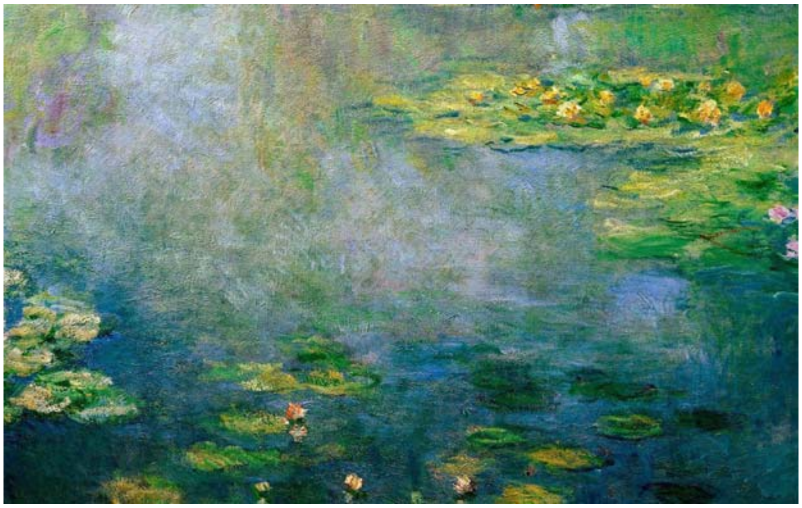
Giverny Capital Inc.



The Keys to Successful Investing

To obtain better results than the others, you must do something DIFFERENT from the others.

- Sir John Templeton (1912-2008)

If stocks represent the asset class that has generated the most wealth over the long term, why is it that so many investors fail to realize good returns with the stock market? Here are a few keys, according to Giverny Capital, that could help you in increasing your likelihood of success.

1- Consider stocks as fractional ownership in real businesses

When we study the great masters of investing and the many decades of available data, we find a critical point in common: these investors behave like businessmen. When they buy a company's stock, they first and foremost are buying part of an enterprise. Whether they are purchasing a hundred shares of Johnson & Johnson or several million shares, these investors consider it no different than if they were buying the company in its entirety. There is no single moment when they consider stocks to be tokens at a casino. They behave like owners of enterprises and they never "play" the market.

2- <u>Being present</u>

One of the flaws of many investors in trying to play the market is to attempt to time the market. If we look at a study by the behavioral research firm Dalbar Inc., we see that for the twenty year period ending in December of 2008, an investor would have realized an 8.4% annual return by investing in the S&P 500. Yet, if we look at the actual average performance of mutual fund investors during this period, we see a mere annual return of 1.9%. How can this significant discrepancy be explained? With management fees being a small portion of that difference, the only plausible explanation is that these investors were selling and buying at the wrong time. To experience returns on the markets, one must first and foremost be present with the market.

3- <u>Profit from market fluctuations rather than suffer from them</u>

The metaphor of "Mr. Market", as taught by Warren Buffett's mentor Benjamin Graham, illustrates the attitude that the rational investor must adopt when facing the market. Mr. Market is your business partner (you are co-shareholders in the same businesses), but he is afflicted with an incurable emotional condition: he is manic-depressive. Every day, he lets you know a price at which he would either buy or sell his ownership in the business you own together. His psychological temperament is reflected in the prices he offers you. When he is euphoric, he only sees the bright side of things and asks a high price for his shares. And on the days when all he sees is dark and dreary, he is willing to sell you his shares at a discount.

In fact, the irrational attitude of Mr. Market is the source of investment opportunities for the investor who knows how to stay rational and unemotional. This investor knows that stock market prices will reflect the fair value of the underlying enterprise in the long term. So, from this perspective, market fluctuations are your allies and not a source of suffering.

4- <u>Leaving yourself a margin of safety</u>

The concept of "margin of safety" is borrowed from the world of engineering. When an engineer is building a bridge that has a capacity to support a five-ton truck, he will build it so that it can support a truck of eight or ten tons. This represents a margin of safety. When we use this concept within the context of investing in a company's stock, it is the difference between what we think the company is worth versus the value of its stock price.

The starting point is the intrinsic value of the company, which we determine theoretically by calculating the current value of the future cash flows generated by the company over the course of its life. Since this is a highly subjective analysis, we must consider a wide margin of error. The more the market is irrational about the value of a company during a selloff, the lower the price we can pay for the company's shares, thus increasing our margin of safety.

Furthermore, one should consider that the margin of safety also exists with more qualitative factors as well. For example, the quality of the company's management team, its competitive advantages, and its intellectual property to name a few. Finding solid companies at attractive prices is the keystone to our approach.

5- <u>Stay within your circle of competence</u>

When it comes to selecting businesses to invest in, Warren Buffett is guided by what he calls his "circle of competence". What is critically important, he says, is to know the limits of your circle of competence. For example, if you don't know the difference between the atomic number of Titanium and the one for Uranium, you should probably steer clear of this sector. To wander outside of your circle of competence significantly increases your probably of making a poor decision.

In the market, to realize better returns than others, you must have better knowledge regarding the value of the businesses in which you invest (the others *are* the market). To succeed, it is important to stay close to companies that one can understand well and evaluate well.

6- <u>Know when to sell</u>

Philip Fisher, the famous investor, once said: "if you've done your work well when you're buying, the time to sell is… almost never". Ideally, we would love to keep our outstanding companies forever, but life is not ideal and a realistic approach is necessary.

We believe that the reasons for selling a stock should be harmonized with the reasons for buying it. We should consider selling if these reasons are no longer valid. In other words, once the investor becomes aware that he made an error in his analysis or the prospects of the business have deteriorated, it is the time to sell. Our firm evolves and companies evolve just as much, for better or for worse. Our investment approach must be aligned to the nature of the capitalist world within which it participates.

Another more pragmatic reason for selling is that the majority of investors do not have unlimited sources of capital at their disposal and they may, quite simply, sell in order to invest in another company whose potential seems brighter.

7- Learn from your mistakes

Mistakes are inevitable in the investing world. The key is to recognize them quickly and learn from them. There are two categories of mistakes: mistakes of commission and mistakes of omission. The first consists of failing in what you decided to buy, whereas the second consists of failing to buy a stock that met all your purchasing criteria. Generally speaking, mistakes of omission are often the most costly. To miss a stock that climbed 1000% is ten times more costly than losing 90% of you capital in a stock that did poorly.

Other mistakes fall into the category of "psychological biases", with anchoring and overconfidence being good examples. Anchoring is related to the fact that our human nature is such that we often remain anchored on first impressions or first data points, even when those perceptions become detached with reality. For example, an investor bought stock ABC at $50 two years ago and it is now trading at $25 following news about the loss of a significant contract and/or lower profits. The investor remains anchored to the notion that his stock is worth $50 simply because this was the purchase price. In reality, there is no link whatsoever between the price paid for a stock and the value of the company. What matters is the future prospects of the company.

Finally, overconfidence manifests itself often and under different forms. Its only remedy is humility.

8- A constructive attitude

What differentiates successful investors from others is not related to intelligence, but rather related to attitude. Warren Buffett often uses the adjective RATIONAL to describe good investors. Rational investors do not let themselves be influenced by fads or crises. Aside from a rational attitude, another important quality (and one apparent in Warren Buffett) is the capacity to always want to learn and progress. The world is in a perpetual state of evolution and it is not easy to for someone to also constantly evolve. To be in a constant state of learning, one must not only be passionate for their art, but also humble. Without humility, there is no opening for something new.

Therefore, paradoxically, successful investors must be able to combine both a high confidence in their judgment while also remaining constantly humble. A difficult and fragile equilibrium.