FARNAM STREET Investments

October 2013 Letter

Insight Into a Specific Investment: KWT

- It's an amazing time for investors from a cost-savings perspective. The creation of Exchange-Traded-Funds (ETFs) allows us to build client portfolios with specific characteristics and ample diversification, all for extremely low trading costs. What would have taken easily thousands of dollars in trading fees before, can now be done for 1/100th of that or less.
- For background, an ETF is a collection of stocks that share a specific theme, be it the same industry, sector, or country. The stocks are bundled up and traded as one individual security, allowing us to purchase a basket of similar stocks for the price of one transaction. ETFs are similar to mutual funds, but more targeted to specific themes, and usually lower in structural costs.
- We hone in on good deals by looking through to the underlying fundamentals of the securities contained inside the ETF so we can assess the attractiveness of the group as a whole. Think of it like checking the quality of every egg in the carton before buying the dozen.
- One such ETF that we purchased for client retirement accounts was a collection of approximately 30 solar energy companies called KWT. It caught our attention after it had dropped 95% from it's previous high. We first started buying KWT for clients in early April at around $36 per share.
- At the time, there was great uncertainty in the solar industry. At that price, the markets were effectively saying the solar industry was disappearing, which we knew was highly unlikely. The markets dislike a hazy future so much, they provided us the chance to purchase solar assets at 75 percent of a conservative accounting value, even as that intrinsic value was being added to by still-profitable operations. It's like buying the cash register at the local grocery store for 75 cents on the dollar, while they're still selling groceries and adding more money to the till for us to have. What's not to like?
- Although we had no special insight on where the solar industry was headed (other than it wasn't going the way of the wagon-wheel in the next year), we knew that buying a collection of assets so attractively priced usually works out well for investors. We put 5% of each client's portfolio into KWT.
- We held long enough for some of the uncertainty to clear and the underlying assets to become more realistically priced. We exited in early October for a 90% gain (180% annualized). Although the stock is up another 13% since we sold and may keep going, we don't feel bad in the least. The easy, low risk money was already made. From here upward requires speculation we aren't comfortable with.
- We're always on the lookout for deals of this nature for clients, and there are currently a handful that we've been able to find. Due to today's overpriced markets though, there aren't enough low-risk, high reward opportunities to fill the entire portfolio. C'est la vie. We're content to buy what we can, and hold the rest in cash as we wait for opportunity's knock, which usually sounds a lot like panic.

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