FARNAM STREET CAPITAL LIMITED

Wednesday, 24rd April 2019

Dear Investors and Friends,

Final Report for the period ending March 2019 – Net Asset Value: £157.0

During the six-month period to March 2019 the Fund's NAV has fallen 4.5% to a NAV of £157.0. This figure is after all fees and expenses.

A volatile, but useful time

Our year end letter of September 2018 was arguably a little long (rambling or thorough – take your pick). It outlined our thoughts on areas like Brexit risk and the US interest rate cycle. It also outlined once again some of the regular traits we look for in a successful investment giving examples of Ryanair and the US banks. In doing so it covered much of what we think investors need to know about how we are running the Fund. Readers will be pleased to know that this letter is somewhat shorter.

This six-month period has been a volatile one for markets (and our NAV) and we used this volatility to make a number of changes to the Fund which we think improve its outlook. In many cases changes made often resulted in having to sell the shares in one cheap company to buy the shares of another. We mostly made these changes due to the increased quality of the new companies we were able to buy. With each of the companies purchased having something the ones we chose to sell did not – an impressive and aligned owner manager.

Owner managers – The secret sauce

In almost all of our past letters we have spent a considerable amount of time outlining what traits we look for in the companies we chose to invest in. Often you will have heard us refer to our search for businesses that **operate** well in their industry, **generate** good returns and then **allocate** their funds wisely. Alternatively, we have talked of trying to find **great companies,** run by **great managers,** at **great prices.**

However, a common factor we have found in almost all of our successful investments to date has been an aligned owner manager. By that we mean a company that is run by either its founder, biggest shareholder or someone thinking in the exact same way. Indeed, we perhaps now would go further than our previous writings and say that if we could only pick one trait rather than the multitude of big and small factors we seek, an owner manager being present would be it.

Whilst we will not lay out in this letter the multitude of qualities that such a leader can bring to a business, a few are worthy of singling out:

- A focus on what is in the very long-term interest of the business even if there is a short-term cost
- A strong focus on the customer and what is good for them
- A desire to keep the businesses evolving/fresh
- A feeling that it is not necessary to always explain and promote the business to every cynic and stock market commentator

These points however do not always align with what investors may want to hear about from a company/believe to be true. As such some great businesses that are well run by what we assess as aligned and impressive owner managers can at times be mispriced.

Portfolio Structure

The above reflections we hope are not new news to our investors. Indeed many of the companies we have owned for years and written about before exhibited these management traits (Ryanair, Exor, J P Morgan). We have known how important aligned owner managers are to the compounding power of our investments and thus have sought them out for many years. However up until recently we have not been able to construct almost a whole portfolio out of them. Other investments we have made (and will continue to make) are often more due to the cheapness of the asset rather than the compounding ability of the owner managers we were investing alongside.

The reason for this explanation is that quite a few owner managed type investments were offered to us at what we thought compelling prices in recent months. In order to invest in them we have sold some other holdings that whilst were cheap did not offer the same quality. The result of these changes is an exciting evolution of our portfolio. Today of the total 26 investments that we hold in the Fund, 18 could be said to be run by aligned managers with a significant stake in the business. Each of these also has a great business model. Does this mean that we have stopped being value investors? Far from it. We are still very mean in the starting price we are prepared to pay for such companies even when they are of the highest quality.

An example of this is a company we recently purchased (to a 3.5% position, but we would like to own more). It was founded by a family in 1938. Today the family still own 45% of the shares and the grandson of the Founder is CEO. They have compounded their earnings per share at 19% for the last 10 years and made consistently high returns on equity during the same period. They are innovative in developing new products in-house and recently showed themselves as good allocators of capital also; selling a long-held division when a bidder offered a high price and then returning much of the resulting cash to shareholders. We recently bought these shares at PE of 8x current year earnings. They have rallied somewhat since our purchase, but we are hopeful Mr Market might offer them to us at such a bargain price again one day soon (hence our secrecy).

The result of having more and more of our combined funds invested with aligned owner managers we hope is clear to all. Day to day they are running such businesses with great care, attention and a long term focus. This means we have very little to do apart from monitor them and enjoy the ride. This is different to deep value investing in cyclical sectors where the manager (us) must study industry trends very closely to try and ensure maximum value is achieved for the investor at the inception of each investment and its exit. Also, after exit each follow on investments then need to be made, as the saying goes:

'Find a genius and hold on tight'

Examples of owner manager businesses we have given in the past include Ryanair, Exor and J D Wetherspoon. We would also add Charles Schwab and Disney to that list today. Both are shares that we have purchased in the period.

Outside of these types of companies other special situations can still bring great value to investors (particularly as they may offer value when wider markets might not). An example of one can be seen in the growing size of our position in the preferred shares of Freddie Mac & Fannie Mae (US mortgage companies). NB: The position size is rising due to their share price rises not additional purchases.

Describing the history of these companies and the rationale for our investment in them could run into volumes, not pages. At its most simplistic level these we assessed were state US controlled entities that were subject to emergency (post-2009) measures that were not tenable in the longer term. In any likely restructuring of these companies that must ultimately result, the preferred shares we own are treated as their names suggest (receiving preferred terms over ordinary shareholders). These shares have a 'par' value of $25 per share and if fully restored would pay an annual income of c.7.75% on that $25. We purchased them at c.$4 and today they trade at c.$11. As the US Government prepares to start engaging in new policy to 'fix' these companies, we think it possible these preferred shares could yet trade at par. There is much complexity in a special situation like this but simply put at $4 in 2013, we thought the risk reward was just mispriced.

Our modus operandi is hopefully clear. To try construct a portfolio of excellent compounding businesses run by impressive and aligned owner managers and occasional supplement this list with the occasional Freddie/Fannie look alike special situation.

The portfolio today has 55% of its investments in US dollars, 24% in Sterling, 15% in Euros and 6% in other currencies. Due to its size we have often disclosed to investors our exposure to the banking sector. This (now split between US and UK banking investments) still equates to c.20% of fund assets. Additionally, we thought some further exposures may interest investors. Investments that could be considered media content businesses (c.11% of assets), lowest cost leaders in their industry (18%) and business that control and invest insurance float (14%). Cash represents 3% of the current portfolio.

We like very much the businesses that we own and believe the current portfolio to be significantly undervalued.

Thanking you for your ongoing interest and support.

With kind regards,

Andrew J Hollingworth, Fund Manager

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