

FARNAM STREET CAPITAL LIMITED

Monday 23rd October 2017

Dear Investors and Friends,

Final Report for the period ending September 2017 – Net Asset Value: £164.4

During the year to September 2017 the Fund rose in value by 30.8% to an NAV of £164.4. This after the Fund's modest running costs and all fees.

This report takes the form of the others we have sent to investors at previous year-ends first reflecting on the economic back drop we are investing against, then providing a commentary on our experiences in the last twelve months. Whilst the Fund's return is much improved, it actually tells an investor very little about our activity, or the effectiveness of it, in the last 12 months as the vast majority of the investment return was from decisions made some years before.

The economic backdrop

We have written before about the three distinct cycles we observe. These being the political cycle, the economic cycle and the stock market cycle. Considered in those terms we might observe today that the stock market cycle seems mature or even extended, however on the current position in economic cycles of both the US and Europe we are far more sanguine. Assessing the market cycle first it seems realistic to suggest that the easy money has likely been made. That said we would also assess the equity bull market as one that has been hated all the way up. More to the point however we are not market timers but investors. At points such as this we think it apt to reflect on the statistic that the US stock market grew by 9.8% pa in the 20 years to December 2015: The average actual investor return however was only 5.2% pa. The biggest determining factor between these two returns; market timing. In short too many investors try too hard to time market investments. Our job as we see it is not market timing it is to invest as wisely as we can the funds that have been entrusted to us so as to achieve the best rate of long term compounding. That said some acceptance of whether market cycles are depressed or extended helps us in that decision making.

'You should be fearful when others are greedy and greedy when others are fearful'
– Warren Buffett

At the economic cycle level many commentators are keen to see all that is wrong in the world. Lower recent growth rates are extrapolated and the potentially difficult consequences that might result analysed to the nth degree. Indeed a low growth, low inflation environment does still seem the most likely future scenario we face, but as long as it does not tip into a deflationary downward spiral (now seeming a remote prospect) then that is a stable enough economic base for us to invest against – even if it is not the one most investors were used to pre-2007.

However we also think an alternative scenario is quite plausible too. This is one of faster than expected growth, maybe in time resulting in higher interest rates as a consequence. Many dismiss this prospect as they cannot see what can drive faster growth as highly stimulative policy (low interest rates + budget deficits) has been in place for c.10 years without creating such an outcome. Our suggested requirements for possible future higher growth are simple: time and a sentiment change. We have discussed this idea in our past pieces on the velocity of money.

In essence we speculate (for it is no more than that) that a once in a generation recession maybe resulted in long lasting changes in the behaviour of consumers, businesses and many other market participants that are hard to measure. All were scared by the scale of the economic downturn that occurred and this created a mood of prudence and reticence that has lasted. However we suspect that it will not last forever (the deepest cuts take longer to heal after all). Whilst this is not a central case that we are predicating all our investment decisions upon, we think it worthy of consideration as we feel its likelihood is greater than the many assets prices currently discount. Such an event would bring a growth surprise such as is now occurring in Europe. It might then be followed by higher interest rates than some expect. Each of these events in turn would have notable consequences for the likes of banks, economically sensitive companies and then in turn more leveraged organisations.

All of the above are just our reflections on the investing backdrop to the Fund. Our investment approach remains unchanged and the driving analogy we have used before for considering macroeconomics remains: The macro backdrop is what we see out of our car wing mirrors – we all use this helpful additional information when driving, but rarely does it determine our direction of travel. Our front windscreen is focused on our future journey – that of finding mispriced quality companies and other assets that we think offer compelling value in almost any economic outcome.

Franchise investing

Our approach in looking for undervalued franchises is the same as we set out six years ago. We seek to find companies that have the five following traits:

1. Make high returns on capital
2. Excel in their field with a demonstrable moat
3. Grow
4. Are well managed – by owner managers
5. Allocate capital well

The key to doing so and getting value at the time of purchase (and thus increasing our IRR) is often to buy into such companies when others do not see those characteristics – or choose to ignore them.

“You can have good news or cheap shares – you can’t have both” – Jim Grant

This was the approach we used to buy into the shares of a number of leading US banking shares c.4-5 years ago. Then we concluded that we had found great companies run by talented managers and they were offered to us at cheap prices. Mr Market disagreed. He saw depressed earnings, ever increasing regulations and the all too recent memory of a once in lifetime economic collapse; hence the opportunity was created. Today with the US economy recovering and the combined prospects of higher future bank earnings and a little less regulation, the shares of companies like JP Morgan and Bank of America are once again in demand.

Reflecting upon such an investment opportunity in such a brief/superficial way makes the process seem almost easy. At its very essence maybe it is, and certainly those with the clearest investment minds (Buffett/ Munger) seem to find it such. For us mere mortals the lived reality of such decisions is far more complex and in truth sometimes a stressful experience. Every week a new piece of news emerges or new commentators stand up to tell you are wrong. In addition the political backdrop changes and then changes back. All are tempting you to change your mind. Then a little time may elapse and the share prices you have long favoured start rising so you have finally made some money, having waited for what seemed an age. Again, Mr Market is tempting you to change your mind, taking the profit you had long hoped for.

“Of all the investment skills it is the sitting and the thinking that has made us the most money – mostly it’s the sitting” – Charlie Munger, Berkshire AGM 2012

The reported performance in this letter suggests that overall we have made a decent fist of this challenge. The truth is that you as investors would have fared far better if your manager had not shown up for work in the last year as firstly US election outcome fears and more latterly some nervousness about stock market levels saw us reduce some of our very profitable US banking positions a little earlier than maybe we should have. Today NAV might have been c.5-7% higher had we done nothing. In truth we cannot have real regrets over this course of action taken as most of the trimming of positions were made with prudence in mind and that is rarely a bad policy. The point here however is that even out of successes we can learn a great deal. Just sitting and doing nothing is hard but often if your initial thesis is proving to still hold it is the right thing to do. Munger (above) as ever says it best! As we write today the fund still has 22% invested in the US banking sector and 32% in financials globally – a sector we still feel is undervalued.

Contra cyclical value investing

A similar experience to that outlined above has also occurred with one of our more counter cyclical value investments – General Motors (GM). We wrote about the value we saw in GM in a past letter, but despite the company delivering (and more) on every profit expectation they ever aspired to the shares just would not budge. It was a dinosaur we were told. ‘Have you seen Tesla?’ many would assert. Indeed the evidence was quite overwhelming of an industry that might be left behind as a whole host of technology innovators stole their lunch. Having upped our holding size in GM during 2014/2015 we found ourselves trimming the position this year. Partly this was to fund newer holdings we are excited about and partly it was due to our waning conviction or put more bluntly our worries that others views might be right. Then suddenly the shares have risen 35% in the last 6 weeks for a variety of reasons, not least that many are now seemingly excited about the battery and self-driving innovation inside GM itself. Not such a dinosaur it seems. Sometimes it is hard/impossible to say why a share price will respond to the value it demonstrates, but we are of the mindset that says: ‘Good things happen to cheap stocks’, especially if they are well run. Today post a 35% rise GM shares trade on PE of under 7x – hardly demanding. Our holding size is c.5%.

We have no special mechanism for such decision making – no stop losses, no advisors telling us when to sell. Our reference point is the intrinsic value we find in companies others dislike and an ongoing brutal assessment of whether we are wrong – be that due to a poor initial assessment by us or a changed circumstance.

Post both of these experiences we resolve in future to have even more patience and resilience when we are convinced our core thesis is correct and the value offered is real.

Recent portfolio changes

With markets levels assessed as high and with our admission of a little selling of our favoured sector – US financials, all things being equal our cash position might have been expected to rise, but today it stands at 4%*. The reason for this is a range of new opportunities that we have found over the summer. Whilst market levels as a whole may be high there will always be a variety of companies or sectors that at any point in time are having their own bear market. We are looking for such special ‘niches’ or for special people (owner managers) and of late we have found a few new ones we are excited about/have invested in.

This Spring, we listened to an excellent investor present on the merits of a shipping company. Normally we would have quickly switched off but like us this investor’s core approach is Franchise investing but he admitted to not be able to resist the value offered in this situation.

We worked extensively on this company over the spring/summer months and as a result you see the name of Teekay Corporation as a 7% holding in the Fund (note it was a 5% position when we initiated it in June).

We have since looked at other opportunities in this depressed and loathed sector of late – our total exposure to which is now c.10% of the Fund. To be clear these are not franchise investments that we expect to own forever but assets we see as significantly mispriced in today's momentum orientated capital markets.

Another new share that we think fits the idea of 'special niches and special people' is Fairfax Financial (5% holding). This share we also bought over the summer. In truth it is a company we have followed for some time - seeing in it (as we do in Exor) the Berkshire-like trait of a well-managed investment float that should deliver longer-term, faster rates of compounding. We bought into it this summer as its founder's (Prem Watsa) reading of markets, was for once, a little off. Mr Market, we think, over-reacted thus creating the opportunity.

Whilst we primarily seek out the mispriced franchise opportunities that we can own for the long term we think that our diversity approach is hopefully becoming a competitive advantage. Franchise investing and the power of compounding are now well understood but as a result more than a few investors are so wedded to this approach they cannot look at a deep value share like GM at all, whatever value it offers. Thus, having an ability to be able to move between different types of value investing we think (and hope) will deliver a real advantage over time. Today fund investments that could best be assessed as 'Franchises' equate to 64% of assets. Those best labelled as 'Special Situations' represents 32%. This 2:1 ratio we would ideally like to be much higher, but no matter how compelling the business model the starting price must be right too. For clarity, where we cannot find franchises at the right price we will look for mispriced special situations. If we find neither we will not be shy to own cash.

Today the Fund is 96% invested with 4% in cash*. 49% of our assets are invested in US Dollar and 14% in Euro valued assets respectively. Please see the corresponding September 2017 factsheet for a list of our larger holdings.

Thanking you for your ongoing interest and support.

With kind regards,

Andrew J Hollingworth, Fund Manager

* The 4% current cash outlined differs from the 1% shown in the end of September factsheet as a short-term bond held matured in early October.

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