



July 12, 2021

To Our Clients & Friends:

For the second quarter of 2021, the Giverny Capital Asset Management model portfolio generated a return of 7.29%, net of fees¹, vs. an 8.55% return for the S&P 500 Index.² For the first half of 2021, the GCAM model, which is a Poppe family account, generated a 16.31% return, net of fees, vs. a 15.25% return for the Index.

Our firm doesn't focus on short-term results, but it's worth noting that most of our companies, as well as a large percentage of Index components, reported very strong earnings this spring as the US economy rocketed out of the pandemic. Second quarter earnings reports will come out soon, and we expect more of the same. The trillions of dollars of relief pumped into the economy by the federal government (combined with limited outlets for spending during pandemic) have created some of the healthiest personal balance sheets for US households in memory. As society reopens, consumers are responding by spending money freely. Sales of homes, cars, boats and recreational vehicles are soaring. The US inflation rate appears to be at or above 5%, the highest it has been in years, as demand outstrips supply for commodities, products, services and, importantly, labor.

This rising tide of earning and spending should translate into terrific results for corporate America. Just three months ago, I wrote to you that Wall Street analysts generally expected the S&P 500 Index components to earn roughly \$175 this year, versus an Index value above 4,000. As of early July, that consensus earnings number was up to \$189 versus an Index value above 4,300, per FactSet Research. I've seen a few earnings estimates above \$200 from Wall Street firms. So even as the market rose by 8.5% during the quarter, the PE multiple for stocks may be coming down. One economist friend believes the Index components could earn \$300 within four years. Such earnings growth, even if inflation-aided, would go a long way to supporting stock valuations, which have traded at historically high multiples of earnings for some years. That's the good news.

¹The 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's account 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 the common stocks of 500 major US corporations. The index does not incur expenses and is not available for investment.

The not-so-good news is that today's inflation rate is substantially higher than the rate at which the US Government, corporations or home buyers pay to borrow money. Even as inflation exceeds 5%, a 10-year United States Treasury yields about 1.4%. As a math exercise, if an investor in T-bonds thought the inflation rate would average just 3% over the next decade, she would, in effect, be paying \$1,000 today for the right to receive \$14 a year in income for 10-years, and a return of principal that would be worth roughly \$744 at maturity. [\$1000 devalued by 3% annually for 10 years].

No sane person would do that. Yet the Federal Reserve and other bond buyers are doing it. The US Government is able to pump enormous amounts of money into the economy very, very cheaply because the Fed is willing to make what appears to be non-economic investments in Treasuries and other debt instruments to keep the cost of borrowing low. Evidently, the Federal Reserve has little confidence in the recovery. Given the 5% inflation rate currently, a bond buyer must believe inflation will be much less than 1.4% over the next nine years to justify owning Treasuries. The risk here strikes us as wildly asymmetric to the reward. The upside is \$14 a year. The downside is a huge loss of principal. If the recovery sticks, continued access to cheap capital likely will ignite ongoing inflation and make the inevitable tightening of credit very painful. If the recovery is not permanent, despite all this relief ... best not to think about it.

In the interim, vast amounts of almost-free money are finding their way into stocks, cryptocurrency, new homes, cars, boats and everything else.

What's also true, however, is that I have written about the distorting effect of interest rate suppression on stock prices before. More than once. This is not new, but with inflation clearly here for the first time in years it does feel like a problem of larger magnitude.

We had two transactions during the quarter. We exited a2 Milk after an extended stretch of poor business performance. We've written about a2 in recent letters, but to summarize, this Australian company sells a very popular premium-priced baby formula. Much of the product is sold in Australia, with English-label packaging, to small exporters who resell it in China. The pandemic crushed this channel, as travel between the countries became impossible.

Pandemic-related sales shortfalls are not management's fault, and presumably business will pick up if and when travel between the countries resumes. But a2 appears to have not understood how much inventory was piling up in warehouses as its resellers could not find sales outlets in China. It has issued four negative profit warnings in less than a year and recently took a write-off of unsaleable inventory. The key architect of the China reseller business sold a large chunk of stock in August 2020 and quit his job a few months later.

A2 was a small position for us even at its peak, but we exited at a loss that contributed to our underperformance in the quarter.

We used some of the proceeds to buy more Autohome, a Chinese Internet business that has become the leading source of news and consumer-generated reviews of automobiles. China is already the largest market for new autos, by units, yet fewer than one in five Chinese adults owns a car. This compares to more than 80% of Americans, roughly 60% of adults in Japan or Western Europe and 30% to 40% in Taiwan and Korea.

Despite low ownership, interest in cars is high: Autohome hosts nearly 40 million visitors on its web site every day. Car dealers pay it for leads on new customers; auto manufacturers buy advertising on the site to reach potential car buyers; and lenders, insurers and others buy marketplace data on transactions.

We first bought Autohome last fall in the low-\$90s. By early 2021, the stock rose to \$140. Then Autohome announced that it was filing for a listing on the Hong Kong stock exchange in part because it feared being delisted in the United States, where we own its American Depository Receipts (ADRs). The stock plunged back into the \$90s. We added a bit more to our position then. Autohome next issued conservative guidance for the year ahead, based on slowing demand for new cars in China.

Autohome's US ADRs sold for \$63 at the end of June. The market cap for the company is down to \$8 billion. It has \$2.7 billion in net cash on hand, meaning the cash-adjusted value of the business is \$5.3 billion. Against this, Autohome should generate \$500 million of operating profit this year and more than \$400 million of free cash flow. This strikes us as a nice cash flow yield for a company that has doubled profit over the past five years and dominates an immature market that could become much larger.

As an extra plus, many Chinese are buying their first automobile, meaning the used car market barely exists. Autohome has an opportunity to grow in this niche as well.

The market clearly is concerned that the auto market in China is slowing permanently, even as new competitors challenge Autohome's dominance. Ultimately, even if Autohome stopped growing, the company generates cash flow to the point that net cash on hand could be half the current market cap within three years. The company could undertake a huge stock buyback or dividend program, or it could ramp up investment to improve its competitive position. It is not lost on me that the two worst stocks in our portfolio this year are the two domiciled the farthest from our New York office. But Autohome remains a fine business trading cheaply.

Our leading performers during the second quarter were Credit Acceptance Corp., Eurofins Scientific, Arista Networks, Alphabet and Facebook, all up between 18% and 26%. We had three positions that declined in value during the quarter. Autohome and a2 both declined about 30% and Carmax dropped 3% during the quarter.

We're quite optimistic about Carmax, our second largest position. For several years, investors have gravitated to a thesis that a handful of start-ups that sell used cars in an online-only format will end up with a lower cost structure than Carmax. This even though Carmax appears today to have lower costs to buy used cars for its inventory, recondition them for resale and transport them to stores – all problems that are not solved by a good web site. Carmax also amortizes its national advertising over a much larger sales base than competitors, giving it lower marketing expense per vehicle.

Nevertheless, Carmax was slow to respond to the emerging market for online car shopping. The good news is that it ultimately responded with vigor. Over the past few years it has seen operating margins contract as it invested in an omnichannel capability that lets customers buy fully online or do a portion of the transaction online and a portion in the store. Importantly, the customer chooses exactly which parts of the transaction to complete online or in store.

Now, it may be harvesting rewards. Carmax's most recent earnings report was eye-popping. With its omnichannel transformation complete, Carmax reported that comparable sales rose 99% (on a pandemic-depressed comparison) in its May quarter, far ahead of expectations. The two-year

comparable sales increase was 16%. Profit margins expanded and Carmax even suspended a test of lower prices in select markets, which was meant to measure elasticity of demand, because it was having no trouble selling cars at higher prices.

Carmax reported that 75% of transactions in the May quarter involved a customer completing a portion of the deal online, but only 8% were completed entirely online. Customers clearly like doing some parts of a transaction online and some parts in person. Importantly, Carmax now is the country's largest online buyer of used autos from consumers, meaning it is acquiring inventory efficiently in the channel that the start-ups ostensibly were going to dominate.

Since releasing its earnings report in late June, Carmax shares are up sharply. Yet the stock's high-teens PE multiple remains below the S&P average for a business with outstanding growth prospects and a likely return on equity above 25% this year. The used car market, like every other market, is overheated and will cool off at some point. But we feel good about our second-largest holding.

For those who are interested in a deeper dive into GCAM's investment philosophy, I gave a 30-minute talk to the CFA Society of New York in mid-June. A video of the talk is on our www.givernycam.com website. I want to assure all readers that while I may write from time to time about interest rates, I remain focused on curating a portfolio of high-quality companies that can deliver strong earnings growth and returns on capital, and thus superior stock performance, over a business cycle.

I should also repeat that corporate earnings are robust. The market PE multiple is lower today than it was three months ago, even as stock prices keep rising. Our model portfolio is up more than 70% over the five quarters since inception, besting the S&P 500 Index. We can't sustain this rate of compounding but we also know that market timing does not work and that stocks outperform other asset classes over long time frames. We've chosen this portfolio carefully and believe it should deliver satisfactory results over time.

Sincerely,

A handwritten signature in black ink, appearing to read "David M. Poppe". The signature is fluid and cursive, with a long horizontal stroke at the end.

David M. Poppe

**Giverny Capital Asset
Management portfolio**

June 30, 2021

Top 10 holdings

Alphabet	9.5%
Carmax	7.4%
Charles Schwab	5.5%
Progressive Corp.	5.3%
Constellation Software	5.1%
Facebook	5.0%
Arista Networks	4.8%
Heico Class A	4.7%
SS&C	4.6%
<u>Five Below</u>	<u>4.3%</u>
Total	56.2%