JANUARY 2015 client letter

FARNAM STREET Investments

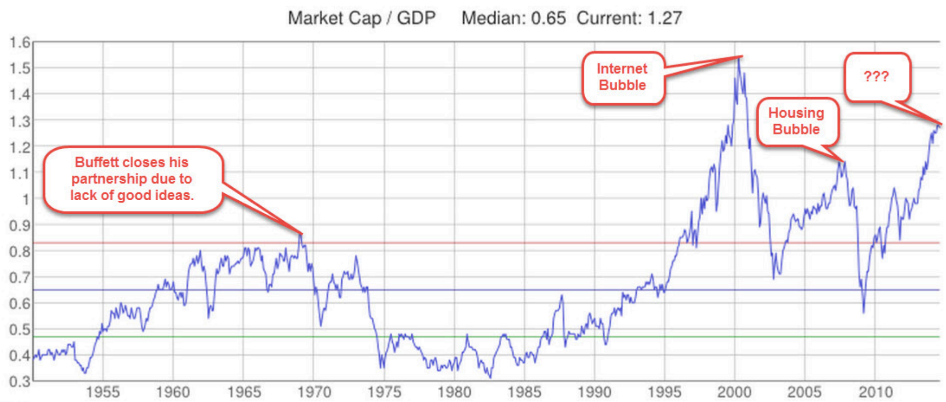
"You pay a very high price in the stock market for a cheery consensus."

– Warren E. Buffett

Timely words of wisdom from our hero. Welcome to all the new partners who joined Farnam Street Investments last year as our investor base nearly doubled! 2014 marked our 7th year in business and we are delighted to have you as part of the family. These letters are a way for us to discuss the past year and our thoughts for the upcoming year.

We also created a video to supplement this letter. It's a little finance jargon heavy, but we wanted to thoroughly lay out our case for why we're so conservative right now. It's our first crack at something like this, so your feedback is welcomed.
http://farnam-street.wistia.com/medias/7dg4wodzio

The S&P 500 index moved upward in 2014, though paradoxically, the average stock in the index actually lost money. How can that be? The S&P 500 is capitalization weighted, meaning the biggest companies have the biggest sway. And those biggest companies (think: Apple, Berkshire, Johnson & Johnson, Microsoft) happened to provide all of the returns for the index, even as the average company declined. If you weren't invested in those few big winners, you likely had a bad year. So in light of this paradox, how'd we do? Depending on whether you're in the fund or a retirement account (and when you became a client), your account is flat to slightly up for the year. This is exactly the result we'd expect. As the year progressed, we were unable to find investment ideas that met our rigorous standards. We protected our clients by moving into increasing amounts of cash. This is standard operating procedure for conservative investors. In 1969, Mr. Buffett closed down his investment firm and went to cash because he couldn't find any good investment ideas. Looking at the chart of Market Cap to GDP, Buffett's favorite metric, you can see we are now significantly above that level! Not surprisingly, he's back to conserving resources again today: Berkshire's $62B war chest is more cash than they've ever built before.



It's customary for value-minded folks like ourselves (investors looking for stocks on sale) to lag a bull market. Thankfully, the pendulum always swings back and we're then rewarded for our patience when the euphoria ends. As we'll explain, investors should be very cautious investing their hard earned money in today's market. In times like these, return ***of*** your money is more important than return ***on*** your money.

The direction of the market over months or even a few years carries little meaning. Short term movements are often based on momentum, while long term is based on fundamental valuations. On pretty much all valuation metrics, today's markets are expensive historically and are poised for little to no appreciation over the next 5-10 years, the same as in 1999 when the subsequent decade produced no returns. How soon investors forget. Anyone considering retirement within a 5-10 year timeframe should be extremely cautious.

We did make one new investment of significance last year. This opportunity presented itself due to issues specific to that company and the management. We think the issues are short term in nature and have no bearing on the value of the business long term. We are the proud owners of a burger and shake chain run by a thrifty operator and savvy investor (a rare combination). There is a long runway of growth ahead for their franchising business and their investments. Even better, we bought the shares at what we think was a nice discount to it's expanding true value.

We're excited to own it and will be traveling to New York for their annual meeting in April for continuing due diligence.

We are generally agnostic on market levels, though finding only one interesting idea in 365 days of searching is a fullblown drought. Even when markets are overpriced like today, we are typically still able to find enough good investment ideas on the margins where no one is looking. This wasn't the case in 2014 due to **tight dispersions** all stocks were closely bunched together and nothing was on sale. It reminds us of 2007 all over again.

The year wasn't a total loss though, in fact quite the opposite. Discouraged by the lack of good investment ideas, we sought an explanation and commenced a full blown study of past market levels and subsequent returns. The result was a better historical understanding of macro market dynamics and where we stand today. This investment in education will serve us well as investors over the next 50 years.

It's important to point out that we are not market forecasters; the timing of market tops or bottoms is impossible. In 2005, it felt like everyone was getting rich buying and flipping houses. It was the same easy money for tech and dotcom investors in 1999. If you weren't participating, you felt foolish for missing out. Then reality set in, fundamentals and valuations mattered again, and the shoe changed feet. While we don't know exactly when the clock will strike midnight, we're choosing to look foolish before. Patience is the key! Our hero summarized it best:

> **"It takes character to sit there with all that cash and do nothing."** – Charlie Munger

In 1982, before the largest bull market in US history, stocks were selling at about 7x price to trailing earnings and interest rates were approximately 15%. Those two factors alone created fertile investment conditions for the next two decades. Today, the markets are selling at approximately 20x price to trailing earnings and interest rates are below 3%, just the opposite. It will be an uphill battle from today's valuation levels. But like gravity, today's prices will be pulled back to earth in due time, and we'll have an opportunity to invest our cash prudently. This time will not be different; it never is.

MARKET STATS*

Warren Buffett's favorite market valuation metric, Market Cap / GDP, is currently at 1.33 vs. a normal 0.55.

On a profit margin adjusted basis (which takes into account today's unsustainably high corporate profit margins), the current Shiller Price to Earnings is nearly 34. For reference, that's twice the historical norm and very close to the internet bubble peak of 37.

The price to revenue ratio of the S&P 500 is 1.8 versus 0.8 historical norm

Investor sentiment remains overly bullish (53% bulls vs. 16% bears).

Entrepreneurs will rush to sell their businesses on public markets when they're able to get great prices for them. To wit, IPOs hit a new 14-year high this year:
2000: 406 IPOs raising $97b
2014: 273 IPOS raising $85b

Based on various gauges of price vs. a fundamental metric, markets would need to drop 50-60% to get back to historical norms.

*http://hussman.com/wmc/wmc141229.htm

As always, thank you for your continued trust and support. We're blessed to have such an encouraging group around us!

Warmly,

Jake & Lonnie

Performance since Jan 2008*

FSI (after all fees)	+70.3%
S&P 500 (w/ dividends)	+63.5%

* Based on flagship fund through 12/31/14

FARNAM STREET INVESTMENTS
1847 Iron Point Rd, Suite 180 Folsom, CA 95630
916.542.2008
www.farnam-street.com