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FARNAM STREET CAPITAL LIMITED

Monday, 27th October 2014

Dear Investors and Friends,

Final Report for the 12 months ending September 2014 - Net Asset Value: £131.7

During the 12 month period to September 2014 the Fund's NAV has risen by 6.9% to £131.7. This is after all performance charges and any costs incurred. Since the Fund's launch in November 2011 the NAV has increased 31.7%.

Fund Performance + Costs

The Fund's rise in value in the year of 6.9% compares to the total return (including dividends) available from the UK FT All-Share of 6.7% and the S&P's total return of 20% over the same period. Whilst our returns have been dampened by my decision to sit on often sizable cash balances, this is a conscious decision on my part. What the Fund must therefore be judged on is the total return we provide to the investor over time. I remain of the belief that it is reasonable for the Fund to have a target average annual return of $\geq 13\%$ over the long term, but we can all be certain that this will not be achieved in a linear manner. I also remain extremely aware of two important drivers of the actual investment return you and I collectively make from the Fund; being those derived largely from the underlying investments we find, but also that which can be lost due to too high running costs and charges. Holland Advisors continues to provide investment advice and analysis to the Fund for no management fee – only taking a performance fee for any returns above the 5% annual hurdle. Additionally, running costs are kept to a minimum.

The Economic + Investing Backdrop

In each of my letters I lay out for you my thoughts on the economic world we are investing against. If I were writing to you monthly, as many funds do, I might be inclined to comment on each twist and turn in the economic outlook that occurs. Writing less frequently however I feel serves two purposes. First, it means I spend the intervening time focusing on analysing companies and investing fund monies, not thinking up new marketing messages. Secondly, I hope it makes sure my focus remains firmly in the long term. That being the case it is perhaps good to reflect that my assessment of the economic backdrop has changed little in the last few years.

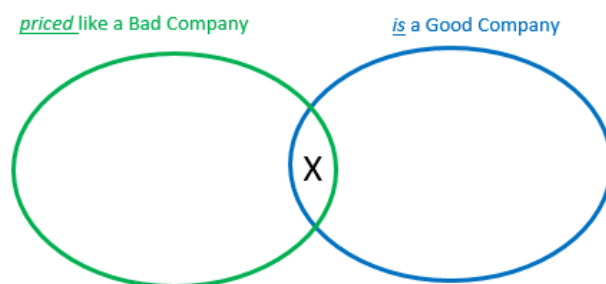
I continue to be upbeat on the US economy, seeing the recession it suffered as a real structural base which many parts of the economy now continue to recover strongly from. The level of innovation and productivity the US economy achieves year in, year out are often underestimated, as are the quality of both the companies that are quoted there and the management skills of those that run them.

My view on Europe has also changed very little. I remain of the view that the tying of slowing and overstretched economies to a currency that cannot be depreciated fast enough results in insufficient stimulus and likely a deflationary outcome. That would appear to be where large parts of Europe find itself today. Much is written about the relationship between Germany and the rest of Europe and how inequitable it is. My (some might say uncharitable) view is that at the formation of the Euro, Germany gave a huge gift to the weaker Euro states in lending them the credibility of its central (Bundes) bank. This enabled less credit worthy nations to borrow at rates similar to those available to Germany.

This once in a generation gift should have been used to invest in improved productivity, and for the rationalising of previously inefficient practices. However it was squandered by many countries and used to fund existing inefficiency, housing over-builds and consumerism. The deflation seen today in some parts of Europe is the hangover of this misguided experiment.

Our Approach

I hope I have now reiterated the investment approach used to run Farnam Street Capital enough times that if needed you could repeat it back to me! That said, just to be sure that no-one feels uninformed, attached is a three page outline of it. This will soon form part of the new Holland Advisors website but I thought you might like to read it here first. The following diagram is simplistic to say the least, but I think explains what we seek quite well:



Please take a look at the attachment. I am proud of the process we have developed and genuinely believe that it is a key competitive advantage which I hope will demonstrate itself over time.

The Search for Value

Having now studied companies, markets and those that commentate on them, for over 25 years, I have learnt from my own and others follies that to have a view on a particular market level (say the S&P or FTSE100) is a mugs game. Some years ago the attractiveness of equities could be ascertained just from what we could see at the individual company level. During 2009-2012 a great tri-factor presented itself of investors being able to buy great companies, run by great managers for great prices. Any caution we may express today again does not result from some technical market analysis (I wouldn't even know where to start). It stems from the value, or the limited amount of it, that we can find at the individual company level.

Three years ago it was like walking down the street and seeing a five pound note on the pavement. It looked simply too good to be true, so you checked to see if it was a trick but ultimately (hopefully) decided to pick it up. Currently there is little obvious money lying around (the possible exception I believe is in the pricing of the US banking sector). So today you think you can see a fiver on the other side of a barbed wire fence – but you will need to stretch to reach it and maybe then will find it was in fact a crisp packet instead. In the process you might have even snagged your jacket!

Simply put, value in the stock market today is harder to find than it was a few years back, thus caution is warranted. However our fund is structured to only need to find a small number of mispriced assets at any point in time and we remain excited and optimistic about the investments we do own.

Checklists + Mistakes

In our last letter I discussed a few errors of omission I had made over the last three years. I now think it is time to more closely consider actual investment errors made (or those of commission). In a world of spin, self-re-enforcement and positive thinking, the old fashioned reality of learning from your

mistakes is something few seem to want to admit to. The reality however is mistakes are a powerful driver of human improvement, so I admit to them, seek to learn from them, and try very hard not to repeat them.

"Those who fail from history are doomed to repeat it."

George Santayana

Anyone working in the investment business who claims not to make numerous mistakes should be avoided because they are a liar. The interplay of businesses, economies, managers, evolving levels of innovation and quoted markets means that at times the investment management job can feel like a minefield, which is why we need our map (i.e. our well defined process).

The key is to see the mistakes, both your own and others, and to try to learn from them. I try to do this in a variety of ways, the most significant of which is via actual checklists that are written up. For example I now have a 4-5 page checklist which I go through prior to the purchase of each new share, and a different one I use for 'Work-out' type situations. Every time I make a mistake I try to understand why, and add an appropriate question to the list to try to improve the process used for future decision making. I will admit that this list has grown in the last three years.

Three years ago I had a lot of investment experience in analysing companies, today I now have three more years of investment management experience and they have been invaluable, but some of that experience came at a cost in mistakes made. Recently I have been reflecting on a number of these, on why I made them and how the process of investment selection can be improved to reduce their number in the future. Part of this can be achieved via mechanisms like checklists, but also having time to think more clearly, slowly and objectively about businesses and their prospects helps a great deal.

Tesco - A case study in mistakes and learning

Tesco was one of the first shares I bought in the Fund in early 2012. I did so for a variety of reasons not least the fact that I believed its historic business model of compounded growth with scale being reinvested for customers benefit was misunderstood by many UK based investors. Tesco looked a lot closer to its US peers, Walmart and Costco in business model than it did to local competitors like Sainsbury. I had noticed years before Buffett's purchase of the share and thus felt reinforced in my view as his understanding likely mirrored my own in seeing the comparison between Tesco and the US food retail models he knew and understood well. Even now I would conclude that my and Buffett's assessment of Tesco past business model was broadly correct. What I got wrong was that the future would look so very different.

When a previously successful business fails many are keen to jump aboard a bandwagon that says 'I told you so'. Others have recently observed that Tesco's slowing rates of return on capital in the last few years was a sign that the business was in decline, but that is a highly simplistic approach. Tesco's returns also slowed in 2002/03 when the group invested strongly in its overseas expansion. The group's returns then recovered strongly over the next five years as did the share price. The reality is that an investment phase in a good company looks a lot like the stalling of returns for a bad one.

To get a true understanding the answer lies not in extrapolating a chart but in the understanding of the group's competitive position and how that is changing. In 2010/11 Tesco was again investing heavily in its US expansion and widening its offering into financial services. Had these investments paid off the 'told you so' camp would have been wrong and Tesco's compounding machine would have rolled on.

A reflection on Tesco today suggests to many that its problems were self-inflicted. But the greatest damage being done to its business model I concluded a year ago, was that of changing customer attitudes towards how and when they shop, largely caused by the convenience of internet shopping and home delivery. On a first look at the likes of the Ocado business model, I was dismissive seeing such a business struggling to make any sort of profit, let alone a return on its capital, almost irrespective how much scale it achieved. Equally Tesco also had a strong online delivery business of their own. What changed my mind in the spring of 2013 were two realisations.

- The first was that irrespective of the profits made, or not, by the likes of Ocado, such sales were being removed from large format retail stores that were getting fewer visitors. As a result the all-important metric that has driven the dominance of companies like Walmart and Tesco for decades (Asset/Turn) was being driven into reverse. This is a huge problem for such an asset intensive industry which cannot move or change its assets around easily.
- The second realisation I made last year was that Tesco's previously all-powerful dominance in bringing new products areas to their customers at ever lower prices was being clearly challenged. In spring 2013 they admitted they were getting out of the electrical appliances sector as they could not compete on price with the online players. I noted that this was the first product category Tesco had exited in maybe 15 years.

The powerful business model that drives the likes of Costco is predicted on it every day giving its customers a better deal than can be gotten elsewhere. As a result more footfall is driven to their stores and the virtuous circle of more volume and lower prices is repeated. Such a model has been successfully rolled out for decades by companies such as Walmart, Ikea and in the UK Tesco was the dominant player in doing so. So powerful have such retail models become that they became very, very hard to displace.

But changed consumer habits largely resulting from the effect of internet and home delivery were just such a powerful force. This combined with the underestimation by the main supermarkets of the discounters (Aldi + Lidl). The result: what was once an impossible business to compete against became an almost impossible problem to fix due to Tesco having the wrong assets in the wrong places at a time of changing customer demands.

Learned Lessons

We bought Tesco shares in the Fund at an average price of £3.63 in early 2012. We then sold these shares at an average price of £3.48 in the Spring and Summer of 2013. Hopefully it is evident to all reading that we learnt a lot from this experience. This includes:

- The need to look for powerful new challenges that can result in dominant business models not retaining such positions in the future.
- The need to be wholly objective in assessing business models afresh when new events transpire.
- The need to be able to change our mind when the facts change.

By putting some of these points into practice we were able to exit our Tesco holding without too much damage to the Fund's capital, but if we had better used all of them earlier we would have saved ourselves much time and used that part of the Fund's capital better elsewhere.

"Experience is what you find when you are looking for something else."

Federico Fellini

In the future I think that the process we have and the fact that we read and follow the ideas of the world's greatest investors will lead us to finding some great businesses to invest in. However, what I think will make the difference between our performance being satisfactory (as I would assess it so far) and exceptional, will be a reduction in the error rate of investments. This can be best understood by imagining a simple two stock portfolio level with two equally weighed investments (X and Y):

- In scenario A, stock X's price increases 50% and stock Y's price is unchanged. The total portfolio will have risen 25% in value.
- In scenario B, stock X's price increases 50% and stock Y's price falls 25%. The total portfolio will have risen 12.5% in value.

*“Rule Number 1 – Don't lose money
Rule Number 2 – Don't forget Rule Number 1.”*

Warren Buffett

In short whilst I will be spending much of my time in the coming years looking for wonderful franchises I will be mindful of Buffett's moto above. Putting it into practice will hopefully mean we end up with a portfolio that looks more like Scenario A, than B. Despite an acceptable progression in the Fund's NAV over the last 3 years I will admit to mistakes, but I have learned volumes from each one and hope my investment process improves by a step each time I honestly reflect on them.

Direct Stocks + Collective Investments (84% of Fund Value)

As I write our Direct Stock and Collective Investments combined represent 84% of the portfolio today with a little money invested in the recent market correction. The fund currently has 15 Direct Stock investments and 3 Collective ones. I am pleased that we added four new investments in the last six months, including one in the UK. The main exposures of the Fund are little changed in the last year with 65% of the Funds assets invested in US Dollar priced securities and 28% invested in US financials. Our Sterling based investments are running at 16% of NAV.

We would really like to find more domestic UK investments, but we will not compromise on quality or price just to have a little less US Dollar exposure. In fact as we remain more confident on the relative strength of the US economy vs the UK over the coming years we are happy with the dollar exposure, even if it mostly results from bottom up stock picking as opposed to any macro currency call.

Work Outs + Cash (16% of fund value)

The Work Out part of the Fund has been quiet in the last six months. With bond yield so low and many newly confident investors pouring over every day-to-day move there are fewer mis-pricings. That said we keep looking as we think this will be a key area for the Fund to differentiate itself and its performance over time. Today the Fund has 1% of its assets in Work Out and 15% in Cash. With Work Out opportunities recently reduced and some new Direct Stock investment being found, we could easily have run the Funds cash balance down and become more fully invested, but with markets having run so strongly for so long we were a little reluctant do so. Recent market falls were a reminder of the value of cash in a portfolio.

Developments of the Fund

I believe some other fund managers make the mistake of being too focused on marketing sometimes at the expense of fund performance. Our performance fee structure is specifically designed to tackle this point creating the right incentives for me as a manager. Funds with a flat fee can be clearly incentivised just to gather more money to run, rather than run an existing fund better.

That all said, some development in our Fund's size would clearly now be beneficial to all of us (Managers and Investors alike). As such I have spent a little more time than usual in the last six months meeting a number of institutions that might be able to help up grow our funds under management meaningfully. The feedback from such investors, who were often impressed with the approach being taken, is that they would be keen to invest in a Fund that was more traditionally structured.

As a result we are looking into setting up a UCITS Fund that will be run alongside the existing Farnam Street Capital Fund (FSC) and would likely be slightly more diversified than that FSC. For clarity however we point out that the two funds would be run identically to each other with holdings only diverging when UCITS regulations on diversification deem it necessary. Additionally, neither Fund will be prioritised over the other, but one (your one) will be run in a more concentrated manner. We will keep you informed of our plans and the timetable for such an additional fund which we hope will enable us to attract more institutional type investors and thus greater funds under management. Such a new fund will, of course, require some marketing. That said, the ethos towards focusing on investment management over marketing laid out at the start of this section will not change and I hope, that in time, word of mouth and recommendation will do a good amount of my marketing for me.

With kind regards,

Andrew J Hollingworth
Director – Farnam Street Capital Limited

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