FARM ROAD CAPITAL

January 5 2021

2020 letter to partners

Topics: a lesson from Napoleon; the unprecedented risk in stocks; our investments; trust as leverage; gratitude shout-outs

Dear partners and friends,

Year	FRC Return	S&P 500 Total Return
2017	66.1%	21.8%
2018	-7.9%	-4.4%
2019	19.9%	31.5%
2020	139.5%	18.4%
CAGR since inception	44.8%	16.0%
Cumulative since inception	339.4%	81.3%

Farm Road Capital gained 139.5% in 2020, while the S&P 500 gained 18.4%. From inception in 2017, FRC gained 339.4%, while the S&P 500 gained 81.3%.

Your manager assures you that the S&P is not an unduly short yardstick. 68% of my peers under-perform benchmarks over the most recent 3-year period (2016-2019). Over 5 years, 82% under-perform. Over 10 years, a staggering 89%. The numbers suggest that excess return is rare. Your manager faces long odds, but hopes you are assured by the alignment of our interests. 99% of your manager’s net-worth is invested in the same securities in which you are invested. Your manager eats his own cooking.

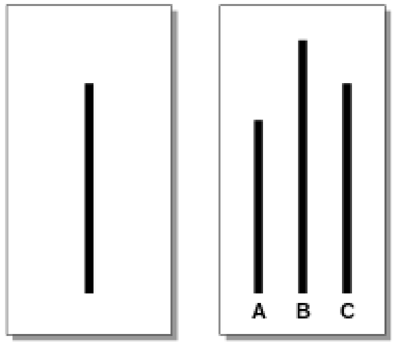
Your manager is also the first to assure you that the success in 2020 is unlikely to be repeated. Unprecedented conditions created once-in-a-lifetime (maybe twice) opportunities that are unlikely to repeat in the foreseeable future. Your manager prefers to avoid throwing cold water on your returns, but would do so only to adjust your expectations to reality. There is nothing like cold water in wintry January to wake one up to the real world. It is your manager's goal to perform in excess of benchmarks by 10% annually over the long-run.

A lesson from Napoleon

Some pilots describe their jobs as "hours and hours of boredom punctuated by moments of sheer terror." It is almost the same with investing (replace 'boredom' with 'uneventful reading').

What pilots do during terrifying moments determine the fates of many. The few decisions made in those moments have impacts larger than many decisions combined in routine flights. The same principle applies to investing. What investors decide during extreme market turmoil have outsized impacts on performance.

Napoleon perhaps has the best response, that is "the average thing when everyone else is losing their minds". An experiment first conducted in 1951 showed why this is difficult. Psychologist Solomon Asch showed eight college students two diagrams:



He asked them: "Which line - A, B, or C - is similar to the line in the other diagram?" Each participant answered sequentially, such that the next participant could hear the previous answer.

The correct answer was simple. Yet when the first seven participants (who were actors with predetermined responses) gave the wrong answer, the eighth (the sole real subject) almost always gave the wrong answer as well.

The researcher viewed the results "as a striking example of people publicly endorsing the group response despite knowing full well that they were endorsing an incorrect response." The experiment demonstrated the tendency to conform with the crowd.

When everyone else is losing their minds, the easy choice is to lose your mind as well. The difficult choice is to "do the average thing". In investing terms, the difficult and "average thing" to do is to take action when the market goes crazy.

I wrote a short article to buy stocks on March 23 2020. With hindsight, the day coincided with the market reaching a bottom after plunging at the fastest pace since the Great Depression in 1929. On March 23, there was no way to tell whether the market would decline further, but there was a reason to buy:

"How do we know that stocks have bottomed? The truth is that there is no way to tell, despite what you hear from Goldman Sachs and CNBC. Steve Jobs said that "you can never connect the dots forward. You can only connect the dots backwards", which means that we will only know the bottom with hindsight. Because you can't be certain to buy at the bottom, you should only buy when you expect reasonable returns. Using 90-year averages for the S&P 500 as a benchmark, the investor can expect roughly 7% returns per year in the next 10 years (see Appendix at end of article for calculation), a reasonable return."

-Farm Road Capital on March 23 2020

Buying during turmoil entails a few overlooked yet important nuances:

1. **You must not have excessive leverage**: You cannot buy when a significant downturn obliterates your equity. You can only buy if you survive the downturn. This sounds obvious, but it is difficult to expect a downturn when the going is good. Because there is no way of knowing when downturns occur, your manager operates with limited to no leverage.
2. **You know what to buy**: The most opportune windows do not stay open for long. Your manager keeps a wish-list of the best businesses to own should opportunities arise.
3. **You know what to abandon**: This is perhaps the most difficult yet important. Significant downturns tend to alter the economics of some businesses. The investor must be aware of the paradigm shift. The endeavor requires an unique and rather contradictory blend of skills: sound logic backed by commonsense and financial history, the foresight in imagining what hasn't happened before (that may defy current logic), and the sturdy independence of thought when commonsense is on shaky ground.

An old saying in Chinese opera goes: every minute of performance on-stage is backed by ten years of hard work off-stage. Investors toil in the shadows for years, ready to perform at a moment's notice when opportunity arises.

The unprecedented risk in stocks

The exuberance in some technology stocks - electric vehicles, autonomous driving, software - is hard to miss, but the mania is nowhere near the previous sector bubble. These stocks may still decline, just not because of a bubble burst.

I am old enough to remember Yahoo listing on the Nasdaq in 1996. The then-quintessential search engine was valued at $850 million, implying a massive revenue multiple of 607. China.com (a Chinese clone of Yahoo) was listed in 1999 with a $5 billion valuation and $2.4 million revenue, an astonishing *2083x* revenue. Even mega-caps with slower growth rates were valued highly. AOL was valued at $200 billion at its peak, even when it generated slightly more than $4 billion revenue. These bubble conditions are absent today. There is only a handful of technology stocks (about 40) trading at 30x revenue or more, and only 4 at 100x revenues or more. Recent popular IPOs such as Snowflake and C3.ai trade at 245x and 125x respectively, which are very expensive but not bubble-expensive. Mega-cap technology companies (Facebook, Apple, Netflix, Google) trade at 8x revenues or less, a far cry from AOL's 50x.

The general market does not seem expensive either. The S&P trades at 22 forward PE, near its 2000-tech-bubble peak of about 24, raising alarms for a probable (and painful) mean reversion. But it is likely wrong to assume that 24 applies as the ceiling for valuation today. The economy was very different in year 2000. Quantitative easing and Facebook were not invented yet. Netflix only delivered DVDs. Amazon offered mainly books. Banks were over-levered and held little equity relative to risky assets. Overnight rates were 5-6%, compared to 0-0.25% now. The American economy is stronger and better supported today. The large technology companies are delivering consistent double-digit growth in revenue and profits with no end in sight. They make up 12% of the S&P, up from nothing in year 2000. Banks now hold plenty of capital relative to risk levels, and still make record profits even with lower leverage. The Federal Reserve is much more effective in responding to crises. A stronger economy, with unprecedented supportive monetary (and now fiscal) policies, should see higher multiples.

The question is how long the support would last. This is a complex topic, because the central bank does not have complete control. The Fed has a dual mandate of maintaining stable prices and maximum employment. It currently keeps rates low to promote job growth, and affords to do so because inflation has been below the 2% target in half of the past decade.

What happens if inflation is above 2%? The Fed would raise rates to control inflation, yet higher rates reduce job growth. Fulfilling the dual mandate would be trickier. What happens if longer-term rates increase? The Fed only has control over overnight rates, which influences, but does not determine, longer-term rates. Higher longer-term rates depresses growth. What can the Fed do when overnight rates are already at 0%?

What is certain is that the Fed is determined to expand its influence. It sends the message through a relentless stream of unprecedented and timely policies during the past 12 years, whenever the outlook is dire. An influential Fed amplifies the upsides of its supportive policies, but also intensifies the downsides of policy missteps. The global economy is fortunate that the Fed has not made major policy errors since 2008. The lack of errors is actually an aberration. The Fed made numerous errors in the 94 years between its birth in 1913 and 2007. Its inclination towards novel policies means that significant errors in the future may be difficult to reverse, because history would offer little guidance.

We should count ourselves lucky for a responsive and (almost) error-free Fed for the past 12 years, but should not count our chickens before they hatch.

Our investments

Your manager is invested in the same securities as you are. Our portfolio contains 6 US-listed equities in the technology, media, and healthcare industries, with market capitalizations ranging from $100 million to $100 billion.

Your manager favors businesses in sustainable, predictable, and non-traditional niches growing at above-market rates. History has shown that sustainable above-market growth is rare, because the required ingredients tend to exist separately. Each ingredient appears ordinary in isolation. When bundled together, each ingredient reinforces others, and, in a flywheel fashion, results in a multiplier effect and a whole that is greater than the sum of its parts. The ingredients include heavy commitments to innovation and people, clear visions for market leadership, industry tailwinds, excellent unit economics, and incentivized leadership, among others.

The value of our holdings in ecommerce and digital advertising have significantly increased. Social distancing and lockdowns caused by the pandemic accelerated the shift to online retail and advertising. Consumers are unlikely to favor physical retail after experiencing the seamless nature of ecommerce. Advertisers are also less likely to commit to non-digital formats after benefiting from the greater efficiency of digital advertising over alternative formats. More importantly, the management teams of our holdings delivered. No one expected the scale of the pandemic and disruptions. Yet our management teams recovered quickly from the economic shock, took advantage of disruptions, and led their businesses to new highs.

The key risk in technology and media is the unintended consequences of regulations. Not the regulations in and of itself, not even the immediate effects, but the second, third, and subsequent order effects of regulations. Ecologist Garrett Hardin advocates asking 'and then what?'

Regulators start with good intentions in restricting the outsized, black-box influence of Facebook and Google (black-box because many elements of ad pricing are proprietary). The results should unfold like any worthy economics textbook says so. More players in digital advertising results in more competition and innovation. Advertisers can shop for the lowest cost amidst the plethora of choices. The lower cost of advertising would benefit the ultimate end-consumer.

Reality is more complex. Human behavior, unlike physical phenomena, unfold in unpredictable ways. Facebook and Google have commanding leads because of their copious collections of data. New and smaller players do not have an edge in data. What would they do to get an edge? Would they resort to new methods of data collection that threatens consumer privacy further? Would they refuse transparent reporting on collection methods to protect their edge? Would digital advertising then become less transparent than it was?

There is no one easy answer that balances the interests of all involved. Your manager does not dream to be a regulator, but would align our investments with the way the world works.

Trust as leverage

I have been told that the logo is an abstract image of houses or mountains. It really is simply a handshake, which is a universal representation of trust.

Any self-respecting investor knows that it is impossible to know everything about a company, though it is just as important to work as hard as possible to know as much as possible.

So how is it possible to be sure of a good deal? One has to trust that the other side would hold up its end of the deal. And that is what the handshake really represents. You trust that the other side would take care of things, that you would never have known, to your benefit.

In this perspective, trust functions like leverage. In engineering, leverage allows for results that are multiplies of the effort exerted. When you trust the other side, the Pareto principle works (80% of results from 20% of effort).

How is trust established for an investor in practical terms? Your manager hardly has contact with holdings. There are no boots on the ground. Your manager favors publicly available information, and it is usually sufficient to know whether management is trustworthy. How does the CEO represent the business, industry, and competitors? Does the CEO fulfill promises? What excuses does the CEO or CFO have for missing targets? How do senior executives talk about other employees? The catch is to read enough to know what makes sense.

Gratitude shout-outs

Many have provided advice and support to your manager:

- My wife and mother-in-law, who have believed and supported me in every way possible (nothing motivates an investor more than having the mother-in-law's savings on the line)
- My parents, who provided the opportunity for me to pursue my education in the United States
- Peter Kaufman, who generously showed me how the world works by teaching me its timeless and unique principles
- Scott Hendrickson and Mike Kimpel, who taught me their research framework and provided useful feedback on my ideas at Columbia
- Alex, Ben, James, Roger, and many others who provided useful feedback

If you have any questions, contact me at farmroadcap@gmail.com.

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1/5/21