit would be above $70 billion in 2024 vs. $46.7 billion last year. The market value of the company with the stock at $220 is about $600 billion. Back out $50 billion in cash held by Meta, and the market thinks Meta Platforms is worth $550 billion.

These huge numbers are hard to wrap one’s brain around. But ask yourself, would you pay $550 for an income stream that could reach $70 (pretax) in two years, and should grow for years after that? I added to our position in February and then watched the stock decline even more. I bought another slug in March, just below $200. To be sure, it is possible that Meta will invest heavily in the metaverse and earn no return from it. Or it may still be in investment mode in 2024 and not harvesting cash for shareholders. But Meta’s problem is not adequate cash flow, it’s managing the rate of investment in future growth.

We’re acutely aware of the discomfort this business causes thoughtful people. Meta actively steers some people to misinformation with algorithms designed to maximize time spent on the site. Yet, we repeat what we wrote last quarter: the people have spoken and Facebook, Instagram and WhatsApp are where they want to spend time. Roughly 2.8 billion people log onto a Meta-owned social media site every day, and they stay for a while. That makes Meta the best advertising vehicle in the digital world.

As for our other big decliners, Carmax is the country’s largest seller of used autos. Last year, amid supply chain shortages, production of new cars slowed. This created huge demand for used cars, and prices surged. Carmax opted to hold its gross profit dollars per vehicle flat in this environment, which benefits customers. If historically Carmax sold a used car for an average price of $21,000 with a $2,100 gross profit, in 2022 it sold used cars for an average price of $29,000 with a $2,200 gross profit. This decision was not well-received by Wall Street. In fairness to the critics, Carmax faced inflationary costs in wages and other areas that may have justified charging higher mark-ups. Still, Carmax sold 23% more vehicles in 2021 than in 2020, earned a lot more money and grew its market share to 4% of all transactions for used cars under 10 years old, from 3.5% a year ago. Presumably, the decision to price responsibly won it some customer goodwill that will result in future business.

Recently, those very high prices for used cars have caused demand to wane. Carmax may sell fewer cars in 2022 than in 2021, which unnerves investors. But it continued to gain market share in early 2022 and still generate healthy profits. Carmax has become quite inexpensive relative to its proven ability to grow profitably in an enormous industry. A 4% market share leaves a lot of room for growth. We added modestly to our position during the first quarter.

Five Below is a variety store aimed at young people – teens and tweens. The merchandise is an eclectic mix of toys, school accessories, candy, low-priced electronics, room décor and apparel. Stores are
colorful and fun, with a strong focus on value. Five Below more than doubled earnings in 2021, coming out of the pandemic, and management believes earnings should grow by about 20% annually for years to come. The company has 1,200 stores around the country; management believes that number can grow to 3,500 by 2030. Encouragingly, the stores do well everywhere -- suburban shopping centers, small towns, big cities.

Investors admire Five Below, putting a rich valuation on the stock. The omicron wave of coronavirus hurt store traffic in January and February, and some inflationary cost pressures are pinching margins. This bad news was not received well. But Five Below arguably has the strongest growth profile in bricks-and-mortar retail and the stock is more reasonably priced after the recent correction. We’re very confident in this business and expect to own it for a long time. We bought more shares during the quarter.

Eurofins Scientific is a scientific testing company with a broad array of tests across food, environmental and life sciences. It has earned windfall profits the past two years because of COVID-19 testing. The stock skyrocketed in 2021 as demand for COVID testing seemed insatiable. Recently, it has felt like the market is wrestling with the question of what Eurofins’ normalized earnings power might be, post-pandemic. The good news is that Eurofins’ non-COVID-19 businesses have been growing strongly, with non-COVID revenue in 2021 up 12% over 2019 levels. The company is confident of at least a 5% organic growth rate for the next few years in its non-COVID businesses.

Earnings will be lower in 2022 than in 2021 as COVID testing drops off faster than the core business grows, but the company’s core is highly attractive and worth a premium price in the stock market.

I wrote at some length about Credit Acceptance in my last letter and won’t repeat myself. [Our letters are on our www.givernycam.com web site]. This business is poorly understood, and the stock tends to be volatile. Management bought back 10% of its outstanding shares in 2021, on top of a 5% buyback in 2020. That tells me a lot about how they feel about their future.

Turning to trading, during the first quarter we exited our two smallest positions, Amazon and Topicus, and lightly trimmed our holding Charles Schwab.

Amazon clearly is one of the best companies on the planet, and probably most readers are receiving more packages from Amazon this year than last year. Amazon’s cloud computing business, AWS, is a world-beater and today generates most of the profit of the company. But there are a few things about Amazon that concern me.

Amazon generated $325 billion in revenue from its online store plus third-party seller services last year, yet generated only a 2% profit margin in retail. You don’t need to earn high margins to be a great business. Costco is one of the best companies I’ve ever followed, and it earns only about a 3% margin. But Costco suppresses the margin so that it can offer customers exceptional values. Amazon offers exceptional convenience, but (in my experience) not always exceptional value. Costco also earns extremely steady, and high, returns on capital. Amazon’s returns on capital have trended down significantly recently.
The return is doubly concerning because Amazon is incredibly ambitious. Like Meta, it is investing massively for future growth, including in its own freight operation. Owning lots of airplanes to support a marginally profitable retail business does not seem as promising to me as trying to build the metaverse.

When the stock got down to $2,700 per share last fall, I thought hard about whether I wanted to buy more. I don’t like owning 1% positions as they consume research time and don’t add much value to the portfolio when they do well. But I wasn’t excited about increasing our weight in Amazon, which trades roughly 30x an estimate of 2024 earnings per share vs. 15x for Alphabet and 14x for Meta.

Flash forward to early February and the stock was back to $3,100. I decided to exit. I feel sure Amazon will continue to thrive, but I am comfortable having less exposure to mega-market cap stocks, and especially to mega caps that are quite expensive relative to Alphabet, our largest holding.

Topicus is a computer software business that was spun out of Constellation Software in late 2020. It was less than 1% in our portfolio and not very liquid, partly because Constellation continues to own 60% of Topicus. The company had a great first year in the market, trading at a premium to its parent. We didn’t think it was more valuable than Constellation, so after it went long-term for tax considerations we sold it. We retain significant exposure to its growth though Constellation.

We trimmed Schwab after a big run-up. It remains one of our top five holdings.

During the quarter we established a new position in Installed Building Products. It is early days, but our timing was terrible. Our basis is about $109 and the stock finished the quarter at $84.49.

We remain excited about the prospects for IBP. The company is one of two large installers of fiberglass insulation nationally. The insulation goes mostly into new homes, but also into commercial buildings and other structures. Installing insulation struck me at first blush as uninteresting. But the glass companies that make insulation are operating large furnaces that they cannot turn off and on at will. Their volumes are locked-in and they need large, reliable buyers. We think IBP buys insulation for about 20% less than regional installers. It enjoys similar savings in freight.

That’s quite a competitive advantage. Importantly, when IBP buys a mom-and-pop local operator, it can move the acquired business to its pricing structure. That makes acquisitions very attractive as IBP can boost profitability almost overnight, without great effort and without cutting jobs. In fact, the company has retained local management at many acquired companies.

Further, many of the large national and regional homebuilders are trying to outsource more work to subcontractors, to reduce their labor force. IBP in recent years has begun buying installers of things like rain gutters, closet shelving, window blinds and garage doors, to become a preferred subcontractor to homebuilders. Not surprisingly, the more parts of the home that IBP installs, the more profitable it becomes.

CEO Jeff Edwards has done a masterful job over many years of growing IBP both organically and through acquisitions. He also owns 15% of the stock. Over the five years from 2016 through 2021, operating profit grew more than 20% annually and earnings per share more than tripled, to $5.44 last year. We bought the stock believing that earnings could continue growing rapidly for some time, but rising interest rates may hobble the new home construction market. The market certainly thinks so as IBP now
trades for about 12 times the 2022 earnings estimate of $6.50 per share. It is possible that IBP’s earnings
growth will be not meet our original expectations if housing endures a prolonged downturn.

Our other purchases, of Ciena and B&M European Value Retail, were opportunistic buys of holdings we like.

It’s a queasy time. The Morningstar US Market Index moved either up or down at least 1% on more than half of the trading days in the first quarter, a high proportion. Given the war in Ukraine, soaring inflation, supply shortages and the expectation of sizable rate hikes by the Fed, I expect volatility to continue. That may feel uncomfortable, especially if the market trends downward, but it is impossible to invest well with one eye on current events. The war in Ukraine is deeply disturbing, but market timing does not work and geopolitical events rarely create lasting market impacts. In any case, the best defense against economic uncertainty is to own high-quality, productive assets.

This is a long letter, so thank you for reading till the end. Better, in my opinion, to provide too much detail than not enough after a rocky quarter. Clients also have video replay access to the recent Giverny Capital Inc. annual investor meeting in Montreal, which I participated in. Hopefully, clients will find the review of our portfolio and investment philosophy helpful.

I continue to believe that we’ve curated a collection of superior businesses run by excellent managers that should perform well over time, come what may.

With every good wish,

David M. Poppe

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**Giverny Capital Asset Management, LLC**

*March 31, 2022*

<table>
<thead>
<tr>
<th>Top 10 holdings</th>
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<td>Alphabet A&amp;C</td>
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<td>Arista Networks</td>
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