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FARNAM STREET CAPITAL LIMITED

Friday, 25th October 2013

Dear Investors and Friends,

Final Report for the 12 months ending September 2013 - Net Asset Value: £123.1

During our the 12 month period to September 2013 the fund's NAV has risen by 23.4% to £123.1. This is after all performance charges and any costs incurred. The fund is now at £8.5m and whilst some new monies were received during the year much of its increase in size is due to the rise in the underlying asset value.

Fund Performance and Costs

The directors remain acutely aware of the need to keep fund running costs as low as practical so as not to impact on investor returns and additionally are keen to ensure no investor feels the fund is in any way disadvantaged due to its currently smaller size. As such Holland Advisors, whilst continuing to provide investment advice and analysis to the fund for no management fee, also continued during the year to reimburse the fund for any general expenses incurred in excess of 0.4% of the NAV. During the year such expenses actually incurred amounted to 0.36% of the fund value (0.54% in 2012). The result being that no reimbursement from Holland advisors was received (£7500 received during 2012)

The Economic and Investing Backdrop

In order to set the scene for the investing backdrop we operate in we commented quite extensively in the last two letters on subjects such as the credit crunch, its ramifications and the economic world it resulted in. Whenever we feel our macroeconomic view differs notably from that prevailing at the time and is therefore likely to have an effect on the funds structure or performance we will make investors aware. The rest of the time, both in our writings to you and in our running of the fund day to day, we will focus more on what we see as the core part of our job, that of individual company analysis, idea selection and portfolio construction.

One area we will admit has surprised us in recent months has been the strength of the UK economic data and Sterling as a result. Maybe we sit too close to the trees to see the genuine economic green shoots appearing or maybe, as a few suggest, the new found economic recovery is being driven once again by momentum in the housing market. As contrarian investors we are often interested in companies exposed to economies that can be said to have genuinely suffered real hardship (currently the US, Ireland or maybe even Greece) and will tend to avoid those that look to have had it good for too long. At most points of other normal cycles most economic data is just too hard to predict.

We do remain nervous that one day the UK might have an economic price to pay for relying on any renewed love affair with housing and the service sector/consumer recovery it looks to be now leading to. That said, only a fool stands in front of a steamroller that is aided by both political and central bank policy. We will just try to do as we stated in our original fund outline, i.e. to look for the best quality investment franchises we can that come with give good margins of safety due to attractive purchase prices. In doing so with a sceptical eye, the result (we hope) is to try to avoid sectors, or areas of the economy that are a little hot, perhaps favoured by others.

How we are going about investing your (and our) money

Investors by now are familiar with the fact that we split the portfolio into three: *Direct Stock Investments*, *Collective Investments* and *Work Outs* and we will briefly discuss each of these areas within the fund shortly. Our most important investment area is that of direct equity investments and within that we often state that we are looking for ‘franchises’. Therefore we thought we might expand on exactly what we mean by a ‘franchise’ and what traits we seek out when trying to identify them.

Knowing what to look for

In the briefing documents we distributed to investors prior to launch and subsequent investor letters we have tried to explain as clearly as we can the process used in selecting investments and the construction of the portfolio. We are also aware that the investing knowledge base of the owners of the fund varies significantly and so endeavour to make the process simple enough to be understood by all. We will even go as far as to make a rod for our own back at this point by quoting no less than Albert Einstein “*if you can't explain it simply, you don't understand it well enough.*”

Despite what many will tell you the process of investment, or indeed that of running a business, is actually incredibly simple. Many a wonderful entrepreneur did not finish their schooling. In essence investing and business comes down to a simple ‘money in’ vs. ‘money out’ equation, when these two events occur and importantly with what risk. At the next level there is the importance of needing to be in control of your emotions so as not to get too carried away in the good times or bad. Additionally we would add the Boy Scouts motto of “Be Prepared”. Clearly such a quote has many interpretations but we try to use it in a way that we hope differentiates us from a number of other equity managers. We strongly believe in the need to be prepared enough to know exactly what we are looking for in an investment before we even open the Financial Times each day.

On our office wall we have a quote by a highly successful but little known US investor. It reads:

Choosing individual stocks without any idea of what you're looking for is like running through a dynamite factory with a burning match. You may live, but you are still an idiot.

Joel Greenblatt

Many good investors allow their judgment to guide them through the thousands of potential investments at their disposal. They will use analysis (some of the time!) but also their experience to sniff out the best ideas. There is nothing wrong with this approach and many managers use it successfully. Clearly we use analysis and our experience too but we do so by laying them on top of a process that outlines exactly what we are looking for first. We use this approach and add to it the use of checklists that remind us of past mistakes (our own and others) in an effort not to repeat them. Not only do we hope this improves the quality of investments we end up owning it also saves us wasting time looking at many that could otherwise distract us.

Opportunistic franchise investing

In 2011 when we wrote out the objectives of the Farnam Street Fund we stated that the fund would seek equity investments in companies that:

- I. Have long and well proven histories in business the Advisors understand
- II. Have distinct and sustainable competitive advantages
- III. Make good or excellent returns on capital
- IV. Have great operational managers who also make wise decisions in the allocation of shareholder capital
- V. Have little or no financial leverage

This list describes many of the traits a franchise investment should have but we expand a little further. Many businessmen or investors love to talk about ‘profit margins’ as a measure for the quality of their business. Equally others love to talk about ‘growth’ defined in a myriad of different ways. Returning to the ‘money in/money out’ observation earlier what really matters, in business and thus in investing, is how much cash a business can generate vs. what cash needs to be spent in order to generate it. In investing speak this is called ‘return on capital’. Those that make high margins may have invested vast amounts of capital to achieve them and their high margins might not last. Equally those that grow need to very carefully consider the real cost (both financial and other) of that growth in a way very few actively do.

The perfect company makes a very high return on capital and can achieve stable long term growth at little extra cost. Such companies are rare but do exist. Many are priced highly most of the time, but occasionally some are not, hence opportunities arise. Crucially despite their quality we must still not overpay for them. As an example in real life, consider a local hardware store (my Father ran one). There is a need for significant stock so as to offer customers a selection, the stock might also be slow moving and the competition, from say B&Q, might keep margins thin likely resulting in low return on the capital. The company may also rely on the owner’s personality to give a level of service that drives repeat business and loyalty. Is such a company cheap if offered for sale by the owner at 8x annual earnings?

Alternatively there are businesses with much lower levels of capital needed to run them: A leasehold hairdressers for example, but the barriers to someone else opening a new one next door are low. What about a sandwich shop or tea shop? – Here capital is light and thus returns could be good but a constant competitive threat still remains of new entrants. What about a well branded sandwich or coffee shop that others would find hard to quickly copy where customers liked the services and prices offered, identified with the brand and thus returned regularly? This is a more interesting business model and in the stock market we find examples of such quality companies like Starbucks or Pret-a-Manger (now owned by McDonalds). Both arguably tick many of the boxes we are looking for and thus would be interesting to own all or part (i.e. some shares) of. But there is a catch, Starbucks, shares currently change hands for 38x last year’s earnings (i.e. in layman’s terms if they only ever make the profit after tax they reported last year it will take us 38 years to get our money back). That is a long time, thus telling us that much of the ‘quality’ and future growth of Starbucks is likely already priced into the shares.

Quality companies must still come at attractive prices

What we have done crudely above is mix the quality of businesses with price they are available for to illustrate that buying a cheap poorer quality business (local hardware shop - sorry Dad!) for say 8x profits or paying 38x for a wonderful one can still both be mistakes.

In short, a great company franchise combines many features, both financial and non-financial that all add up to an assessment of its quality and this quality should be visible when we look at financial metrics like return on capital. But this quality needs also to be bought at a modest enough price; for the price paid has almost as big an effect on the investment return as does the actual asset owned. With so many shares to choose from and so many prices flashing up daily to tempt investors to do something the details that define both quality and price must clearly be understood by the person buying long before they start looking. This is perhaps Warren Buffett’s greatest lesson that Joel Greenblatt’s quote surmises so well. But surely we hear you say ‘investments such as these are impossible to find?’ Not impossible, just hard. That is our job. Sometimes the job is easier, sometimes harder. Three years ago

no one wanted to buy shares at all. As a result well run, branded companies, making great returns on capital could be bought for modest multiples of profits. Today sadly that is no longer the case. Investors like Warren Buffett illustrate the patience required and how it can then be rewarded. Today he owns 9% of Coke and 14% of American Express: two excellent companies we have studied that easily pass our franchise hurdles. Their quality means that today each compounds nicely for the benefit of Berkshire shareholders but importantly both were bought at modest multiples compared to both their quality and likely future growth prospects.

'Diversification'

The above two examples illustrate that bargains do not come round every five minutes so you need to be both patient, know what you are looking for and not need own too many of them. However if you are a mutual fund manager who runs a 'diversified' 60 stock portfolio, you need to find 60 mispriced quality companies. If you then constrain yourself to only one geography, say the UK, your chances just reduced a lot lot further of achieving an acceptable investment result.

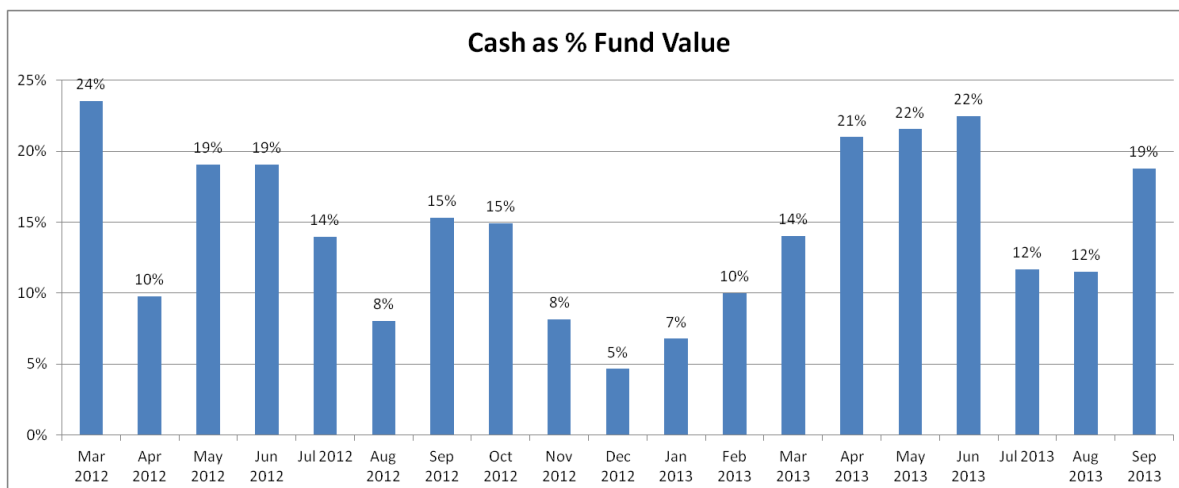
Simply put we seek companies that as well as possessing the five traits laid out earlier, do three things very well. They should operate their business in an excellent manner which enables them to be leaders in their field and give customers great products and competitive prices with good innovation. They should also be good generators of capital by way of profits/cash being a high % return on the capital deployed in the business. Thirdly, and often the most rare, they must be great allocators of capital – using cash always wisely so that the long term per share value of the entity is maximised.

Again these traits make the search for a great investment even harder but we remind investors we only need a small number of such companies in order to have a well diversified direct equity portfolio that sits alongside our Collectives and Work Outs.

Risk/Portfolio Structure

Our definition of risk remains the same – what is the real likelihood of permanently losing some or all of the capital we have? This definition ignores other clever definitions of risk and 'under' or 'overweight' thinking. Hopefully it will at times stop us buying overpriced shares, often justified by some 'because 'everything is expensive'. It also makes us reconsider companies we hold honestly to re-visit if we are wrong or the facts have changed. Clearly we also need to watch for concentrations of holdings in sectors or asset classes.

Today our main asset class exposure is of course equities but in City speak we are nearly always 'underweight' as the chart of our cash position overleaf shows. That markets rose strongly so soon after the fund was established whilst we still had high cash holdings was unfortunate. However, the cash balances that we hold today are intentional. In the last twelve months our average cash held (earning nothing) has often been as high as 20% of the fund's assets. This is partly a function of our prudence in fast rising markets but also due to the way our Work Out investments run, these being held for shorter periods (1-4 months). Whilst some of these investments come with market risk, many do not and they offer a different source of return to the overall fund, hopefully boosting returns whilst allowing us to have the comfort and the lower risk that higher cash balances bring. Post 4 years of rising markets it is easy to forget the opportunity that can come your way when you own cash and others do not.



Note: Average cash balance held during November and December 2011 = 85% of fund value and 50% of fund value during January – February 2012.

Most investors know that Farnam Street is copied from the original Buffett Partnerships; which were structured in a very similar way in order for Buffett to pursue Work Out type opportunities. The only difference being that in the 1960's Buffett was fully invested much of the time and used some modest leverage in order to purchase the Work Out opportunities. This is indeed the right way to maximise returns and is why our fund was set up to allow for a leverage ratio of 20% of NAV. At some stage we may adopt Buffett's approach to the fund structure but for the time being remain happy holders of cash and like the options it brings.

Our other area of exposure remains the Dollar bias of the fund. As we write today the fund has 55% of its asset invested in dollars. For a Sterling priced fund we accept that this is not ideal, however we continue to find far better quality companies at far better prices in the US stock market than at home. We would love to own more high quality, cheaply priced UK shares but we just cannot find enough of them (please shout if you know of any!). As a result of this Dollar bias the fund NAV was dragged down in the month of September by (c.3%) as Sterling/Dollar moved from c.\$1.50 to c.\$1.60. Whilst in a perfect world we would have no currency exposure, the £/\$ exchange rate is the one we are most relaxed about for a variety of economic and historic reasons and whilst we have been wrong recently on the relative strength of these economies and currencies we still think a Dollar exposure could make an interesting contribution to the fund one day. In the meantime we believe the opportunity to own better, cheaper, underlying investments more than compensate for any currency volatility.

Direct Stock Investments (57% of Fund Value)

As of today the fund has 11 direct equity investments that represent 57% of the NAV. Seven we would best classify as outstanding franchises, where we expect the company value to compound at 10-13% rates into the future and additionally believe them to be currently mispriced. Investors surprised that four of our 11 equity holdings are not classified as 'franchises' may like to know that the size of such Special Situation holdings tend to be smaller than those we classify as franchises. As a result the franchises are a bigger percentage of fund assets than their number may suggest. In seeking companies to be included in this franchise section we have now assessed literally hundreds of businesses. A number we found were of good enough quality to be included but few priced cheaply enough to justify buying.

We have also sold two investments outright during the year. One was sold for a 50% profit, the second at roughly the price we paid. The first having been too cheaply priced we felt a year ago, its quality was

moderate as opposed to high and it was a business that required capital to grow, thus we sold it post the substantial re-pricing of the shares. The second was a business we knew very well and have analysed for many years but during the course of the year we re-appraised the company's franchise quality and assessed it as impaired vs. what we concluded two years earlier. In short we changed our mind as new facts emerged.

Collective Investments (22% of Fund value)

Since last September we have made some small changes to our collective holdings. One we have sold out of completely and another reduced our exposure by 50% recently. Both have been good contributors to fund performance. In both cases the managers have changed, and in such collective investments we consider management continuity as key. We remind investors that we only invest in collective holdings if we think the managers either have exceptional talents vs. the price they will charge us or have very specialist skills that we think it wise to currently invest alongside. We added one small holding in the year. As a result we have currently five collective holdings; arguably three core ones and two smaller positions. Out of our three core holdings only one charges an annual management fee and this is only 1% pa.

Work Outs (2% of Fund value)

Whilst the collective and stock ideas sitting side by side are unusual in an active equity fund, it is the Work Out section of the portfolio that we hope might give Farnam Street a competitive advantage over time. As described earlier this part of the fund is often sitting in cash and thus can be used selectively for good annualised returns in holdings that may last only a few weeks or months. We again illustrate how the Work Out portion of the fund can quickly change as at the time of writing (mid-October) the value of the Work Out portfolio has risen from 2% to 8% of NAV.

Fund Expansion

We take the liberty of repeating our thoughts on this subject from our April 2013 letter:

We have modelled Farnam Street Capital on the Buffett Partnerships from the outset. Much of the way we approach both individual investments and portfolio construction is influenced by Buffett's approach. The success only fee structure is also a direct copy of how he set his early partnerships up and some of you also know why we have the name we do. Those early Buffett partnerships also relied on word of mouth to do the marketing for them. In short, when (or if) you get to a point where you feel you know and trust what we are doing with your money in Farnam Street and are maybe inclined to recommend us – do not be shy! If you have a wealthy aunt or paperboy we would be pleased to hear from them.

We thank you for your continued support. If you do have any queries then please get in touch with either myself or Barry Monks and his excellent and hard working team at Apex (barry@apex.im).

With kind regards,

Andrew J Hollingworth
Director – Farnam Street Capital Limited

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