

FARNAM STREET CAPITAL LIMITED

Friday, 16th October 2020

Dear Investors and Friends,

Final report for the period ending September 2020 – Net Asset Value: £127.4

During the year to September 2020 the Fund's NAV fell 21.6% to a NAV of £127.4. This figure is after the Fund's modest day to day running costs and no management fee charged.

A new format

We have decided to separate our commentary into three this year:

1. We provide you with the normal fund fact sheet which is attached to this letter.
2. Our commentary on the current economic and investing backdrop is in a separate document. This is also attached (*Holland Views: White Swans + Buckets*).
3. We then outline below how we have managed your money during what has been a somewhat eventful year.

Portfolio Management

Investing is the strangest of businesses. You could make a single great decision to buy shares in a company 20 years ago and it could make you rich while you just 'sat on your ass' as Munger would say. Or you could do as we have done this year: which is to perhaps have never have worked so hard 'trying to invest with a margin of safety' and then to 'try to invest prudently ahead of the Covid storm you saw coming'. All of which to only end up earning a -22% investor return and zero management fee. As somebody once said, "you don't go into value investing for the group hugs!"

In our September 2019 letter we stated that our portfolio was 'very different to that of the overall stock market'. Seeing the market then as too growth biased and somewhat expensive we thought that was a good thing, but little did we know what was to come next. Our contrarian approach resulted in us finding value in old economy sectors and these came with a leisure/consumer bias. While these businesses do not have the sort of growth that digital businesses today enjoy, they are long term growers. As such when priced at reasonable levels, we saw mispricings. However fate had a hand to play against us as many of these companies were somewhat exposed to Covid shall we say. We are pleased to say that the actions we took in February moving to c.20% cash reduced the damage to our performance in a number of these areas significantly, but it did not eliminate it entirely.

What has transpired since in markets has been a further extrapolation of previously established trends with online growth further accelerating and the valuations associated with the shares of such companies accelerating also (PEs of 100x are the new normal it seems). As a fund investor looking through the list of the companies, we own you might be forgiven for thinking we are philistines still using abacas, parchment and a fax machine. Do we not appreciate the brilliance of the Amazon business model or see the growth in Netflix or Peloton? Of course, we do but we also think a certain amount of discipline must be used when deciding which shares to buy.

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Fighting with our neighbours to buy the last toilet roll in the supermarket in March is not the manner in which we feel it right to conduct ourselves in public. Nor is it a prudent way we think to invest. Has it been right in recent years to pay higher prices for businesses that were on the verge of high rates of growth? In hindsight, of course the answer to that question is now yes if judge against today's prices. However, believing as an investor that one can correct such a past mistake of underpaying for past growth by overpaying for it today is surely folly.

“the more imprudence with which others conduct their own financial affairs the more with which you should conduct your own” – Warren Buffett

Both Mark and I lived and worked through the investing world of 1999-2001 in real time - we did not read about it in book. Whilst it is never right to make exact comparisons between now and then it is important to that we use the extensive experience we have of such previous market cycles and the dangers and opportunities they create.

The flip side of the growth/ESG hyperdrive

The flip side of current investors quest for growth is that other businesses (some good) are either being discarded or are too small for successful PMs to look at due to the scale of funds they now run. This was occurring before the pandemic but now even more so, particularly if these businesses are currently experiencing poor current trading. This is music to our ears as seekers of wonderful businesses at points of mispricing/uncertainty. Whilst we sometimes call ourselves ‘value investors’ (for we have suffered like that group) we actually seek out companies that grow over the longer term. The difference between us and the GAAP (Growth at any Price) brigade is that we are a little more discerning in the price we will pay for future compounding.

Portfolio changes

Whilst some names in the portfolio might look the same investors should know that we have changed the position sizes of these companies quite dramatically during the year. At first (pre Covid) some share prices represented risk, then opportunity, then risk again (JD Wetherspoon is perhaps the best example of this).

We have also used this period to make some difficult decisions. The most notable of which has been to reduce our holdings in the banking sector. Whilst a number of the positions we sold still look cheap on many measures we just think there are better uses for this capital in companies with tailwinds to their business (fiscal spending/consumer recovery) rather than headwinds (stubbornly low interest rates). Importantly also many of the banks we were invested in were not led by brilliant, aligned owner managers. Almost all of the companies we were able to redeploy the capital in are.

Whilst this last six month period has been a difficult one for coping with volatility in underlying business revenues and profits, let alone share prices, we think we may look back on it fondly. A number of companies previously loved by the market for their growth and resilience have seen dramatic falls in valuation due to current depressed trading; Greggs and Jet2 are perfect examples. Both are unlevered businesses, even now. Only 10 months ago they were loved and respected for the quality of the product they offered the customer pre-Covid. That their shares are down 50% and 75% from the levels earlier in the year we think speaks to how focused on the ‘here and now’ stock markets have become with little discounting of any return to normality. We are delighted to have built sizable positions in such businesses at or below current prices.

These are two examples of what we have been trying to do since May i.e. trying to find businesses that we think are long term winners in their sectors, that are run by aligned owner managers/CEO's. They have earnings and share rating recovery potential in the short term, but also longer term compounding power thereafter. Whilst the NAV of your investment may be c.20% lower than it was this time last year we think the underlying intrinsic value of the companies we all collectively own is far far higher.

As I stated at the start of this letter investing is a strange job in that there are periods where you get very little reward for what feels like a great deal of work. Equally there are periods where you can invest a dollar and get far more (or less) than a dollar's worth of value. Whilst I will not criticise high growth investors of recent years (how can I, when they have done far better job than I) what I would assert today is this. Investing \$100 today in Peloton or Shopify shares might not get you \$100 worth of 'value'. The same \$100 invested in the range of companies we own at today's starting prices I believe could in a few years' time be worth far far more than \$100.

Just a word on Process vs Outcomes

The reason for setting up an independent investment business some twelve years ago was a desire to be able to constantly improve at the business of investing. Over that time, we have invested a great deal of time in developing what we think is now a wonderful investment process. That today's outcomes do not currently match the quality of our process we must not be discouraged by. Indeed, whilst we do not look for such comfort, we cannot help but note that many of the investors we most admire for their longer-term track records are also struggling. A great approach to a problem for period of time, let's say, will not guarantee a certain outcome, but it will greatly improve the chances of a better range of outcomes. That is what we are trying to do.

EXHIBIT 1.1 Process versus Outcome			
		Outcome	
		Good	Bad
Process Used to Make the Decision	Good	Deserved Success	Bad Break
	Bad	Dumb Luck	Poetic Justice

Source: Russo and Schoemaker, *Winning Decisions*, 5. Reproduced with permission.

Fund structure update

As many of you know I set this fund up in the Isle of Man as it was an easy way to establish a first fund when I was just starting out. Since then the UK fund industry has adopted UCITS as an industry standard. In recent months Holland Advisors has applied to the FCA for permission to be a manager of UCITS fund and I am pleased to say that this approval has been granted. As a result in due course we will be making arrangements for the fund to convert into a UK UCITS likely early next year. This will make it much easier for us to accept new investors which in a number of cases we have had to turn away in recent years. Whilst I will write to you about this event nearer the time I would just state two things. Firstly that this will be structured as an event that is a simple transfer requiring little or no action from existing investors. Secondly when putting a fee structure in place for the new fund I intend to give all existing clients preferential rates irrespective of the size of their current investment.

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It is never easy to report negative returns whilst others are making money – seemingly with such ease. I thank each of you for your continued support and remind you, as the largest investor in the fund, our interests are aligned.

I am optimistic for the future – on many levels.

With kind regards,

Andrew J Hollingworth, Fund Manager

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