FARNAM STREET CAPITAL LIMITED

Tuesday, 21st April 2020

Dear Investors and Friends,

Interim Report for the 6 months ending March 2020 – Net Asset Value: £118.5

During the six-month period to March 2020 the Fund's NAV has fallen by 27.1% to £118.5. 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 remains below its high watermark.

The Black Swan that was hiding in plain sight

"It is one thing saying it is going to rain. It is quite another to build an Ark"

In previous communications we have outlined numerous times that we are not macro investors, preferring to focus on trying to buy mispriced good businesses with great managements and compounding power. We have also talked of how we look at the macroeconomic world as a driver of a car might us his wing mirrors. I.e. we use them to check on the world around us occasionally but not often are they are our main focus. In January/February 2020 we spotted something in our mirrors that worried us, particularly so because almost no one else in the western investing market seemed to be paying attention to it. That something, Coronavirus is now dominating all of our daily lives.

The last few months have been some of the most stressful we can remember. Not because we were losing money on our invested capital but because we felt there was danger in something that many close to us were dismissing as a risk and that that dismissal could cost lives. As more draconian measures have been brought in by governments, we have felt more relaxed knowing that the right actions are being made to save lives.

From an investment perspective it has been a strange period. We are pleased to have seen this risk coming when so many others did not, moving to a 20% cash position in mid-February. Those that have known us a long time will also be familiar with our caution leading up to the 2008/9 crisis. We are proud that we seemingly have an ability to spot some black swan risks early (that will have cursed us now as we are now bound to miss the next one!). However, having started in equity investing in August 1987 your author has now lived through a number of these crises in real time – and 'real time' is a very different experience to reading about it! The quote above about building arks is something we picked up during 2008/9. It talks to the point of a) being open minded enough to see such an outlier risk as Coronavirus but b) also being determined enough to do something about it.

In February we did act but our mistake was to give the risk of coronavirus becoming a Western problem <u>some</u> of our time. We should have given it <u>all</u> of our time. For only by doing so might we have better fully thought through the knock on consequences of its arrival. The 20% cash position we raised came from selling c.80% of EasyJet/Ryanair shareholdings, all of our Formula 1 and c.50% of our holdings in JD Wetherspoon and Frasers (Sports Direct).

With the backdrop of these actions our investors would be right to ask as a result: Why have you not performed better than the wider markets during this period then? The reason for this is our consumer and banking tilt and the fact that we owned very few defensive shares as we saw them offering little value. With a consumer centric portfolio at the start of the year our Fund would have fared far worse in performance terms if we had not taken such actions. A look at our top holdings as of December 2019 is a list of companies, many of which have seen c.50% share price falls. However, we do not believe that this is proof we were wrong to own those shares, only that they have been: a) uniquely hit by this event and/or b) that today some of these shares might be extremely undervalued as a result.

Hindsight Investing

It is perhaps easy for an observer to suggest we owned the wrong portfolio ahead of such an event. On this idea we are tempted to use a Charlie Munger skill and suggest we invert the question. What if the virus we are all facing today was not of the medical variety but a technological one that crashed all digital systems? Instead of working from home we would all have to be in the office to communicate. Instead of Skype calling we would all be flying to meet our suppliers or clients face-to-face and following up on the telephone. We might even have had to go to the high street to shop rather than online. In such a scenario arguably many recent share price performances we have seen could have been reversed (oil/travel up/technology down). This is the reality of risk and truly black swan events-we just can never know where they might arise.

The way we have thought about risk has been to focus on stronger business models that are run by aligned owner managers that do not take unnecessary risk. Our past highlighting of Ryanair is perhaps an interesting example of this. Yes, its share are down c.33% so far this year, but IAG, American Airlines and Easyjet are down c.60-65% and Virgin Atlantic may or may not survive. Ryan's resilience is partly due to a low-cost base, but also due to its owned fleet and cash reserves. That the company's third largest shareholder is also its Chief Executive is not lost on us either. Such aligned people see risk differently to those with share option schemes and an eye on the exit.

The other way to think about risk is that which comes from purchasing something without a margin of safety. Indeed, one of the reasons for our caution in February was the fact that markets were high, i.e. pricing in so little risk. An example of our thinking on this can also been seen from the only US bank we still own, Wells Fargo. Some years ago, we made investments in both Bank America and JPMorgan owning their shares (and warrants) when we thought they were significantly undervalued vs. their longer-term earnings potential. In time both companies' earnings and share prices recovered strongly to a point that we felt they were fairly valued. As result we sold them.

We did not however sell Wells Fargo. Why not? This was because while other US banks were enjoying a recovery in returns due to higher interest rates and a stronger economy Wells had fallen foul of its regulators due to a past mis-selling scandal. The result was/is a bank that still has a huge deposit base, but is not able to grow the lending out of those deposits in the profitable way its peers have. Additionally, the combination of reduced growth and high regulatory scrutiny has resulted in Wells having a cost base that is far far in excess of its peers (or its own efficient history). We knew in January before coronavirus hit that the risk/return in Wells Fargo was far better than many of its peers. That is not because it was making higher returns than them, it was because of its potential to improve its profitability through its own actions. I.e. more lending out of existing deposits and cutting costs, not just relying on the economy at the time. The changing environment of the last three months makes Wells Fargo or any bank a hard company to analyse, but our risk return assessment still holds.

The Double-Death of the value investor

Franchise and technology type businesses have seen their defensive and growth qualities priced off of interest rates, as such their shares have climbed ever higher in recent years. Anyone not prepared to jump aboard this band wagon is seemingly a fool. We admire many of these companies, but continue to ask the question: Does paying a PE of 25-30x for a business bring the margin of safety that you seek in your investments? Some of the most thoughtful and experienced investors we have ever come across have instead chosen to seek out the value offered in discarded parts of the stock-market (Note: Buffett having c.10% of US Banks + Airlines). He may be right or wrong, but to suggest the former group of companies are worth any price and the latter no price at all flies in the face of almost every investment and analytical insight we have picked up over the last 30 years. That Adobe is a good company we will not dispute, but do we want to pay a 40x PE for it? That IAG is in a tough spot right now with a grounded fleet is clearly the case. Maybe it even needs an equity raise. But it trades on a PE of 2x the earnings it made in 2019!

Smart, hardworking, value orientated investors have been looking at such mis-pricings for c.5+ years now, but they have been fighting against huge headwinds. This is partly the anchor of low interest rates and partly the scale of capital that has flowed towards franchise and growth strategies chasing past performance. That was the scenario as of December 2019, then coronavirus hit. And what did it hit? The value sectors! Some of the worst performing sectors this year have been those value seekers have been looking to find mispricings in, banks, airlines and oil. At the start of the year we had sizable holdings in two of these sectors. By mid-February that was reduced just to one – banking. All of this of course has just re-enforced the growth/franchise seekers' view that paying up was well worth it. Against the risk that surfaced this year this argument holds, but that does not mean it holds for all risk.

Fish in a barrel?

Buffett was once asked about investing in some complex area. His response was something along the lines of, "*we prefer it when we can just shoot fish in a barrel*." Post the now double-death of value investors we are prepared to suggest that this is one of the best environments to buy undervalued equity assets we have ever seen. Many well run, decently capitalised businesses with a great assets and strong market positions are trading at prices few thought they would ever see. Why is this happening? It is partly due to short term fear that coronavirus has bought about. But it is more to do with the fact that there are just so few buyers of these 'hated equites' because so many investors have convinced themselves just to buy more Adobe!

What are we doing now?

In the past our main holdings have often changed rarely from one quarter to the next as we stick with businesses we feel are misunderstood and mispriced by Mr Market vs. their long-term compounding power. Whilst our ethos is unchanged, we have been making far more changes to the portfolio than usual in recent months. This is not because we feel that our past analysis of a company was incorrect but because with a consumer facing list of companies, we think it important to be brutal about how each might be affected by the length of consumer lockdowns that are being imposed on societies. Good businesses and managers can still be unlucky in the position they find themselves in. Attached to this letter is a flow diagram we put together a month or so ago. It shows how during this period we have tried to ensure we are far more focused on the balance sheet strength of companies and the asset backing they have to help them survive long periods with low levels of trading. Companies with strong market positions today will be well placed to grow ever stronger post coronavirus, but it is important that our equity ownership of them remain intact during any downturn so we fully enjoy our share of that future growth.

In short, we are working perhaps harder than we ever have and doing so with two overarching goals. Firstly, to try and ensure that your (our) capital is protected from any permanent value loss during this period, but also to trying to ensure the portfolio is perfectly positioned for the recovery when it inevitably comes.

Our cash position having been 20% in Mid-February is now in the 0-5% range.

With best wishes to you all.

Andrew

Andrew J Hollingworth: Director – Farnam Street Capital Limited

"Value investors must be strong and resilient, as well as independent-minded and sometimes contrary. You don't become a value investor for the group hugs. Indeed, one can go long stretches of time with no positive reinforcement whatsoever. Unlike some other fields of endeavor, in investing you can do the same thing as yesterday but achieve completely different reported results. In the long run, the research and analysis you perform should overcome market forces; the fundamentals ultimately matter. But in the short run, markets can trump effort and insight." – Seth Klarman 2015 year-end letter to investors

"Value… is not quite enough. Buying low is a start…..but you need the patience, discipline and grit to buy lower and still lower if the opportunity presents itself, shutting out the extraneous noise coming from within the market and over the airwaves" - Seth Klarman April 8,2011