MicroCapClub Investor Transcript

François Rochon - Giverny Capital

"The Art of Investing: Analyzing Numbers and Going Beyond"

Google Talk

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Saurabh Madaan: Hello and welcome, everyone. We have a very special guest with us here today, all the way from Montreal. Chances are, if you've enjoyed the writings of Warren Buffett, if you've heard Chuck Akre speak here, you are very likely going to enjoy the message that Francois Rochon has to share with us today. He is one of the investors whose letters I highly admire. I love reading all of your communications. I love the clarity in your thoughts.

The special thing for us, as Googlers, is, this is one of the most successful value investors in the world today who started off as an engineer. So without giving away too much, I'd like to welcome Francois Rochon.

François Rochon: Thank you very much for inviting me. I'm really honored to be here. I wanted to do a presentation, and I call it "The Art of Investing." Yes, I was trained as an engineer. I also had a very big passion for art, so when I started Giverny Capital, probably you've guessed that Giverny is the name of the city where Claude Monet lived, and so you see a little painting of Claude Monet on the first slide. The Art of Investing, I call it "the art of going beyond the numbers."

I got the idea, really, by reading Peter Lynch's book "One Up on Wall Street." He said that investing in stocks is an art, more than science, and people that were trained to think very rigidly to quantify everything, it's a big disadvantage when you invest in the stock market. So we're going to start with that.

As an engineer, I was trained with a scientific education. We're trained to develop a rational mind. We need to understand numbers. I think it's a big advantage, because there was a lot of financial beliefs that people that are trained in the finance business, I think they learn things that I believe are not really scientific, and we don't need to unlearn those things.

But at the same time, scientific education, I think, has some of disadvantages when it comes to the stock market. We're trained to look at past numbers on the belief that the future will be similar. Humans, sometimes, they don't behave like atoms. So you have to understand that the financial world is a very strange world and when you train to think very rigidly, it's hard, sometimes, to understand what's happening.

As a scientific, we're trained not to judge, but to gather facts. And judgment is a big part of the stock investing process. Also, we're trained to be very precise and right. But investing is about being imprecise and also accepting that you will be wrong 30%, 35%, 40% of the time, and that's a good ratio.

I wanted just to put a quote by one of the great engineers of all time, Nikola Tesla. He said that, "Instinct is something that is important in science. It transcends knowledge." I think that's a very interesting quote. But at the same time, there's a big difference between art, science and alchemy. You know, during many centuries, alchemists tried to change lead in gold, and that's not

really science. This idea that "I have a great feeling about that stock," that's not really art. Neither it is investing. It's really just being lazy.

If you want to be an artist in the investing world, well, you want to master that art. You want to first choose an art that you really love. You want to study the masters of that art. Also, it's important that, as master paints, investor invests, so you want to be active in your art. You want also to develop your own style, have an independent mind, and always strive for improvements.

I have this quote by Woody Allen. He said that, "In order to be a jazz musician, you have to listen to jazz. And it's an act of love. You listen to music not because you want to learn it, but because you enjoy it. Gradually, through kind of a system of osmosis, it learn into you." That's I think any art that you want to learn, you have to go through it, through an act of love.

I have this quote by Jim Collins. He said that, "You can either follow a paint-by-numbers kit approach to life, or you can decide you want to create your own masterpiece." In the investing world, if you want to be original, you have to accept that probably you will be different from the others. You'll probably have to be eccentric, rash, unconventional.

That's a quote by John Maynard Keynes. He wrote the book called "The State of Long-Term Expectation" in 1936. "It is the long-term investor that, in practice, will be very different from the others and probably criticized at some point, because in the essence of his behavior that he'll be eccentric, rash, and unconventional in the eyes of the average opinion." That means that if you want to obtain better results in the stock market, you have to be able to stand on your own and you'll be different than the typical crowd of investors. It's fun when you look at that picture, but it's sometimes a little hard because you have to be different and have sometimes a very contrarian opinion than the average view on the either a stock or the stock market in general.

Let's look at the results of money managers in general in our investing world. That's the normal bell curve of the typical results as investors. This line here is the S&P 500. The S&P 500 is not right in middle for the very simple reason that managers charge fees. So from scratch, they start from, probably, 1% or 2% behind the S&P 500. Just because of that, the S&P 500 probably beats out 85% of investors.

You want always to think what not to do if you want to beat the index. If you want to beat the normal distribution, what do you want not to do? Well, if you think the same way as most investors and you have the same time horizon, you'll probably end up with the same results. Also, if you own lots of companies, it's very hard to differ from the index. I would add to that, if you believe that you're smarter than the others, and you can predict the stock market, I think it's a road to failure.

What do you want to do if you want to beat the normal curve? Well, so far, the last 24 years, we've probably been in the top 1% of investors. Let's hope it's not pure luck and that we do have an investment approach that helps us to beat the index. What do we do? We try to think for ourself; we try to own very few selected companies; and develop the right behaviors, which I'll go through a little later. These are: rationality, humility, and patience.

Perhaps we can go to our stock selection process. So that's the science part of it. We start with the financial strength of the companies. We want companies that have higher return on capital, that have grown their earnings per share, that also, at the same time, have a strong balance sheet, so the debt to profit ratio. Usually you would want something like less than four times.

We want a business model that is very solid. We want companies that are market leaders, that have competitive advantage, and low cyclicality. Competitive advantage is very important and I'll go back to that point a little later.

The management team. We want, you know, the CEO, the CFO, the high management team to own lots of shares in the company. We want a high level of ownership, so they're really in the same boat as we are. We want managers that have good capital allocation skills. They make constructive acquisitions and they really think long-term when they make investments.

Then we have market valuation. We want to stock that we'll purchase at a level that we can double our money over five years, which is something like 15% annual return. So without being very precise, because we know that probably it's an illusion when you try to be too precise, we try to have a view of what we think the company can earn in five years and it's going to help us to modelize what kind of valuation we can expect during that time.

A few words about art. First, I want to say that art and beauty are, in some ways, interrelated. Very few money managers talk about beauty, but I think it's important. How do you define beauty in the investment? Well, we say that beauty, usually, to our eyes, is something that is rare. We usually find something beautiful when it's something that we seldom see. Something that is unique is we never see, So it's really the rarest of all the beauties.

Sometimes when I read an annual report and look at the numbers, when I have these feelings that, well, this is a beautiful company, it returns high return on capital, it has much better margin than their competitors, there's something that lights up in my mind. So what you want is to find what I call masterpieces. They have one quality, they're rare and unique. I've taken some example in the art world, so the Mona Lisa, a Rothko painting, a Vincent van Gogh painting.

If you want to take some example of business masterpieces, well, I've gone through the history of the capitalist world, mostly in the US, and we can start

with probably one of the first technology company in the 1880s called National Cash Register, that you've probably heard about. Hewlett-Packard, that, many years ago, was a very innovative company, Apple, IKEA, T.J.Maxx, Geico, the insurance company owned by Berkshire, Washington Post, H&R Block, Dun & Bradstreet, Gilette, McDonald's, Starbucks.

I think all these companies, and we could certainly add Google to that loft, these are business masterpieces. You want to study those kind of businesses and see what do they have that was so unique. Usually, the uniqueness in either their product or their service or the culture is the equivalent of having a moat that protects your castle, your economic castle, from invaders, which are competitors.

That's the key thing. You want to own a moat with lots of crocodiles and piranhas in it so competitors don't want to come near your castle.

If we could resume kind of what we look for in a company, it's really three things: the competitive advantages, which we could say is the artistic part of that; the financial strength, which is really the science part; and the management team, and this is where judgment comes into play. It's very important to be able to judge management. That's kind of a subjective thing when you're talking about judgment. I always say, I have this phrase that, when you meet a management, you ask yourself, would I like this man to marry my daughter? If the answer is yes, it's probably a good man to be partnered with.

We end up with something like 125 stocks that fit our criterias. The one that we do buy for the portfolio are the ones that fit our criterias in terms of market valuation, that we can buy at a price today that we hope we can earn something like 14% going forward, yearly.

Perhaps just take a few examples to illustrate our approach. Well, one company I think that's very unique is Walt Disney. They have great brand name. They own the Star Wars franchise. They own, of course, all those historical stars like Mickey Mouse and Winnie the Pooh, and they bought Marvel a few years back. I always say that Mickey Mouse has three great qualities. First, he is highly popular and known all around the world. Second, he is immortal. The third, he has no agent. So you really own your star. And that's a great thing for Disney.

The uniqueness of business model of Disney is that they have these big movie blockbusters. Like "Alice in Wonderland" in 1951 and then, 50 years later, they can redo a new version and make money again with the same name. They did that recently with "The Jungle Book." They released their first animated version 1967 and they did a real live version last year, which was also a big success. It's kind of like owning an oil field where you take all the oil and 50 years later you go back to the field and there's even more new oil to take out. You don't need to spend money on capital and pay people to guard your field. It's really an extraordinary business model.

We bought that stock probably 11, 12 years ago, I think, in 2005. We paid about $24. It was the day that Bob Iger was named CEO and we've owned it since then. There was a period when the stock did not do much. As you can see, for four years the stock didn't do very well, but earnings kept growing and we were patient. If you look over the 12 years we've owned the stock, earnings have grown about 13% annually. In the end, the stock has more than quadrupled. So if you're patient and companies grew their value, eventually, the stock will follow.

I want to take another example of a stock that's been a while in portfolio. CarMax, it's been 10 years in the portfolio. As you can see, earnings per share have grown at about 16% annually since we bought it in 2007. The stock has done very similar, even though the P/E ratio is a little lower today than when we first bought it. We first bought it in the summer 2007. At that time, the P/E ratio was about 24 times. We bought more shares in 2011 at 14 times, and more shares in 2016 again, at 14 times. Today the stock is above 18 times earnings.

Even though the P/E ratio has been reduced a bit over the years, the stock has done pretty well. It's done about 13% annually, even though earnings grew about 16% annually. That's about 5% better than the S&P 500. Dividend included, it has done about 8% annually over the last decade. So it's been a good investment.

I want to say a few words about a competitive advantage. As investors at Giverny, what kind of competitive advantage can we have? Well, first, I think it's three things: patience, humility, and rationality. Humility, I think we do believe that it's impossible to predict macroeconomic events. So we don't try to predict them. Also, one key element is to focus on your circle of competence and to know where the limit of that circle is. Thirdly, we want to recognize our mistakes when we do them and always try to improve our stock selection process.

A few words on the timing of purchases. Woody Allen said that 80% of success is showing up. That's one of the main reasons we always want to be invested in the stock market, because we believe that owning great companies, not trying to predict the stock market, is the key thing to be able to beat the index over the long run.

By always striving for improvement, we try to study our mistakes in details. Each year, on our annual letter, we have this yearly medals that we give to our best mistakes. It's a very popular part of our annual letter. I don't know why, because it's very painful. I think that's very important if you want to continue to improve yourself.

A few words on rationality. We try not to be affected when others make more money than us in stocks, because there's always fads. We don't get into fads. So sometimes we'll be different from what's going on in the very popular part of the stock market. But we try to be rational and say, "Well, if we don't really

understand it, if we don't think that's a good area where our capital should be invested, we just stay away from it."

We try to be impervious to the stock market quotation in the short run. So it takes a lot of rationality, because the stock market can be very, very volatile. We try to always be calm and try to always have the eye on the long-term horizons of the company we purchase.

We accept that we don't know the future. We try to focus on part of the process that we can control. It's really, like I said, to look for companies that we understand, that we believe, that have a competitive advantage. We accept that we don't know exactly how things will work out. But if you own great companies with great managers, eventually you should be okay.

That comes up to something we put out a few years back. I call it "the rule of three." It's really to accept that: one year out of three, the stock markets will decline about 10% or more; one stock purchased out of three will not perform as expected; and one year out of three, you'll underperform the index. The best managers usually underperform one year out of three. It's still a very ambitious rule, a group of rules, but if you accept that from the start when you'll have some bad years on some bad investments, you'll be better prepared psychologically to deal with that.

A few words on patience. Well, I have this saying that patience is not the ability to wait, but the ability to keep a good attitude while waiting. So what's the good attitude in the investment world? It's really to focus on what's happening in the company, not what's happening to the stock. That's sometimes a hard thing to do.

If you go back to the example of CarMax, CarMax stock over the last decade has been quite volatile. It went down 25% a few times. But if you look at the earnings over those 10 years, it's been a pretty stable business. If you just focus on what's happened to CarMax over the last 10 years, I think, besides 2009, earnings went up every year and it grew earnings by more than 16% annually. So just focus on that and forget about the stock price movements, you'll be okay.

I want to say another word about patience. That's not the same thing as being stubborn. Sometimes we fail to recognize mistakes we make. I like to think about the analogy of, how do you get a frog to be cooked? If you put it in boiling water, it will jump out of the bowl. So what you do, you put it on mild water and slowly increase the temperature and the frog won't get out because you always think, well, things are getting a little hotter, but they'll cool down eventually. You know, it never cools down and eventually get cooked.

What you want is not to buy a stock and, you know, earnings are a little disappointing, the fundamentals start to deteriorate, the stock go down, but

you don't want to sell at a loss. So when investment doesn't work very well, try to focus on what's happening to the company and to be sure that I'm not getting cooked like a frog. That's really important. There's a big difference in knowing when to keep your shares because the fundamentals warrant I, and recognize you made a mistake, and just get out of that stock. That's a big difference between being patient and stubborn.

To summarize, what differentiates an artistic investor? I would say the conventional investor, the typical investor in the stock market, either professional or amateur, it's really the focus on market quotes. They are short-term oriented. They have an opinion on everything. They try to predict when to buy stocks. They cannot resist the latest fad.

I would say the unconventional investor, well, he focuses on intrinsic value, he has a long-term horizon. He's agnostic about many, many things, including where the stock market will be in a few weeks or a few months. At the same time, he doesn't try to predict when to buy, but he focuses more on what to buy. I would say the right verb is what to own. Of course, he resists the fads and the popular beliefs. It's easy to write in a presentation, but it's harder on the day-to-day to resist what's been very popular. So that takes a lot of independence of thought, I believe.

A wise investor must be able to kind of balance many things. I talked about the love for the art, but at the same time, you want to be very rational. You don't want to fall in love with stocks. You want to always be rational. You want to have a very large field of knowledge and look at many, many companies, but at the same time, you want to focus on your circle of competence. You want to be open-minded, but at the same time, you have to have independence of thoughts. You want to be able to value the business, but at the same, time, like I said in this presentation, you want to be able to go beyond the numbers. So it's just not numbers. If it was just numbers, mathematicians would all the billionaires. So, of course, it takes a little more than that.

You have to have patience, but at the same time, you don't want to get cooked like a frog. Finally, you want discipline, but you want to be able to break the rules. I always say that the discipline is to follow your own rules, but wisdom is to know when to break your own rules. So sometimes we've bought some stock that didn't really fit our criteria. But you know, we made a judgment call that we believe, most of the time, either the business has really something special or the management has really something special, or ideally, both.

Finally, to summarize in one sentence, "To obtain better results than the others," I would quote John Templeton, he said that, "you have to do something different from the others."

At Giverny Capital, what do we do differently? Well, first, we think independently. We own very few selected companies. We have a very long-term horizon. I mean, I think, on average, we own our stocks seven years and the

typical investor on Wall Street's at seven months. That's kind of a 12:1 ratio. Also, we try to develop the right behaviors. We want to be rational, humble, and patient.

That concludes the presentation.

Saurabh Madaan: Thank you. Thank you so much. Fantastic. Folks, I want to read something for you guys. I think you might find this interesting. "Good businessmen or businesswomen are like artists. They have to do something with passion, something innovative and unique that will last and that will inspire others. In the final process, I try to figure out how much this marvelous company should be worth and try to buy it in the market at half of what I believe it should trade in five years if everything goes as planned, which is about 15% a year."

These two paragraphs are from an interview of Francois in the year 2005. I'm sure it's kind of obvious how consistent your philosophy has been over the years. It's remarkable. It's sort of in the Francois Rochon of 2005 would have probably given the same talk in very similar words, as I can tell.

So what I want to ask you is, has it been easy for you to follow this approach consistently? Has it been tested over the years? Have there have been times where you've questioned how you've thought about these things?

François Rochon: Yeah, it's been tested, because like I said, we have to accept that we underperform one year out of the three. In the good years, it's easy to say; but when those bad years happen, it's really painful. When you have some partners, well, the word you use for clients, you have to explain to them why you have a bad year. It sometimes can be tough and it can last more than one year. It can be two or three years in a row.

I think it takes a lot of conviction that you're on the right path and you're doing what you think is best for your partners. I think if the principles are sound, eventually, they will work out. Again, the importance of patience, I think that's probably the most important quality you need when you invest in the stock market.

Saurabh Madaan: So to people who are listening to this talk, there might be young graduate students, people who are getting into the investing profession, or a lot of individual investors like ourselves who are saying, "This is a good approach. Maybe I want to try it," and they could have a couple of bad years to start off with. What is your advice there?

François Rochon: I think the patience, also, it's important, of course, but I think there's a quality behind patience: humility. You have to accept that you'll make some mistakes. There's always things that you can learn. I would say that the greatest quality of Warren Buffett is not necessarily intelligence, it's the humility. I mean, he's the greatest investor of all time. He's the greatest of all. But he's still very humble,

always looking to improve and learn. I think that's his greatest quality. He's 87 years old and he's still striving for new learning everyday. You always want to learn new things and understand new things. If you have those qualities, I think you'll succeed in almost anything you do.

Saurabh Madaan: That's very interesting, because he has been quoted to have said in interviews that if you have an IQ of 160, you might be better off giving 10 points to someone.

François Rochon: Well, I think he said selling.

Saurabh Madaan: Selling? Yeah, selling. Sure. Thank you. Yeah. You do believe that it's more than the IQ, it's the behavioral traits after a point that are critical.

François Rochon: Yeah.

Saurabh Madaan: Okay. Any advice to individual investors, young investors, who might not be professional investors like yourself? What are some best practices that one can adopt?

François Rochon: I think, first, you have to look for a company that you can understand, because there's many, many companies out there. There's thousands and thousands and it's hard to really understand all those companies. Some are just very, very complicated. So you're trying to play a hard game when you want to be able to value every company. You play an easier game when you're very selective and you just go for the company that you can understand.

It goes back to the analogy of Ted Williams that he wanted to wait for the perfect pitch that was in the sweet spot zone. I think that's the beautiful thing about the stock market. Warren Buffett said that many, many years ago that investing is the greatest business of all because that's the one you can choose the ball you want to hit. So you have the luxury of standing at the plate and waiting for the perfect ball. There's no called strike. That's, I think, the most beautiful thing in the investment business. But at the same time, it's a very competitive investing world. There are some disadvantages too. But if you have the right behavior, the right approach, and you're very patient and very selective, I think, in the end, you'll succeed.

Saurabh Madaan: Great. In your presentation, Francois, you said there's an element of beauty, sometimes you recognize it. You also said that there is science and mathematics of investing. I was wondering if you could take one company as an example. One of the logos on your slides was, I think, Starbucks.

François Rochon: Yeah.

Saurabh Madaan: I'm sure a lot of people here recognize the company. Can you describe what you see in terms of the qualitative, the beauty-like aspects, like you said, what are the earnings potentials five years from now?

François Rochon: Yeah. Well, Starbucks, I looked at it, I think the first time was in 1994. I thought that was a unique business. I remember coming to the US in the early '90s and drinking coffee in hotels; and it was bad coffee. I said, "Well, if you go in Italy or in France, you have great coffee. But you come to the greatest country in the world, then you drink bad coffee." I said, "This didn't make sense." When I first tried Starbucks, I said, "Well, these people are on to something, and they'll do well." I remember, I mean, Howard Schultz was a very ambitious and a very driven CEO. He was very confident that Starbucks could have thousands and thousands and thousands of coffee stands everywhere in US and in the world. I thought it was indeed possible.

Saurabh Madaan: Is their coffee better than Tim Hortons?

François Rochon: Oh, yes, I think so. Yeah. But I want to be patriotic here and say Tim Hortons is a great company also, because it's Canadian. But if I had to have coffee, I would go with Starbucks. The only thing that prevented me to invest 23 years ago was the P/E ratio of Starbucks. I remember it was trading at 40 times earnings. That was way too high for me. But I don't know, I didn't look lately, because it's too painful, but the stock is probably 100-fold since then. So it's been a wonderful company, a wonderful stock, and never owned it.

Saurabh Madaan: So what P/E ratio, 40 years maybe too expensive. But what might be a P/E ratio where it would merit your attention?

François Rochon: Well, with some insight, I would say that 40 times earnings in '94 was cheap because you know, it didn't at all discount the future growth to come. But you want a big margin of safety. I think it was in 1949 that Ben Graham said that the cornerstone of intelligent investing is margin of safety. So if you pay a very higher P/E ratio, you don't have as much safety as if would you pay a lower P/E ratio. Is it 20? Is it 25? Is it 15? That's where judgment comes into play to help you decide.

Saurabh Madaan: Right. I think I'm trying to sort of make it more practical for people who are listening. I think, today, it's like 23, 24 times P/E ratio. Would that sort of a metric, you said you had 125, would it come up in those for you to look at, for example?

François Rochon: Well, I think the management is great. I think the business model is great. You just have to ask yourself, where it is today, will they be able to continue to grow at a superior growth rate going forward, which I would define 12% or more. I mean, every company, even the greatest companies in the whole history, they come to a point where they hit maturity and it's harder to grow at a high growth rate. I mean, growing earnings at 8%, or 9%, or 10%, that's still quite an

achievement, but it's not as exciting growing at 15% or more a year. So it's going to be, probably, harder for Starbucks, but I've been saying that for a few years. I've been wrong so far.

Saurabh Madaan: So maybe let's just take a step back, Francois, for the audience here, what are some areas in the market where you do see both the elements of beauty and the art of value today?

François Rochon: Well, I think we took the example of CarMax. I think that's a company that I believe can grow by about 15% annually for many, many years.

Saurabh Madaan: Revenues or earnings?

François Rochon: Well, probably earnings. Revenue is going to be closer to 10%. But with some margin expansion and some buyback of shares, I think they can obtain that 15% growth in earnings per share. It trades at 18 times earnings. So the P/E ratio is similar than the market. But I think their growth profile is probably twice as good.

Saurabh Madaan: Okay. I have a couple of questions just, typically, we ask all of our guests. What are some of your favorite managers or business people that you look at? Then, the second part of the question is, what are some books, investing and non-investing, that you've enjoyed that you might want to share with us?

François Rochon: Well, managers, well, I have a deep respect for Mark Leonard at Constellation Software. I think he's an artist. I mean, he's really unique. He's really original. He has a very, very long-term horizon on everything he does. I think Constellation Software, which is a Canadian company, is I think, I hope it continues to be, but if you looked at it today, it's really a masterpiece. It's really something quite unique, and a great culture, and great artists at the helm.

Saurabh Madaan: It's interesting you bring it up, because it's a technology company. Typically, value investors, they've had this rough interaction with being in technology versus not being there. Also, it's one of those companies that has grown by acquisitions, which, again, value investors tend to shy away from. How do you look at those two aspects?

François Rochon: Well, I would say there's many ways to get rich. Some, it's Starbucks. It's just having one concept and they clone it a thousand times. Other companies, I mean, Berkshire Hathaway, that's an example of a company that grew by acquisition. It's a holding company that now have, we could say, hundreds of divisions. So there's many ways. I mean, McDonald's, for many years had just, like Starbucks, one concept that they cloned many times.

I think that, in the end, what really counts is over, let's say, a decade, it's the growth and earnings per share. If you have a great business model, if you have great management, a great of return on capital, it will translate into earnings

per share growth, which will translate into a stock that will go up. If you pay a reasonable price and the earnings per share quadruple over a decade, there's a good chance that the stock will do the same.

Saurabh Madaan: How do you apply the earnings per share concept to a company like Berkshire, you mentioned, but even Markel, for example, an insurance company where you may not realize the earnings, because they're just piling up on the balance sheet?

François Rochon: Yeah. Well, in terms of Berkshire or Markel, probably a price to book is a better, it's not perfect, but it's probably a better way to value. You use a ratio. I think, for both companies, 1.5 or 1.6 times book value would make sense because that's the nature of their business, that the earnings are more erratic. So you have to value them some other way. You have to adapt to the business model of the business.

Saurabh Madaan: Francois, we had one of our guests they brought up a very interesting concept. They said, you know, you look at all these great companies, and you recognize that there is a moat. Over the past 10 or 15 years, they've displayed that in their numbers. Then you sit back and ask yourself, the future may not necessarily be identical to the past. So they said what really matters is that the moat be growing. It doesn't matter whether its size is small or big. How do you think about growing moats or emergent moats versus established moats?

François Rochon: That's very hard because moats always keep changing. I remember, a few years back, Charlie Munger said that, I asked a question to Charlie about moats and all those great companies that seem to see their moats shrinking. He said, "Well, I know all those moats are getting filled with sand." So I asked him, "Which company do you think has an expanding moat?" That was six years, seven years ago. He said, "Google. I think that's an incredible company."

I remember thinking, "Well, I knew about Google, of course." I said, "Well, I should take a new look at it." We bought shares in 2011 after that comment. So we were lucky because at that time the P/E ratio was 15 times. So if it would have been a few points higher we probably would have passed and missed an increase of 400% since then.

There's always new companies with moats. Some are expanding, some are shrinking, so you have to follow that closely. But if I had to choose one criteria to help me decide what's the direction of the moat, it's the managers. I mean, those moats are not built by angels. They're built by human beings. So what makes a moat grow, I think, is something in the culture of the company. Those things doesn't come from thin air. It comes from the top management that builds that culture, and then it translates into a moat, and then high return on equity for the shareholders.

Saurabh Madaan: When you look at the high returns of equity over the last 10 years, do you say it was because of the culture? Or are there other things beyond just the numbers that you try and study to identify whether this is a culture you want to be associated with?

François Rochon: Well, there's many things. It's really what's the nature of the products, what's the nature. The funny thing with Google, it was not the first company that had a search engine on the internet.

Saurabh Madaan: Right.

François Rochon: It was the last one that come up with a new search engine, but this one was better than the others. I'm thinking of Yahoo, or AltaVista, or Excite, Lycos, all those first companies that had search engines. Sometimes, it's the first arrival and sometimes, strangely, it's the last arrival. That's a tough thing with investing. Every story is new and different.

When I said it's important to have an open mind, it's because if you have this very strict frame to analyze companies, probably you'll miss lots of things. Because every situation is new and the future is all the world's uncharted territory. So you have to have sound principles. You look for certain things. But in the end, you have to judge every situation differently and by their own parameters.

If you look at our portfolio, we own something like 25 companies, I think the reasons we invested in those 25 differ very much from one to the other. Sometimes it's really because of the management. Sometimes it's really because we think the brand is very solid. Sometimes we think the company has lots of room to grow, and it's just like a Starbucks, where they just have to clone the concept that they have built. So there's no one recipe. It's really to have an adaptive mind and trying to understand the nature of the business you want to invest into it.

Saurabh Madaan: That leads into my next question, actually, which is, when do you decide to sell? You said your average holding period is about seven years and you invest in quality companies. You gave the example of CarMax, which you have been holding on for several years, but you sold a company like Intel, if I remember correctly.

François Rochon: Yeah.

Saurabh Madaan: Can you talk about how you think about selling companies? Because you think of yourself as a partner so it must be an emotional process as well, maybe.

François Rochon: Yeah. We try to remove emotion from the process, but it's never easy, because we're human beings. We're emotional. We have to accept that. Sometimes

accepting it and going beyond, well, that's why we have those rules or processes that helps to make a decision. There's really four reasons we'll sell a stock.

The first one, if we realize we made a mistake. That happened. I don't know the ratio, it's probably one out of three or four stocks that we buy. For some reason, we've made a mistake and the thing to do is just sell. Accept that it's part of the process, and you're a human being, and it's a tough world. So when you've made a mistake you just sell and go into some other investment.

The second reason, it's a little different, is that you didn't really make a mistake, but the nature of the business has changed. There's a new competitor, there's a new economic environment, there's new technology. Whatever has changed in the industry or the company itself, it's not as great as when you first purchased it. So when you realize that, you have to sell. It can be a year after you bought it or 10 years after you bought it.

The third one is probably when I look at the situation and I don't agree with a management decision. Usually, it's a big acquisition. When I feel that I don't agree with management, I just sell.

Saurabh Madaan: Okay.

François Rochon: I mean, I have this saying that if I had to resume, in one sentence, what investing is, it's you become partner with the top management. If you don't trust them anymore, there's no reason to be a partner, so we sell. The fourth reason, which is probably the most common one, we just found an investment that we think has better prospects. We sell A to buy B, not necessarily because there's a problem with A, but it's just that we think that B will be more rewarding.

Saurabh Madaan: Okay. Finally, before we let it out to the audience, I want to talk about my favorite part of your annual letters, which is those medals. Correct me if my memory is failing me, but was Valeant one of the medals?

François Rochon: Yeah. Yeah. It was a mistake. We were lucky, because we did make money with that investment, but it turned out to be a mistake.

Saurabh Madaan: Yeah. Can you talk to the audience, explain the medals a little bit more? Tell us how you give a medal, even to something you call a mistake and still make money out of it?

François Rochon: Well, I always say there's a difference between being good and lucky. So we were lucky there. That was still a mistake. Basically, well, we make many mistakes. We only choose to three to give medals to, bronze, silver, and gold. Most of the time, the mistakes are omissions. Starbucks is an example as a company that fits all our criteria and we decided not to buy for, sometimes a simplistic reason and you miss 10,000% gain in over 25 years for that reason.

We try to give medals to the most costly mistakes. The most costly are usually omissions. Sometimes it's like Valeant. That was a stock that we did purchase. We made a mistake. Well, in the case of Valeant, I think we have a lot of confidence in the management. Also, at the same time, they had much more debt than we were usually willing to live with. We did kind of an exception to our rules. It turned out that it was a mistake.

Saurabh Madaan: But you got out way before a lot of the other.

François Rochon: Yeah, but the selection was a mistake. It turned out, in the end, financially, it was okay. but that's still a mistake. That's the hard part. When you look at your mistakes, you want to be very objective and say, well, this is a mistake for those reasons. But some stocks that I didn't purchase that went up 100 times, but I really didn't understand, that's not really a mistake. It's just that you decided that this was outside your circle of competence and you missed it. But that's not really a mistake.

It's a mistake when it was in your circle of competence and for some reason you didn't go through with the purchase. Or it's a mistake when you thought that the company was in your circle of competence, and in the end, it was not. That's basically the two reasons a mistake will be in the chapter of the annual letter.

Saurabh Madaan: It's interesting you separated luck and outcome, which is what one of our previous speakers, Michael Mauboussin, talks about skill and luck, and then, Howard Marks also says that, when he was here, he said, what will happen might be different from what should happen so you need to decouple them in your thinking.

Thank you very much. With that, let me open it up to the audience if we have any questions for you. Okay? Folks, any questions for Francois? Yeah?

Audience: Hi, Francois.

François Rochon: Hi.

Audience: Thank you for the excellent talk.

François Rochon: Thank you.

Audience: I've been reading your letters over the years and it's really excellent. One of the questions I wanted to ask you was, you were showing us this chart about Walt Disney and buying it at 24 times earnings, right? How do you pay up for good businesses? Because the times when these businesses are available with this margin of safety is maybe when something is wrong, maybe when the market rightly or wrongly thinks that something is off. If that's not the case, then how do you pay up? But if that's the case, how do you separate what the market is thinking versus reality?

François Rochon: We try to focus on the very long term. So we try to look five years in the future and we come up with our best judgment, what we believe the earnings per share should be in five years. Let's say, Disney, when we bought it in 2005, we said, well, we think this company can earn $3 a share in five years. Then, if you think that the fundamentals will still be good past those five years, we say, well, it probably will warrant a P/E ratio of, let's say, 20 times. So that gives you a $60 stock in five years.

If you can buy the stock at $30 or less today, and you're right on the $60 in five years, you should be rewarded earnings of something like 15% annually. The earnings that the company has today is not really relevant to that. If they earn $1 this year, it looks a little pricey at 30 times, but if you have a long-term horizon and you're focusing on where the stock will be or the earnings will be in five years, in the end, you'll be okay.

Having this long-term horizon, I believe, helps you to defocus on the P/E ratio of today. It goes the other way. If you find a cheap stock, but you look five years in the future and you don't see any growth prospects, there's no real reason to believe that the stock will be higher in five years. It can be higher in three months just because the P/E has gone from 10 to 12 times. But we don't try to invest for three months, we try and invest for at least five years.

Audience: Thank you.

Audience: Thank you very much for the great talk, and welcome to Google.

François Rochon: Thanks.

Audience: I have a question. Considering now the current market conditions, there's a lot of warning by people about the risk and there are a lot of fund managers returning funds to the investors. I wonder what do you think about the market in general and what's the risk and the expected return for the, maybe, next five, 10 years? Thank you.

François Rochon: Yeah. Well, of course, it's not as exciting for an investor today as it was, let's say, in 2009 when stocks were really, really cheap. But it was scary then too. I always try to kind of defocus what's happening to the market and more focus on the companies that we own in portfolio. When we look at our portfolio and we've got this group of 25 companies that we're pretty confident that they'll grow their earnings by at least 10% to 12% in the next five years and their P/E ratio seems reasonable, there's no reason, I think, to be worried.

I don't know what the market will do in the next six months, a year, or two, but I think the companies we own, in the next five years, will do okay. If you look at the general stock market, we don't have views in general, but we think that companies can continue to grow their earnings per share at, say, 5% to 7% annually in the next five years, and you add a dividend of 2%. So even though

there's no P/E changes over the next five years, well, that would translate into a total return, for stocks, from 7% to 9%.

It's not as exciting as eight years ago, but still it's pretty decent returns when you compare that to bonds, which probably yield something like less than 2% over the next five years. It's not extraordinary exciting to find opportunities, but I think the returns will be decent, mostly for the stocks we own, and probably the stock market as well.

Audience: Thank you.

Saurabh Madaan: We have one question over there.

Audience: Thanks for the talk. I actually have a couple of questions. The first one is, I don't know if it's accurate or not, I was just looking at your holdings and I noticed you have MasterCard, you have Visa. MasterCard, you have, I think, a position of $210,000, whereas Visa, you have a position of $35 million. I'm just wondering why you bother keeping MasterCard with such a low number rather than, because it won't even move the needle, right? Why not just put it all into Visa because they seem to track each other anyways? That's the first question.

François Rochon: Yeah. Well, that's very easy. We prefer Visa, obviously. MasterCard, we own a few shares just to follow it. But we think both companies are great. These are fantastic businesses. We prefer Visa. MasterCard, just to follow the company, we have a few shares.

Audience: Is that because of Visa Europe?

François Rochon: No, just in general, I think Visa is an extraordinary business. I think ... It's hard to say, because MasterCard is a great business too. But I think Visa has a little something more.

Audience: The second question is, in terms of the big tech stocks, right, I noticed you have Google. So thank you. But just curious-

François Rochon: Well, thank you.

Audience: I was wondering if you could maybe give your thoughts on Apple, why you don't own it, because I mean, personally, I own a position in it, because I think it's got a low valuation. It's got a very good moat around it, especially with all the services added to it. I'm just curious on your thoughts on that.

François Rochon: Yeah. Well, obviously, Apple could be in the section of mistakes, because I mean, it's up, what, 50 times in the last decade or something like that. So it's been a great investment. It's a great company. I mean, I can't argue with that. The valuation does look very low. I think they do have a moat. Probably, five years ago, I wasn't that convinced that the moat was that large and it turned out

that it is a very solid business. I don't know exactly the number, but I think, today, 10% of their revenues are service-based and recurring. As it get a larger part of their revenues, I think that moat will be expanding.

Still, a large part of their revenues and earnings come from selling new products. When you have to sell something new every two or three years, there's a risk that you'll miss a product launch or something will not exactly satisfy the customer for whatever reason. Or you just have the risk also of having another company that comes up with a new and improved product.

I think, if you compare Apple and Google, I think, Google's business is more stable, and more entrenched, and more recurring. I think the moat is larger in Google than Apple. That doesn't mean Apple is not a great business. You have to ask yourself, at that price, the P/E ratio difference is so high. I think Apple trades at 15 times and Google is probably 25 times.

Saurabh Madaan: What about Visa?

François Rochon: Visa is close to 30.

Saurabh Madaan: Isn't that too high?

François Rochon: Well, I remember, many years ago, Philip Fisher wrote in his book that, "Common Stocks and Uncommon Profits," the further in the future you can see growth, the higher the P/E ratio you can pay. So in terms of Visa, I think you can see the company having the most protected for many, many years. It's hard to figure out who could hurt them. You can see many, many years of growth. So I think that warrants a high P/E ratio. But of course, it was better in 2010 when we bought it. I think we paid, I don't know, 15 times earnings. Obviously, we had a much larger margin of safety then than we have today.

Audience: I've got one more.

François Rochon: I don't know if that answers your question.

Audience: Yeah, it does.

Saurabh Madaan: Yeah, go ahead.

Audience: Maybe, because I noticed one of your largest holdings is Berkshire Hathaway as well and they've taken a big position in Apple.

François Rochon: Yeah.

Audience: So indirectly, you actually probably own more shares of Apple through your holdings-

François Rochon: There you go.

Audience: -of Berkshire Hathaway than Apple. I don't know if you'd looked into that, that I own this company it already gives me exposure, so I won't own it separately. What do you think about that?

François Rochon: Well, that's not really a reason. Of course, when we own Berkshire, we own Apple ,and we own Coca-Cola, and we own Geico, and some Burlington Northern Santa Fe, and Precision Castparts. BNSF and Precision Castparts was in the portfolio a few years back, so we're still shareholders. But if we thought that Apple was a good purchase for us today, owning Berkshire wouldn't be a reason not to do it.

Saurabh Madaan: Francois, when you look at something like Visa or Apple, even though portfolio has low-debt companies, sometimes they might even have excess cash. So when you look at the P/E ratio, do you take the cash out? How do you-

François Rochon: Yeah, you should do that. I think so. Because I mean, that's cash that could be returned to investors. It's a little harder for Apple or Google because a lot of those cash is in other countries. Sometimes a little complicated to get back in the US, the cash, and give it to shareholders. But in the end, in some ways or the other, this cash will be returned to shareholders, I hope, and should be taken out of the valuation.

But what you want to do is really do the sum of what you expect the cash to be generated by the company in the future discounted to today, and then you add the cash that is today, so you get a proper valuation.

Saurabh Madaan: It makes sense. With that, Francois, thank you so much for being with us here today.

François Rochon: Thank you.

Saurabh Madaan: We really enjoyed your presentation and your talk. Thank you all for being such a great audience.

François Rochon: Thanks.