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VT Holland Advisors Equity Fund

17th January 2023

Dear Investors and Friends,

Year-end Investor Letter – December 2022

The fund NAV was -19.6% in the year to 31st December 2022.

As I observed in our interim letter “*experience is what you find when are looking for something else!*” 2022 did not pan out to be the year we, or others had expected. The portfolio at the outset of the year had a collection of high-quality consumer businesses I saw as mispriced and well placed for a post-Covid recovery. Additionally, my tendency to avoid the energy/commodity sectors due to such companies rarely having sustainable competitive advantages, nor aligned owner managers meant I cleverly ducked the outstanding sector of the year!

“An oil company is a hole in the ground with a liar standing at the top of it!” **Charlie Munger**

The result of this positioning meant the fund NAV was down 19.2% at the end of June. Consequently, I discussed the above themes in more detail in our [interim letter](#). In this letter I want to reflect on today’s investing environment and the important change in market cycle that has occurred. I also want to share my optimism. This is not just for how undervalued I think the current portfolio is. It is also how post a big change in market mood we are (I hope) well set for the years ahead.

Investing backdrop

The effects of the Ukraine war and the resurgence of inflation have dominated headlines this year. Both certainly changed the macroeconomic backdrop significantly from where the year began. I have no edge in predicting wars, their duration or likely end. My skill in predicting inflation or interest rates are equally lacking. I have read a few interesting studies on inflation and interest rate outlooks and each one (of often opposing views) I find compelling just as I reach the end. This reading is my wing mirrors I have often described. It will not determine our direction of travel, but it will keep me mindful of future scenarios and risks that maybe I need to be thinking harder about. Warren Buffett talks of not worrying about forecasting inflation or FED rates when he invests. I feel the same. If we can find wonderful businesses, run by aligned owner managers and invest in them when they are ‘on sale’ we will do well, whatever the backdrop. We might not do well each year, but in time our capital should compound nicely.

Ukraine, inflation and interest rate outlooks are discussed ad nauseum by many. I want to share my thoughts on a big change that has occurred in investing markets instead. Long suffering readers of my work will know I think of three distinct cycles: the **political** cycle that plays out on TV most nights, and the **economic** cycle that so many try to forecast, usually without success. My third cycle, the **market** cycle gets far less attention (Howard Marks being the exceptional exception). Often however it is a far more important driver of investor returns.

2022 has seen a dramatic reversal in the investing market cycle. Greed has been replaced by fear, momentum and GAAP (Growth at any price) have lost their seemingly effortless ability to perform.

* All performance figures use ‘I’ class shares.

Money is hard to raise and once again sceptical questioning and margin of safety are (thankfully) back in fashion. Many examples of what Munger calls 'wretched excess' are now being purged (FTX/Ark/Nasdaq valuations etc.).

The changing market cycle

Such a change in mood was always likely to eventually occur, but to those of us outside the boom it seemed to take forever. That events (interest rates/war/inflation) may have served as a catalyst to this sea change in risk appetite should not detract from the importance that will result. This was a multi-faceted bubble in foolish capital allocation that has now clearly popped.

"There is nothing worse than watching your neighbour get rich". Charlie Munger

I will be upfront and say I am both relieved and excited as a result of this change. I will try to explain why below. Having started investing in 1987 I have seen a few cycles. Indeed, I had a ring side seat for the 1999/2000 one as a Transport, then Telecom analyst at Merrill Lynch. The 2022 reversal we have seen is very similar to that which occurred in 2001. Those not in the investing industry perhaps may underestimate how difficult to navigate these periods are. It is simple to assume that if you are say, a value conscious investor and you don't agree with paying a high price for something you just wait. But for how long – a year, two years, five? Most investors are a) very bad at waiting and b) paid to be invested, often in a certain sub-asset class (say US or UK Equities).

Very few people can often hold two conflicting views in their head at the same time. If they could many institutional investors would say to themselves: I don't agree with this valuation or idea, but I will play along because my mandate says I have too. Mentally it is so much easier to agree that company XYZ is wonderful and yes maybe you should pay far more for it than you have done in your past. Company XYZ's shares then double and double again proving to you your new approach is right/skilful. As a result, the next week you are offered shares in ABC and you happily pay more for them. They too then rise. In bubble periods this process happens across the entire capital raising sector (Venture Capital, Public and Private Equity). Those that stand against it often are ousted, ridiculed or lose most of the funds that they run.

*Such periods are often described as "bubbles". Having now lived through a few, I don't think this fully explains the psychological struggle investors experience trying to invest during these times. "Whirlpool" might be better image. Imagine you are in a large lake and a powerful whirlpool emerges in the centre. More and more people are being sucked into the whirlpool. You try to swim away, but the whirlpool builds and builds in strength and the longer you swim the more tired you get. Eventually you are exhausted and feel you have to give in to it. **That is what it is like.***

*Another way to think about it is being at a silent disco. You are enjoying your chosen track on your headset and can even sing along to it in the silence even if you remove your headphones. But then the DJ turns the sound right up on another track. Your brain just cannot stay on your tune. Quickly you relent and sing along with everyone else in the crowd. **That is what it is like.***

Relative performance, benchmarks, fund consultants and career risk make underperformance into a cardinal sin, rather than just a period when a manager's view differs from the markets. The desire to stay in your job forces many managers to comply with the pressure this puts on them. Sadly, not only does this reduce objective thinking in the investment industry (#Lord Wolfson on LDI) it re-enforces bubbles/whirlpools further as more investors are drawn in. Bear in mind also that performance chasing means most investors were encouraged to sell an underperforming value manager and invest with say a Cathie Wood. All this money drives the whirlpool to spin faster still, sucking in more and more capital.

The crucial factor however that drives these big long lasting market cycles is investors' collective mental buy in. This starts as a trickle but eventually becomes a mania. Often it ends with the extreme of believers and ridiculed non-believers (#Life of Brian). Whilst I have spent no time studying crypto and the like it is worth looking at the long list of respected investors and celebrities that who invested in FTX as an example of recent behaviour. What drove these smart people was greed, pure and simple. Then compare this to Munger's 2021 comments on Crypto. He described it as "*trading turds.*"

Fast forward to today

Many investors today are either bankrupt (if too involved in crypto) or in denial, if they bought too many loss-making Nasdaq stocks a year or so back. Others will know what they did but with an over diversified portfolio their sins will be hidden from investors. They will try to keep it that way. The oils/commodity sectors performance has helped hide many sins in such a period. The 1:1 correlation of equities with return free but risky bonds didn't help!

Many investors today are worried. Worried about interest rates, worried about inflation or war. In truth what they are really worried about is losing more money. This is the problem with what is effectively momentum/greater fool investing. If you don't know/cannot independently value the company you are invested in, how do you know it won't halve again or go to zero? I am not worried at all. In fact I am both relieved and optimistic. Relieved that this period of madness is over, so that the professional way I and a few others try to go about this responsible job of caring for other people's money can be respected.

Why am I optimistic? This is not just about the prospects for our portfolio companies but also about the macro/investing environment we now find ourselves in. The great experiment that was zero interest rates (ZIRP) is thankfully being moved away from. For years I could see the impact ZIRP had (pay any price you like for a stock vs 0% interest rates!). However rarely outside the depths of 2008 could I see any net benefit to society from it. Interest rates are today normalising and the world is not ending: That is definitely good news. What is also normalising is investor behaviour. The greed/fear/denial period will need to work its way out, but what we are left with is more rational business analysis and now some more sensible valuations. This feels like a time for buckets.

"When its raining gold reach for bucket, not a thimble." Warren Buffett

My kind of market

I will be honest and say that investing during these last c.5years has been pretty exhausting. The market cycles created by Brexit or Covid are part of professional life and you have to prepare for and weather them. The long super-cycles (of Bubble/Whirlpool type) however are hard. The reason being that you are being told that everything you believe in is wrong, not just this month or next, but year after year. That these excesses are being washed away is great news. In the last 5-10 years I have worked hard on trying to improve my investment process. I have studied capital cycles, superior business models and thought hard on what price to pay for what level of compound growth. Arguably this work has yielded little discernible benefit to fund investors during a tech and low interest rate asset boom. Whilst I wish our NAV were not down c.20% this year, we have survived. I am hopeful that the skills I have developed should start to pay off in the environment ahead.

Anyone that has read my letters knows I love companies with good returns on capital. However when almost all such companies were priced highly what are you to do? The answer is you look for alternatives in other market areas. That is why we have had holdings like Frasers or Biglari. What 2022 has brought however is many excellent buying opportunities in business I admire, but whose past valuations I was not prepared to pay. As a result, I have made investments in **Next, Ashtead, Fever**

Tree, Amazon and Alphabet all pretty near their 2022 lows. I also added to our **Meta** holding, having initially bought it far too early.

It was never that I did not admire such powerful businesses, it was that I only wanted to pay a sensible price, to ensure we had a margin of safety. This new market environment is allowing that.

Looking forward

“THE only function of economic forecasting is to make astrology look respectable.” John Kenneth Galbraith

Whilst you will not find me crystal ball gazing trying to guess the future of interest rates or inflation, you as investors would expect me to construct an all-weather portfolio. That is what I strive to do.

Buffett’s brilliant 1977 study ‘*How Inflation swindles the equity investor*’ has stood the test of time well. I recommend it. It outlines that the best way to invest during a period of inflation is to own companies that make a high Returns on Tangible Assets (RoTA). As these are the type of businesses we seek to own already, I feel happy about the fund’s ability to, at the very least, hold its real term value in a lasting inflationary environment. The companies we have been able to invest in during 2022, (**Next/Alphabet/Fever Tree**) are high RoTA companies that I believe we bought at great starting prices. They and I believe most of our portfolio companies will be great inflation hedges.

Our portfolio is not a once size fits all. Recently I was reading a competitor’s annual letter and noted a table that amalgamated the whole portfolio into ratios including ROCE and gross margin. This is an interesting idea which I might copy. That said today c.10% of our portfolio is made up of companies that are specific beneficiaries of higher interest rates. This includes **Markel** with its insurance float and **Schwab** with its super low-cost Scale Economy Shared investment platform. Both I think are great investments for the future, but they would not conform to standard high ROCE/high margin financial summaries. Maybe that is why I found value in them, because they do not screen like franchise compounders, but are. Another block of companies I own are examples of what we did with your money while we were waiting for sanity to return to good company pricing. I invested in three holding companies that trade at very large discounts to any prudent assessment of their asset/composite value. The largest of these is **Biglari Holdings** that I have discussed before. In aggregate we have c.12% of the fund invested in these types of companies. Despite these sizable value discounts two out of the three companies are completely debt free.

I should be clear, the best types of companies I want to invest in are those with high returns on tangible capital and long runways of growth ahead of them. If a time comes when I am able to invest all of the funds’ assets in such businesses whilst still paying an acceptable price for them I will do so. The reality of these companies however is that many investors are looking for them too. Many investors have followed Munger/Lou Simpson’s quality company mantra, but they just find it easier to skim over the ‘*pay a reasonable price*’ bit!

“Pay a reasonable price, even for excellent businesses” Lou Simpson

To have decided not to pay high multiples for defensive businesses in the last 5-10 years was either a huge mistake on my part or an exercise in self-discipline? The reality of this business is that every day is a learning experience. I am delighted to have found and own powerful Scale Economy Shared businesses like **Ryanair/Schwab** and now **Amazon**. I am also pleased to have added businesses with high RoTA to the portfolio at reasonable prices (**Alphabet/Meta/Fever Tree**).

Some of you know that I wanted the fund to be called “*equity compounding*”, but those nice people at the FCA would not let me (I asked twice). Readers should note that despite the value discipline I try to bring to any purchase of securities, I chose the word ‘*compounding*,’ not ‘*value*.’

This is because it is illustrative of what I am trying to do with our collective monies, i.e. compounding them at the best rate I can adjusting for the risks I see.

As an example of my wider search for compounding rather than mere value, I purchased shares in **Floor & Decor** in 2022 (headline PE multiple then c.25x). Why did I do that? Because I think the growth prospects for the company are both exceptional and importantly have a high likelihood of it being delivered upon. Time will tell if I am right.

Mistakes

I have spent some time reflecting on recent and longer-term mistakes. Interestingly for someone who is often value conscious in purchase prices, rarely have my mistakes come from overpaying in a starting multiple. Instead, they have come from backing companies without a long enough, profitable track record. (Now I ask myself a new question: Is this management team profitable, proven and probable with these assets, in this company?). Buffett’s two rules comes to mind:

Rule number 1: “*Don’t lose money*”

Rule number 2: “*Don’t forget rule number 1*”

Buying what I think are good companies when they are as Buffett says “*on the operating table*”, I believe is a way to great compounding. The timing of such purchases however is hard. In companies like **Jet2** I believe I have timed the purchase well, near Covid lows. In others like **Frasers**, I was early. Today **Frasers’** price is a good step above our purchase levels, but the turnaround took far longer than I expected. In the case of Facebook my initial investment was in the face of uncertainty. I am very happy owning it at today’s crazy low valuation, but simply put, I should have watched and waited for longer. The proven, but disliked/untrusted founder going through a period of change (#Ashley/Biglari) is perhaps my specialist area. But as I have written before such periods of investment or market ill-view can last a long time. I will always be open to such ideas, but need to ask myself on these companies “*Is it on the operating table, or only just been involved in a traffic accident and the ambulance hasn’t even been called yet?!*”

My biggest error of omission in recent years was my failure to pay higher starting multiples for exceptional businesses that have (and likely will keep) compounding strongly (**Moody’s**, **Visa** and **Costco** come to mind).

My biggest errors of commission in 2021-22 were those where I skirted with the whirlpool. Exhausted by swimming against the current I made a couple of small investments in businesses I thought had fallen enough/had good growth prospects. As a great investor says ‘*long shots rarely are*’. I am relieved to say that such mistakes only account for a few % points of negative performance (c. 2-3%). Foolish nonetheless.

Fund development + Outlook

The size of the fund as I write is c.£13m. I/my family remain its largest investor owning c.15% of the units. Whilst I do/will run the fund exactly the same whether its size is £13m, £130m or £1.3bn some increase in scale would now benefit us all as investors. At a simple economic level, the flat administration fee the fund pays Valu-Trac would become a smaller percentage of assets were the fund to be larger. Additionally, as the manager it would be good to have a little more resource to help with areas like compliance that have sadly become a bigger burden on smaller fund management companies

like ours. I seek scale economies in the companies we invest, it would be wonderful one day to have a few of our own. As such feel free to pass this letter on if you see fit.

In Closing

I want to thank the team at Valu-Trac for all their hard work in administering the fund and especially my colleague Claire Brunt without whom very little would happen at all. Finally I want to thank you my investors. Your patience and continued support do not go unnoticed.

Let's finish with a few old words from a now old man. During Buffett's Partnership years of the 1960's he outlined the following each year:

"I cannot promise results to partners, but I can promise this:

a) Our investments will be chosen on the basis on value not popularity

b) Our pattern of operations will attempt to reduce permanent capital loss (not short term quotational loss) to a minimum"

Since starting this fund and its predecessor these two points have encapsulated my approach. As I look forward with optimism this seems like an excellent time to re-assert them to you.

With thanks

Andrew Hollingworth

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