

FARNAM STREET CAPITAL LIMITED

Thursday, 18 October 2012

Dear Investors and Friends,

Final Report for the 11 months ending September 2012 - Net Asset Value: (£99.42)

This is the first annual letter for Farnam Street Capital. You will receive a year end letter each September and a half year letter in March. We feel a six monthly interval for letters is appropriate as it means we spend the bulk of our time analysing or investing rather than writing about doing so. It also means there are no excuses for thinking in anything other than long term. In truth after 6 months has elapsed we are actually very keen to communicate with you and have a desire to do so as openly and candidly as possible. Between these times however do feel free to contact us. We would be happy to hear from you, or even to receive a visit if you ever found yourself nearby.

This letter is broken down into a few sub sections; Fund performance in the period and the costs incurred in running it; how we see the investment world; and how we got on during the year.

Fund Performance and Costs

During the first 11 months of the fund the NAV has fallen by 0.6%. The costs of running the fund (general expenses) during this period were 0.4% of the funds value. There was no management charge taken of any kind as the fund has not yet returned the minimum threshold return of 5%. Whilst clearly our main focus is on making your capital appreciate we are acutely aware of how other fund fees and costs can stack up causing erosion of invested capital over time. It is therefore important that the fund's necessary administration and other services are available for as low a fee as possible. In practice some of the costs associated with analysing the fund investments are borne by Holland Advisors but I am very happy with this arrangement. Additionally, Holland Advisors has also agreed with the Farnam Street Capital board to reimburse the fund for any general expenses incurred over 0.4% of the fund value in each of its first 2 years. This has been done to make sure no investor feels disadvantaged by the fund's small size (currently £6.2m) and the slightly higher costs that might otherwise result. As a result during the 11 months just ended, Holland Advisors has rebated £7,500 of fund costs thus reducing them from 0.54% of the fund value to 0.4% as observed.

The Investing World and Economic World we live in

Farnam Street is not a macro investment fund and we know of very few that have built a sustainable investment track record in applying only macro forecasting to picking investment trends (Top Down investing as it is called in the industry). That said there are also many bright and hard working stock pickers that have been badly caught out by sometimes completely ignoring the macro economic factors around them. We mostly focus on the prospects of the companies whose shares we are considering buying but also try to be mindful of the wider economic risks. An analogy would be the use of mirrors when driving a car. The main focus required to reach a destination when driving is to look out of the front window. That said to drive whilst only ever looking forward is a dangerous habit, the mirrors providing the all important perspective as to what is happening, and importantly what others are doing, outside your personal space and peripheral vision.

Our destination is good investment performance via stock picking, i.e. the business of finding the great companies and investment bargains which will hopefully sustain and build investor wealth over time. A macro-economic view provides us with the backdrop that we are investing against, the road conditions and state of the traffic, if you like. Understanding them better hopefully helps us prevent, or limit, the damage to our vehicle (the fund) from a traffic incident or even the occasional pile up.

The arrival of the credit crunch a few years back was less of a surprise than many economists like to admit. It could be observed that many western consumers had been living a dream for many years. This dream whilst complex, long lasting and global in nature was most evident in rising asset wealth (mostly housing) that was wrongly perceived as real and thus spent. This trait showed up for many years for those that sought to look in the collapsing savings ratios on both sides of the Atlantic – i.e. the amount a consumer saved of their annual disposable income. The US population had saved on average between 6-11% of their income every year between 1950 and 1995. But by 1999 this ratio had fallen to 3% and by 2005-2007 it was almost zero. In the US and numerous other countries money was seen to be growing on trees, or more accurately out of bricks and mortar. The bursting of this and related bubbles was both exceptional in scale and more severe than many suspected. The policy responses it provoked were equally extreme. Many of these are still with us including ultra low central bank interest rates, and record high budget deficits. The best illustration of the extreme economic point we have reached is the incredible fact that some of the most respected central banks in the world have printed money not just once but arguably 3 times in 5 years and seem more than happy to continue doing so. This is something that few investors we know thought would ever happen in their lifetime.

Many investors view the money printing antics of Western central banks as ultimately inflationary. They are of course correct, but importantly these policies were only put in place due to the worrying and real threats of a deflationary spiral that would have resulted post the credit crunch without such intervention. These two opposing and extreme risks (a global deflationary collapse; or a global inflationary spiral) are the ones most commentators still worry about. Both are possible but importantly neither is very likely. Of greater likelihood is a world of slower than past growth with the continued surfacing of both inflationary and deflationary pressures in different guises across difficult economies and sectors; i.e. there will likely be winners and losers from all these forces rather than a another seismic global event that we should all live in terror of. As an example Japan suffered a terrible deflationary spiral during the 1990's while the West enjoyed a boom. Thus whilst my personal DNA was built 'bearish' we try to retain a Buffett/Munger approach to the macro world; i.e. to think about what would hurt the portfolio or the economics of the companies we own but equally look at the value we are offered vs. the risks being taken on. Better put by Buffett; *"We don't like bear markets per se, but we like the prices they bring."*

Other risks that are always around are the threat of further bubbles to burst or the exposure to areas of the world that are structurally challenged (e.g. currently parts of Southern Europe). What we try to do in selecting investment is fish with a net that is fine enough to filter many of the traits we seek at a company level but importantly one that also enables us to find those that give a resilience to the macro-economic and other risks we observe.

As a result the sorts of investments we are currently seeking are:

1. Those that likely come with lower risks as they are exposed to parts of the global economy that have already suffered severely from both an economic downturn and importantly depressed investor sentiment - a good current example being the US banking sector.
2. Those whose business models we assess as robust enough to withstand many of the extreme macroeconomic outcomes possible.
3. Those investments with such a margin of safety (cheapness) so as to more than compensate for any negative threat or surprise that might come upon them or us.

The list of companies that might fall into these camps was a lot longer in 2011 and 2010 than it is today but we still think a few such investments are available - and we only need a few.

How we are getting on

In the 11 months since we launched, the fund is down a little (-0.6%). This contrasts with the FTSE AllShare index which is up by 7% and the MSCI World Index of Equities which is up 12%. Whilst it is disappointing not to be able to report a more impressive performance in our first year the reality is that we have slowly gone from being 0% invested to c.75% invested. During the period we have done so gradually and importantly have tried to do so carefully. So unless we had aggressively invested a high percentage of the of the fund's assets only at either the November 2011 or May 2012 market troughs, the amount of cash sitting in the portfolio was always bound to result in our performance lagging a rising market.

When Theory meets practice

We have often repeated how the formation of the fund was influenced by great investors including, Buffett, Graham and Templeton. What the last 11 months have seen is our efforts to turn this theory into practice. The other day we read the following unattributed quote which we thought of interest at this point: *"in theory, practice is the same as theory in practice it isn't!"*

As a reminder we have learnt much from the wiser and older investors we have studied which we are trying to put into practice. This includes:

- Improved methods to analyse and assess companies
- Better ways to quickly identify great business models
- An understanding of the need to have a high margin of safety when buying
- The importance of learning from your own and others mistakes and use of checklists
- A better understanding of real risk and the need to control emotions when investing

Investors may be interested to know that we use checklists when seeking investments and have a different one for each type of investment - Each checklist being made of a number of questions which we ask ourselves. Sadly they are not foolproof but do make us stop and think about any decisions being made. Importantly each question comes from real mistakes that we, or other investors we respect, have made in the past. The checklist we have for selecting other money managers is about 2 pages long vs. the one for selecting companies which is 5 pages long. In reality we are going to make mistakes running a fund like this – the key is that we learn from each one improving our investment process all the time by doing so. The use of investment checklists we think will help us do so.

Approach to Risk – Portfolio Structure

As far as we are concerned risk is not expressed by a clever ratio, Greek letters or the output of a spreadsheet. Risk is the real likelihood of permanently losing some or all of the capital invested. We split the fund up in a few ways when considering risk. We have the 3 buckets of investments described to you from the outset. These being - ***Direct Stock Investments, Collective Investments and Work Outs.***

Additionally, we also consider other risks that the fund might be exposed to such as its currency risks, sector risks or exposure to any areas that may give us cause for concern from our macroeconomic wing mirrors. Whilst the fund does have an ability to borrow we are currently very happy having a cash balance always readily available. Risk at the individual investment level is also closely considered and whilst financial strength is one of the metrics we seek out, some of our companies do have modest and easily affordable debt. However it may give investors comfort to know that 1/3 of our company investments have net cash on their balance sheets.

In terms of market risk, clearly the greater percentage of the fund assets that are invested, the greater the likely exposure we would have to any market fall. Whilst this is of course true we try to focus on the real risk of losing money in each investment rather than just the notion of market risk. Of the 12 companies we own in direct equity investments (49% of the fund) 5 are currently valued at substantially less than their tangible book value (i.e. Fixed Assets + Working Capital + Cash – All liabilities) and 6 are valued on a 10x or less multiple of recent earnings. The price to earnings and price to book (including intangibles) ratios of the UK stock market by comparison are 13x and 1.8 respectively.

Diversification

What percentage of a fund to invest in each share is something many like to debate? Conventional ‘City’ wisdom spreads portfolios so thin as to make them almost mirror the market, by contrast the greats like Buffett have had occasions when 40% of their assets were in a single security. We will continue to refine our thinking on this over time, but for now we have settled on a concentrated(ish) portfolio that is run with position sized of between 3% and 10% of the fund value. Currently we do not have a 10% position nor think it likely in the near term; but we do have 7 holdings between 5-8% and the remaining ones around 3-4%.

The other exposure worth mentioning is currency. We have stated before that the fund is likely to have an exposure to currencies outside Sterling as it is seeking investments both in the USA and Europe. Today just over a third of the fund is invested in Dollar assets and 15% in Euro denominated ones. We are happy with the currency exposures that naturally arise from our stock selection, and currently are not inclined to hedge them unless we think a currency aggressively overvalued. Separately we do think the UK economy is much further back in the economic cycle than the US and therefore do not rule out the possibility of a longer period of dollar strength which would clearly help the fund.

Direct Stock Investments (49% of Fund Value)

We now have 12 investments that add up to 49% of fund assets (this compares to 31% at end of March). These are a combination of companies we think have a strong sustainable competitive advantage that are not priced as such and a few special situations that we think mis-priced.

An example being a company that has approximately twice its market value sitting on its balance sheet in cash. Whilst each company is considered on its own merits we can find sectors or markets where the distrust or uncertainty presents a greater number of opportunities. That is the case currently in the US financial sector where we have a number of holdings that we think are high quality businesses trading at extremely low multiples.

Over the summer we also found 3 new investments in UK and European smaller companies that we think could be extremely cheap and were pleased to build holdings in them.

Collective Investments (25% of Fund value)

At the interim letter in March we disclosed that we had 16% of the fund invested in collectives - As of today this figure has risen to 25% from which it will likely not rise much further. This is split between 5 investments (only 3 of which charge anything for their services). We used the May dip in markets to add the two new holdings at good prices. One of these was a specialist US mutual fund that we had tried to buy last winter but missed as its price rallied hard. The unit price of which then fell in May and we invested, since when it is up nicely. Like most of the assets in this part of the fund we think it will be a great long term holding.

As communicated before the market exposure of the fund could be considered in many ways the addition of the Collective and Direct investments, ie 74%. In practice some of the work out investments will have some market risk, but we hope it will be modest. As can be seen from these figures the overall fund is now far more invested than it was earlier in the year.

Works Outs (16% Of Fund value)

The logic of putting these investments alongside equity and collective ones remains compelling due to the differing return and risk characterises that they bring. Much effort has been expended in this area this year for less contribution that we would ideally like. In reality we may have to accept that when global headline interest rates are pretty much zero there are fewer bargains to be found in corporate debt mis-pricings or some other areas that offer interesting absolute returns. We keep watching and will be patient.

Now we have had time, to quote Charlie Munger to “*get our feet wet*” we wanted to be a little more descriptive about the process we are taking. In truth we are a tiny bit disappointed to see the US stock market and some of the franchises we have studied recently rise whilst not making a better return for shareholders. That said we have explained the market timing reasons why this occurred. More importantly we think we now have a combination of high quality and undervalued investments in both direct equity and collectives. We also feel we have a good process of finding and assessing companies and continue to learn more all the time.

Thank you for your continued support and please do get in touch with any queries you may have.

With kind regards,

Andrew J Hollingworth
Director – Farnam Street Capital Limited

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