A Beautiful Portfolio

"Beauty is the first test: there is no permanent place in this world for ugly mathematics."
-- G.H. Hardy

What is beauty? Philosophers time immemorial have offered answers:

Socrates and Confucius found beauty to be congruent with that which is morally good.
Aristotle said beauty was order, symmetry, and definiteness.
Thomas Aquinas defined beauty as that which pleases when seen.
Buddhism professes beauty is an intrinsic quality in all things, not restricted to a subjective few.

Perhaps the very definition of beauty is in the eye of the beholder...

Can an investment portfolio be *beautiful*?

Our answer is yes, and not just because it "goes up a lot." The last section of this letter will provide a detailed update on Farnam Street's portfolios and the logic behind our circumspect approach. But first, let's travel back in time...

Early industrialists built their wealth through illiquid concentration. Rockefeller in oil. Carnegie in steel. Vanderbilt in shipping and rail. Their empires were tied to one industry, one set of assets. There were no daily quotes. Instead, they measured progress via periodic business results. Buying or selling their interests to others was arduous.

With public markets, we have the privilege to build up or tear down our empires at a moment's notice, with negligible friction. We're like **helium-3 at absolute zero**, gliding in and out of any set of assets our hearts desire. Want to own an insurance company, a toothpaste manufacturer, lines of code representing a social network, a lumber mill in Ontario, or a space exploration startup? Easy, you can build that empire before lunch.

Yet privilege brings responsibility. Modern super-liquidity isn't free. Tick-by-tick market quotes can stir up emotional stress. Our psychological wiring never evolved to handle violent market swings. The African Savannah where our biology cured rarely doubled or was cut in half overnight. Nature exhibits gradual seasonality with the occasional punctuated shifts.

With the right mindset, we can have the best of both worlds. Liquidity, without liquifying our brains. Aspire to mimic the early industrialists and focus on business results. Occasionally

check prices to see if there's advantageous buying or selling to be done. A temperament tipped toward detachment is *the* continual edge. At least that's a fundamental belief at Farnam Street.

How can we tie this all together to build a beautiful portfolio which respects our liquidity privileges?

Paul Graham has some answers. Graham is a computer scientist, essayist, and founder of the venture capital firm Y Combinator. His **essays are a treasure trove** of clear thinking and modern practicality. In one essay, Graham identifies **fourteen principles of good design**, beauty's close cousin. We'll explore a handful of them and tease out the investment implications.

GOOD DESIGN IS SIMPLE.

In mathematics, a shorter proof tends to be a better one. Good computer programming is tight. Good writing is simple and concise. Ernest Hemingway was arguably the greatest author of the 20th century. Dan Brown has sold more than 80 million copies of *The Da Vinci Code*. They both write at a 5th grade level. Simplicity is sophistication.

"I've felt that before people buy a stock, they should take a piece of paper and simply write, 'I'm buying General Motors at 47, or I'm buying US Steel at 83.' They should just write out their reasoning, and they should be able to get it all on one side of one piece of paper. In fact, they should be able to get it into a paragraph."

-- Warren Buffett

Big surprise, we agree with Mr. Buffett. A good investment thesis should fit comfortably on the back of a napkin. It needn't require higher math. Complexity is the trojan horse of fragility. A broken link in the probability chain sabotages your best-laid expected results. As G.K. Chesterton said observing a random world, "life's inexactitude is hidden; its wildness lies in wait." Keep it simple.

GOOD DESIGN IS TIMELESS.

By definition, every math proof is timeless, unless it contains an error. Good writing stirs the soul, regardless of the publication date. Timeless architecture has generational appeal.

Investing is no different. The methods may evolve, but principles hold fast. Here are Farnam Street's:

1. Spend less than you earn; never interrupt compounding unnecessarily.
2. Stocks represent ownership of businesses, not squiggly lines.
3. Businesses are worth the present value of the cash available to the owners throughout the life of the business. Count the cash.
4. Markets exist to serve us opportunities, not instruct us on the momentary worth of our holdings.
5. Always buy with a margin of safety. The price paid is immutably important.
6. Patience is our only edge.

GOOD DESIGN RESEMBLES NATURE.
With her large sample sizes, we've spilled **plenty of ink** on looking to Mother Nature for models of truth. My segments on **Value: After Hours** are regularly based on physics, biology, and history for this reason.

Anything that emerges from the crucible of time is likely to exhibit good design and be a reliable source of inspiration. Business and investing resemble nature more than any discipline: complex adaptive systems, multiple players, emergent behavior, non-linear outcomes. Nature offers the best analogies and mental frameworks.

Detailed Farnam Street Portfolio Update

Modern man imagines the future lies in front of him and the past flows behind. We step forward into the future. However, the ancient Greeks oriented time in the opposite way: they backed into the future and faced the past. Their old model is logically superior: hindsight is clear and the future is always uncertain. Between pandemics, politics, premium prices, and policy responses, today's investment windshield is as obscured as ever.

Granted, no one has a crystal ball--it always feels this way. But today's cross-currents are historic: extreme fiscal and monetary interventions with debt and deficit implications (some day?), global supply chain reconfigurations, shifts in consumer preferences (work from home vs. downtown offices), pent up animal spirits, hegemonic shuffling between the U.S. and China, rapid technological change.

With a world this in flux, what's an investor to do?
Our answer: *simply survive*.

The goal of our portfolios isn't to maximize one particular view of the future. ("If rates go up, we win. But if not...") Our aim is to survive the multitude of environments. Inflation, deflation, high rates, low rates, growing and shrinking economies. Resiliency is the name of the game. Prepare, don't predict. As race car driver Mario Andretti once said, "Win the race… as slowly as you can."

Note: Even with our conservative approach, the price of our holdings can go down, even shockingly so. Markets are capable of extreme moves, and quotational volatility is the price you pay for liquidity and equity-like returns. One study found market prices move seventeen times as much as the underlying business fundamentals. One must not become too euphoric or despondent from the swinging pendulum. The businesses simply aren't that transitory.

Here's our current portfolio construction[1]:

35% in hand-picked "capital allocators" who intentionally benefit from volatility and economic stress. They're conservative and ready to make smart moves when opportunities present themselves. Thankfully, many are reasonably cheap today due to operating in insurance, which isn't bid up in times of low rates. Berkshire, with its advantaged businesses and large cash pile, is a prime example. Most of our capital allocators have long histories of successful operations which are reflected in their larger market capitalizations. We've also discovered a handful of early candidates who are still small and have lots of room to grow. We expect to add to them over time as we see more execution. The early years of compounding are like watching paint dry.

25% in the cheapest assets we can find on planet Earth. This basket tends to lean more international and has a fair amount of exposure to energy. Thanks to low rates, there frankly isn't a lot of pessimism implied in the majority of asset prices. Stocks, bonds, real estate, baseball cards, .JPEGs on the internet. Prices are high relative to any historic norms.

Our cheap asset basket is a bet on reversion to the mean. Take energy. Not long ago Exxon Mobil had $60b in operating cash flow (vs. $15b today), 35% return on equity (negative today), and changed hands at 4x price-to-book (0.75x when we bought). It was the most valuable company in the world by market cap. After more than a century of inclusion, XOM was unceremoniously broomed from the Dow Jones. How the mighty have fallen. Yet is it so impossible to imagine a period of oilpatch underinvestment resulting in prices jumping to $100/bbl again, and Exxon's economics suddenly returning to form? We don't think so. But as Jason Zweig recently said, "regression to the mean takes its time and keeps its own counsel."

As always, our strategies call for patience.

10% in what we classify as hedges. We own a few well-run gold miners in case of currency issues. They're solidly profitable today, but if gold prices were to run up, the leverage in their business models will really shine. We have military contractors as a hedge for our international and energy exposure should the world become less hospitable to global commerce. Strangely, we'd prefer these investments did poorly and the world trends toward peace and fiscal discipline. You also hope your house doesn't burn down, but you buy insurance just in case. Only this insurance pays *us* to own it via dividends.

5% in "special situations." These are companies where activism is occurring, we know the players involved, and we expect value to be unlocked eventually through productive corporate actions. The businesses are often on the cusp of inflection points, making them invisible to traditional screening techniques. The insights are the fruit from building a terrific network over the last decade plus.

Few are businesses we'd want to own forever, but asymmetry plus a catalyst can do well, regardless of what's happening in the general market.

1 This is a rough approximation of exposure sizing for a typical FSI portfolio. Individual accounts can vary based on when the portfolio was constructed.

25% in cash. The optionality of attractive future prices makes our cash valuable, even when there's effectively no yield on our savings. "Cash is trash!" is a common refrain echoed not too long before you hear "Cash is king!" We were quite happy to have cash in March of 2020 when the market offered us terrific bargains on businesses we'd long coveted. It won't be the last time. The shopping list is ready; we're waiting for the clearance sale.

Farnam Street's portfolios are obviously a long way from the 60% stock index fund, 40% bond portfolio that's typical in the finance industry. That traditional combination has done well the last ten years as rates kept falling (good for stock and bond prices, bad for future returns) and humanity saw one of its more benign decades. The key question: Will it repeat the next decade?

It might. But the same sense of security permeated the air in 1910. Economies were booming, war was a relic of the last century, and man had conquered nature. Then in 1912, the Atlantic swallowed the "unsinkable" Titanic. World war broke out two years later, the trenches costing 40 million lives. On the heels of that blood shed, the Spanish Flu claimed another 50 million. Next we had massive inflation in the Weimar Republic. The Great Depression wasn't too far behind, then a second global conflict which set the standing record for worst in human cost. As historian Will Durant said, "History is always repeating itself, but each time the price goes up."

We're not saying the future is bleak, far from it. Modern advancements like the m-RNA technology in vaccines are a god-send. There's plenty of evidence to be hopeful. But there are periodic cycles in the upslope of progress. Complacency does not go unpunished.

Our portfolios are designed for circumspection and are well-positioned for the next phase, mindful that odds are the terrain will be more difficult than the last decade. As the saying goes, rough seas make for good sailors. If you're looking for a steady hand at the helm, we'd be happy to help you or someone you care about with their investments.

Quick Housekeeping Item

Part of being a registered investment advisor with the State of California means providing compliance updates and disclosures annually. Here's where we keep the most up-to-date documents for our clients: **https://www.dropbox.com/sh/sp5mqetpcwrjc1b/AABxGZXC6vKI-AFosZam6xita?dl=0**

As always, we're thankful to have such great partners in this wealth creation journey.

Jake