

FARNAM STREET CAPITAL LIMITED

Friday, 21st October 2016

Dear Investors and Friends,

Final Report for the 12 months ending September 2016 - Net Asset Value: £125.65

During the year to September 2016 the Fund's NAV has risen by 4.4% to £125.65. This figure is after the deduction of the Fund's modest day to day expenses. Also, no management fee has been charged as the Fund is below its high watermark.

The Economic + Investing Backdrop

It is interesting to watch economic theories evolve over time and the advocates of each approach gradually change their view. Normally interest rates rise and an economy slows, then rates fall and it recovers. The exact drivers of its slowdown and then reacceleration often not identifiable as the inflection point happens too fast - not this cycle it seems. Five or so years ago we were told emphatically by many right of centre, financially well informed politicians that we had to 'live within our means' and 'move toward a more balanced budget', cutting expenditure was our 'only option'. In a surprisingly short period of time this mantra has been seemingly forgotten. In the current US election race the debt burden hardly gets a mention and the only policy both candidates seemingly agree on is the need for more fiscal stimulus likely by way of infrastructure spending. The UK political consensus has quickly moved in this direction also, as it seems have central banks: Mark Carney recently observing that low interest rates suggest a 'fiscal spending plan is justifiable'. Many monetarists it seems are now Keynesian believers also.

Whilst on the one hand this gives investors a clear sign of what direction economic policies are now moving in, it should also serve to illustrate how little those we listen to for leadership really know about the economic outlook. Is this policy on the hoof 101: ie 'X' did not work, so let's try 'Y'? Whilst we can see reasons to worry at a global level if such a spending policy fails to stimulate growth we are not inclined to the global long term Armageddon view some articulate. Indeed maybe a fiscal boost, which would consume a lot more labour and materials, than a QE one is exactly what economies need for a little stronger growth and a little higher inflation. Such a fiscal plan will importantly also keep animal spirits alive in markets and economies.

Productivity

Economic productivity measured in output per head is often seen as the nirvana that all economists and finance ministers are searching for. Its current low growth rate in the US (less than 1% pa vs the 2-3% growth rate of the 1990/2000s) is something that concerns and confounds many an economist. It is also the main factor explaining current lower GDP growth rates. But we find ourselves wondering if the focus on this measure misses a wider point. This being that whilst output per head might not be as high as desired, the cost of living for many vs. importantly the standard of living this cost achieves is today falling in many areas. Thus society and economies are developing (and becoming more efficient) but just doing so in a different way than in the past and in ways economists find this hard to model. A 2% wage rise in 2016 is of course worth less than a 4% one in say 2005? But parts of the modern cost of living are falling faster driven currently by deflation in commodities/oil but also in a lasting way via technological change. Eg better time usage (iPhone) or lower transport costs (Uber) or cheaper entertainment (Spotify/WhatsApp)?

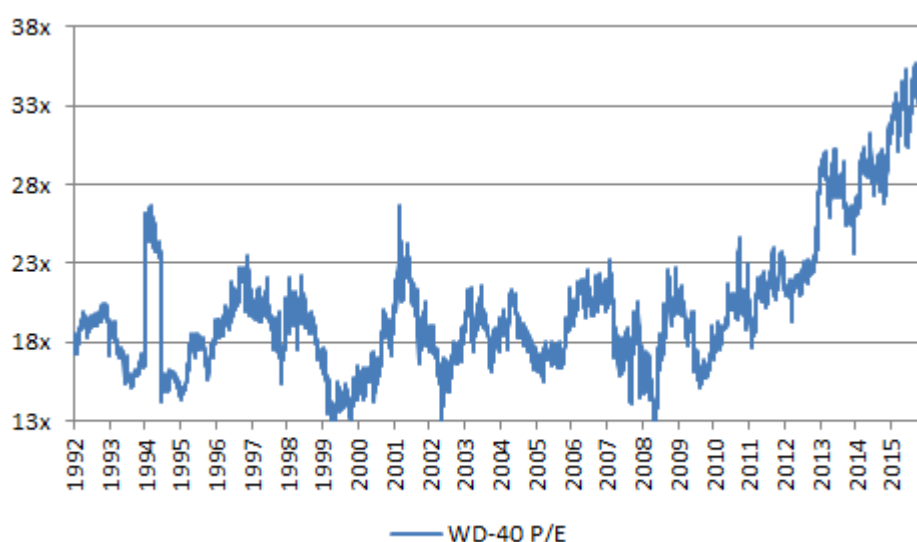
All these services put more power in consumers' hands for often less money, but little of it feeds into national statistics. These just capture that less DVD's are sold, or lower Taxi company taxes are paid.

The money consumers are saving is measured as a worrying economic line item (deflation) not a positive one. We make the above observation just to show that for all of the economic uncertainty that many commentators love to highlight there is much progress in non economic items and improved quality in many people lives, even if economists find it hard to measure.

Markets

Many an investment bear believes that the rise in markets of the last 5+ years has been in some way false, with higher market levels only a result (direct or indirect) of money printing. We can see this point of view, but do not see market prices as in any way false or manipulated. All that has really occurred is a repricing of all related assets to today's record low global risk free rate (Global Long Bonds - which are now either a bubble or at best return free risk). Corporate bonds, Property and Equities have all performed royally as a result with the best gains handed out to those seen to be the lowest risk (prime property, investment grade bonds and top quality companies). As we observed in the spring those investors wanting cheap absolute starting prices for a companies shares, rather than paying up for quality, have found life a little harder (our hand is raised).

We recently came across a chart that we thought put this 're-rating of quality equities' theme into perspective. It is the PE rating attached to the shares of WD40 over the last 30 years.



Source: Capital IQ

WD40 is an interesting example for a variety of reasons not least it sells one product worldwide and has done so for decades. It is also well run with modest annual top line growth, but good Return on Equity. Of note however its expected growth rates in earnings are no greater than those achieved in the past 20 years. The re-pricing of its shares therefore is arguably merely the function of predictable growth being harder to find. We looked closely at WD40 about 4 years ago as a possible investment (PE was then c.18x) and found many of the traits we like. We did not buy the shares however. Why? Because we assessed them as fairly priced. During the 4 years since the group earnings per share have risen a healthy 50%. Its shares however are up 140%. What we thought as prudence 4 years ago looks like folly today. As we observed in our research note of the summer (*What would Billy Beane (or Ranieri) do?*), franchise companies have in recent years received a once in a lifetime re-rating as the market rewarded their quality and resilience.

As interest rates and global growth have stayed low this is arguably a logical sequence of events. However this is not a trick that can be repeated in these same companies again. History shows however that it is possible to be reversed.

We have we been doing (Right and Wrong)

Against a backdrop of quality franchises' being almost constantly re-rated it has been disappointing not to have participated in this process more fully, particularly when we think we understand franchise analysis better than many. It has not been our analysis of such companies that has held us back but our reluctance to pay up as painfully illustrated in the WD40 example above.

We also made some genuine mistakes in the first few years of running the Fund in trying to buy a few deep value ideas. We felt that the risk was compensated by the returns offered, but in a few cases we were wrong. In other cases the jury is still out. An interesting example of this is a share we still own today: General Motors. The full thesis for why we own the shares we will not go into here, only to say that we believe, due to the restructuring it went through in 2009 that GM is a far better business today than in its past. We think it will make higher margins for longer than many believe. As a result we have owned the shares for c.3 years. When we bought the shares they were \$31 and trading on a PE of around 8x earnings. Since then profits have risen faster than the market has expected, but pretty much in line with our and the company management projections. The share price today...? It is \$31. How is this possible? Because today it trades on 5x current earnings as Mr Market seemingly believes the peak in its profits are likely now even nearer and/or Telsa will soon have revolutionised the car market resulting in lower profits for the incumbent operators. These cyclical and structural threats we believe overstated, but as the saying goes; 'you have to remain solvent longer than the market can remain irrational'. Consider that in the last 4 years GM profits are up 80%, but its shares are unchanged. The contrast with WD40 with earnings up c.50% and its shares up almost three times as much is clear. (NB We have received an annual dividend income of c.4% from our GM shareholding).

New Opportunities

Over the last 6-9 months a number of individual company wobbles or market events, like Brexit, have again presented some really interesting franchise opportunities. This has resulted in us buying into a number of companies that we know well/have researched for a long while but up until now not found the share prices to offer compelling value. The result is that we have built positions in companies such as JD Wetherspoon, Ryanair, Sports Direct and Next. All we think have either good or very good franchise characteristics, but importantly offer us compelling value at the entry price. Mostly the reason we are being offered these bargains is because something is going wrong and thus Mr Market is worried. In each case we believe the extent of such worries are more than priced in to the shares. All four companies also have single trait in common; they are run by a determined and experienced manager who owns a significant stake in the business and has extensive experience of running these cherished operations.

We suspect it will not be lost on readers that all of these are UK companies. Likely many of you will have also noticed that Sterling has been extremely weak of late. We have been using that weakness to sell a few US Dollar holdings, to buy what we think are now undervalued UK franchises at compelling starting multiples and at a 30y low in the Sterling/Dollar exchange rate. As an aside we see Sterling's currently depressed level as offering very good value. The resilience of the UK economy has surprised all this summer and we agree with the consensus view that that future open trade between the EU and UK is in all parties' best interests. Thus the recent drop in Sterling reflects the entrenched positions that each side must present before negotiations can maybe start in earnest. We also observe that there has never been a better point in history to have a currency crisis.

Many global economies have worked hard in recent years to depress their exchange rate to steal a little global growth for themselves - The UK then achieves this by accident. The price we pay for this accident? Sky-rocketing UK Government borrowing costs; 10y money costs have risen 35% in the last 6 weeks as the UK credibility has fallen. It now stands at a whopping 1.1%! We repeat; there has never been a better time to have a currency crisis.

US Financials - Blind spot or becoming sweet spot?

We have believed for some time that the only sector that looked notably undervalued in the US stock market was the US financials; particularly the largest banks deemed ultra-safe by regulators, but assessed as un-investable by many an investment manager. The difficulty of competing with JP Morgan in just a single line of business, let alone across its whole scale of operations and fortress balance sheet is daunting and likely impossible. As such surely such a business has a sizable moat, but its share price suggests otherwise trading at c.10-11x earnings (post a 20% run up!) vs. a market PE nearer 20x.

This difference is justified by many due to how hard it is for banks to make money in a low interest rate environment. However despite this significant headwind the best US banks are still making acceptable (10-15%) ROE's achieved by constant product repricing and efficiency drives, whilst building the capital regulators desire. In short, the world's best banking franchises are being run very efficiently at what may well be the trough of the interest rate cycle. As such the operational gearing into any recovery could be very significant. Equally regulators are running out of reasons for them to hold onto further capital, thus greater percentages are now being paid out to income starved investors.

As a result, we have chosen not to give up on our US bank holdings in favour of the WD40s of the world at high starting multiples. However a few new opportunities such as those thrown up by Brexit have seen us trim some of our banking positions. Investors should also remember that the banking sector is one of very few that would perform well were there to be any sign of interest rate rises. The exact same signal could see falls in the value of bonds and possibly the values of assets priced closely off of them.

Portfolio Weights

As a result of the changes noted above today the funds percentage of assets invested in US Dollars are falling (now 53%) and the amount invested in banks is 24%. Additionally the percentage of assets invested in what we would classify as having 'great business economics' is 71%, 24% we would be classify more as Special Situations and 5% in cash.

Our job remains to find value where other investors overlook it. In a number of cases this comes from taking a contrarian view (we own 2 stocks in Greece and 5 banks after all!). But our preferred route is to find what we think are well run companies with good economic models, run by excellent and aligned owner managers and buying into them for interesting(even compelling) starting prices. You should expect us to be adding to these types of positions. We very much like the quality of the companies that we own today and the prices at which they trade. The c.22 companies that we own are on an aggregate PE close to half that of wider markets. As such, whilst markets have performed well in recent years our portfolio is not 'the market'

With kind regards,

Andrew J Hollingworth, Fund Manager

Farnam Street Capital Top Holdings

	%
WWE	9%
General Motors	7%
JP Morgan	7%
Biglari holdings	7%
Goldman Sachs	6%
Exor	6%
Sports Direct	6%
Ryan Air	5%
Other Holdings	42%
Cash	5%
Total	100%

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