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FARNAM STREET CAPITAL LIMITED

Tuesday, 22nd October 2019

Dear Investors and Friends,

Final Report for the period ending September 2019 – Net Asset Value: £162.6

During the year to September 2019 the Fund's NAV fell -4.1% to a NAV of £162.6. This figure is after all fees and the Fund's modest day to day running costs.

The economic/investing backdrop

We have before described the macro environment as the wing mirrors on our car. We need to pay attention to them but they are not our main focus. This year however has provided an unusually volatile environment due to Brexit uncertainties affecting the share prices of some of the companies we own as well as influencing the Sterling exchange rate that our overseas investments are converted at.

We would ask those reading this letter to reflect on the fact that we have used the phrases 'volatility' or 'uncertainty' above – not 'risk'. The distinction we think is an important one that many investors confuse. When high uncertainty (but actually low risk) events are priced in a dramatic manner wonderful opportunities can arise. During the year we have made two distinct changes to the portfolio as a result of the volatility that has been experienced. Firstly, we have sold a number of US securities reinvesting monies into some UK opportunities we assessed as cheaper post their share price falls. In addition we have hedged some of our £/\$ exchange rate exposure.

Bigger than Brexit

Whilst Brexit (and US/China trade) news has dominated investors' minds and economic commentators' voices a bigger top-down event is affecting equity investors today. This being the polarisation of what we will call 'growth at any price' vs. 'margin of safety' investing (others might call it momentum vs. value). We wrote about this at length in a recent research report (*Mr Market's broken machine – Aug 2019*). An abridged version of events goes something like this – As a knock on effect of low interest rates predictable investments such as government bonds, quality property or other utility type investments have been consistently repriced upwards. More defensive (quality) businesses have similarly been repriced as a result. Expressed in this way this is a logical sequence of events. However what started as good logic (pay a little more for a better quality business/cashflow stream) has arguably become something of a cult more recently. An example being that c.30% of global government bonds now have negative yields.

"What the wise do in the beginning, fools do in the end." Warren Buffett

Do not get us wrong, amongst the investors who have performed well in this period are some excellent analysts of businesses who have worked hard to identify quality companies. However for each of these there are many, many momentum investors along for the ride.

Staple holdings of such quality portfolios are companies such as Unilever and Becton Dickinson. These are businesses we have analysed in-depth and owned in the past, doing so when we felt the quality they offered was mispriced on PE's of c.13x a few years ago. Purchasing Becton at a price of c.\$80 as we did in 2011 on a PE of 13x was one of our better decisions. Not continuing to hold it was one of our

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worst! (Today Becton's price is \$253 and its PE 25x). However owning such a company today hoping it will compound investor returns at anything like the rate it has in recent years is folly.

As the saying goes 'price is what you pay – value is what you get.' Below is an extract from our website that we hope illustrates this point.

A well respected global company that many investors would accept as a franchise today makes a return on its tangible capital of 15%. The intrinsic value of this company is likely to rise, we assess, by c.11% many years into the future, therefore it is an interesting company. What we believe makes it a compelling investment today, however, is its starting price of 10x current earnings (PE). We think it wrong that an investment which can compound at c.11% for many years can be purchased for 10% earnings yield and therefore, in time, its mispricing will be corrected by markets. So, a move to a justifiable PE of say 13x in 3 years' time, added to an 11% compound annual return, results in an investor IRR of c.21% over the next three years. However, the exact same company shares purchased at, say, a PE of 20x earnings that then falls to a multiple of 15x in 3 years would make an annual return to the investor of less than 1%. Source: Holland Advisors www.hollandadvisors.co.uk

We wrote this in c.2014 when re-doing our website and whilst it was designed to make a generic point the company example was real. It was J P Morgan, then priced at c.\$60. We are pleased to report that the expected IRR of c.21% was in fact achieved and JPM today is priced at \$120 and on a PE of 13x.

We have written many times in these letters and other research reports that fundamentally we are trying to buy great companies, run by great managers at great prices. For only by doing so do we feel we stand the greatest chance of achieving the best compound returns for you and ourselves as Fund investors. The later point (i.e. 'at great prices') we feel is being missed by many of today's 'quality' obsessed investors. Indeed by paying a little less attention to price they make their day job a little easier. For once you ignore price there are so many more great investments to choose from! Whilst we can observe how the actions of others have changed, with some now overpaying for their definition of quality our resolve is unchanged. **We want to own great businesses with outstanding compounding abilities but still demand low starting valuations that bring a margin of safety.** As an aside we find it interesting to note the recent investments made by Buffett and Munger. Most 'quality' investors today likely learnt from someone who learnt from someone who in turn was originally influenced by Munger's superior thinking on the compounding abilities of quality businesses. As such it is interesting that in the last 5 years almost all of the new investing capital deployed by Berkshire has gone into three areas: Banks, Airlines and Apple. In each case they paid c.10x current earnings for a business they thought had better compounding and pricing power than Mr Market discounted.

As a sign off for this section we thought investors might find it interesting what prompted us to take a look at Becton Dickinson in 2011 in the first place. The answer is that Lou Simpson (who for 20 years was Warren Buffett's unsung investing partner) bought the shares. Lou's investing track record was exceptional (20% cagr's for 25 years). His words hang above Andrew's desk:

- *Think independently*
- *Invest in high return businesses run for the shareholders*
- *Invest for the long term*
- *Do not diversify excessively*
- *Pay only a reasonable price, even for an excellent business*

Whilst all of these points are a great help to keep us focused on the job in hand, the last one resonates more strongly than ever today.

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Owner Managers

We wrote on this subject in our interim letter so will not repeat our comments. However a pertinent question was asked by one investor in response. ‘Why do opportunities to invest in these good managers exist at all?’ There are in truth many reasons but a few common ones include:

- An owner manager’s maverick style meaning they are misunderstood or unpopular with investors (**Ryanair/Sports Direct**)
- An owner manager’s tendency to be brutal with the truth when a career CEO might sugar coat it (**Next**)
- Owner manager’s plan for the very long term thus making investments that incur a shorter term cost to the business but that will position it strongly further out (**Schwab**).

Such actions can create investor confusion, uncertainty and falls in profitability. Thus leading to lower prices for the opportunistic investor. By way of example we give the two year share price ranges for the companies we have highlighted above. Considering the broader resilience of each of these businesses in scale and market share the size of the price volatility we think is notable:

2017-2019 share price ranges

- Ryanair €17 – €9
- Sports Direct 440p – 220p
- Next £66 – £38
- Charles Schwab \$55 – \$35

This is where the role of Buffett’s Mr Market comes in. Each day he chooses to price these whole companies, but we as long term shareholders need do nothing. Occasionally however we can chose to act if we assess the value offered as compelling.

Portfolio Changes

During the year two new sizeable holdings appear on our factsheet, these being **S&U plc** and **Schwab**. It will not surprise investors to know that each has a strong owner manager culture. Charles Schwab founded his company in 1971 and still owns 10% of its equity today. The value he offers customers using his company’s online dealing and custody services is extraordinary. In a research note earlier this year we described it as a ‘flywheel business’ i.e. one that is constantly reinvesting in lower prices and better services for the customer to drive future demand. This is a business model we know, like and have seen used powerfully for decades by some of the world’s most resilient businesses (a number of which we own).

S&U plc has been managed by the Coombs family for 80 years. In the last 14 years they have compounded book value per share at 12% whilst paying dividends worth a further 4%pa on average. Collectively the family own 43% of the company. We were delighted to have invested alongside them at a very advantageous price earlier in the year.

Another notable change in the last year has been a reduction in our US banking holdings. With the exception of our stake in Wells Fargo (which we have recently increased) we have now exited almost all other US bank holdings. While we still see this sector as undervalued vs. the rest of the US stock market, the mispricing is not as great as it once was and we think the comparable prices offered for Lloyds and RBS in recent months made them better investments. Both of these companies trade at or below tangible book values at the time of writing, JP Morgan by comparison now trades (at a justified)

2x tangible book. The other factor that played a big role in this decision to switch some of our US banking exposure to UK exposures was the depressed level of Sterling.

The Sterling/Dollar exchange rate is something we have reflected on a lot during the year. Clearly as Sterling falls the translation value of our Dollar investments rises. But the inverse will also be true. We are sanguine about the real impact of Brexit (in whatever form it arrives) on the UK economy and thus hope to profit from others realisation that the domestic economic damage will not be as great as expected. However it would be annoying to lose some of that upside were a stronger Sterling to impact the translation values of our US Dollar holdings. The result of this reflection is that in early October 2019 we purchased a call option on £/\$ at a very advantageous price. At the time of writing this covers approximately 55% of our US Dollar holdings by value and should ensure that any strong £ rally will have a reduced impact on our NAV. Were £ to fall further post a no-deal Brexit event (now looking less likely) we may well purchase further insurance. However as the hedging we have is in the form of a March 2020 Call option most improvements in Fund values from a lower £ would flow through to the NAV. As a general rule we do not undertake such hedging but we felt this was a short unusual window that could see a sharp change in sentiment towards our pricing currency.

The portfolio today is 42% invested in US Dollar assets (vs. 53% this time last year) and 27% in Sterling and 17% in Euro priced investments respectfully. Our factsheet that accompanies this letter shows our largest investments and collectively these account for 68% of the Fund's value. It may interest investors to know that the next 7 investments account for a further 19%. As a result 20 investments make up 87% of our NAV.

Against US stock markets that trade at near all-time highs it is logical for investors to perhaps have some caution towards equity investment. However a glance at our holdings hopefully shows that most of our favoured shares have very different profiles to the overall market. The polarised nature of equity investing in recent years has meant we have underperformed US markets (but performed in line with UK indices). This environment has also thrown up some unusual bargains which we are delighted to have been able to purchase. We believe this collection of companies to have resilient growth potential that should be able to compound investor capital at high rates for many years to come. As others are overpaying for what they see as predictable growth many other shares are being discarded. This creates a wonderful environment for the patient value orientated investor.

Thanking you for your ongoing support.

With kind regards,

Andrew J Hollingworth, Fund Manager

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