Castlebay Investment Partners

Security through compounding: Knowledge, Returns & Trust

Dear fellow shareholders,

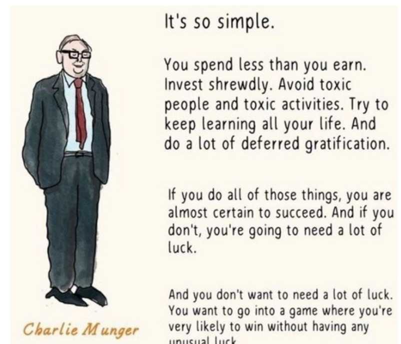
An ode to Charlie

On the 28th November 2023, a long life came to an end with the passing of a fascinating, wise man. He was a month short of his 100th birthday—a century of time that has encompassed unimaginable change. It is not an exaggeration to say that this person has left his mark on the world. Through his wit and 'wordly wisdom' he has influenced our own investment philosophy, more than any other individual. So, it seems only right to acknowledge the passing of Charles Thomas Munger. Known to many simply as 'Charlie', he is probably best known as the business partner of Warren Buffett. Charlie was born in Nebraska, Omaha on 1st January 1924.

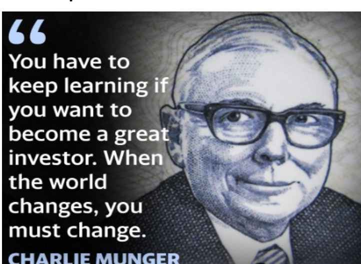
After his childhood, which included working in the store of Warren Buffett's grandfather, in 1941 he began studying Mathematics at the University of Michigan, whilst also taking a course in Physics. However, his formal education was interrupted by the Second World War, when in his second year he enlisted in the US Army Air Corps—being trained in meteorology, before being stationed in Alaska.

Following the end of the War he married and applied to his father's alma mater, Harvard Law School. Whilst he was accepted, despite not having completed his undergraduate degree, his subsequent graduation—with distinction, supports the more unconventional admission's process he followed. Probably, the most important point to make though, is his learning did not stop there. Munger always saw himself as a life-long learner. An important dynamic is revealed through this ethos, one that we continue to try to follow. Implicit in this life-long learning ethos, is the idea that we don't know all the answers—there is always more to learn. We should always be prepared to revisit what we've learned and ensure our current assumptions are still valid.

We continue to question our beliefs and assumptions, particularly when new evidence comes to light. For example, for many years we didn't own a discretionary retailer like Next plc. We were concerned about the variability of demand in this sector and also the discretionary nature of demand. However, their capital efficient, anti-fragile business model trumps such considerations. They have revised up their financial expectations five times over the last nine months! It is difficult over this shorter time period to disaggregate the difference between cyclical trends—an improving consumer backdrop with rising real wages and disinflation; against the structural advantages derived from its business model. Over a longer time frame, however, the latter aspect will likely drive the greater part of Next's future value creation.



Charlie Munger is famous for his 'wordly wisdom' and his 'uncommon common sense'. If we were to highlight two of the most important aspects of his thinking that have shaped the investment world—'mental models' and 'Quality compounders' would be the top two. Over the last nine years we have written many times about how we use mental models to make sense of the world. Charlie Munger has been our main influence in this area. He is the giant, upon whose shoulders we have tried to stand. Ideas, such as 'Inversion' have shaped our valuation analysis. The principle that the 'Map is not the Territory' helps us to understand that company accounts are reductionist in nature—reducing millions of transactions to one revenue number for each company a year! It helps us question what is lost in this process and how these 'big numbers' could be manipulated.



Thirdly, the power of incentives is a crucial model to understand. As Munger regularly said, 'show me the incentive, I'll show you the outcome!' We use this idea to understand whether management teams and employees are aligned to our interests as long term shareholders. The benefits of this mental model thinking can be enhanced further when multiple mental models are used together. Munger called this the 'Lollapalooza effect' — the total being greater than the sum of its parts. In short, the more we think using mental models the better able we are to question our assumptions and continue to see our investment process evolve.

The second idea of 'Quality compounders' has been seminal to the investment success of Berkshire Hathaway over recent decades. Initially, Warren Buffett was a great disciple of Ben Graham as one of his students at Columbia business school.

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Charlie Munger: an investing life

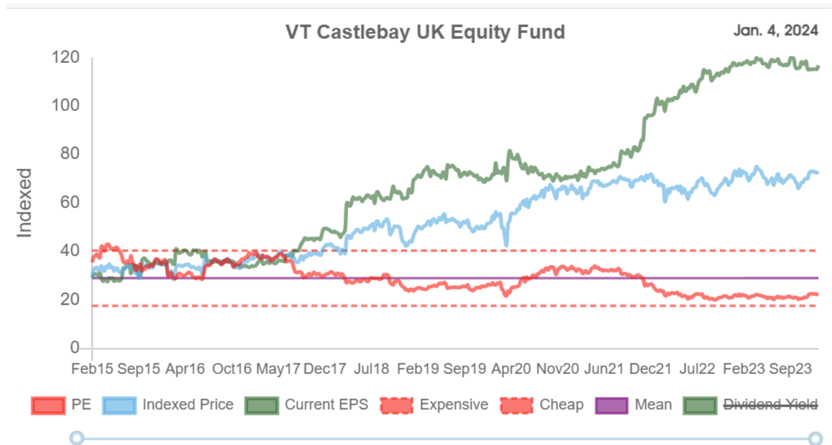
Castlebay Investment Partners

Ben Graham was a proponent of deep value investing in the 1930s, during the Great Depression. At that time, many businesses were selling for less than the value of their liquidated assets. As Buffett started investing, he adopted this approach with great success. Yet, it was Munger who showed Buffett the investing way. As Warren said of Charlie, 'the blueprint he gave me was simple—forget what you know about buying fair businesses at wonderful prices; instead buy wonderful businesses at fair prices.' At the heart of this assertion lies a protection against what we term 'the equivalency trap'. It is easy, but wrong, to equate one year of earnings with another year of earnings. This approach would suggest that a business priced at 10 years of earnings (10x Price/earnings) is necessarily cheaper than one trading on 11 years of earnings.

This ignores the capital required to generate these respective earnings, the ability for companies to reinvest retained earnings and it also ignores the rate at which this can be done. This last point will ring loudly in the ears of our fellow investors, with whom we have met over the last decade, as it describes the 'Mungerism' we have quoted and described the most—that over the long term a stock's share price return effectively reflects the underlying returns the business makes.

Over the many years of the Berkshire Hathaway annual shareholder meetings, attended by Buffett and Munger, Warren would normally lead responses to questions. Charlie became renowned for only answering if he thought he had something useful to contribute. So the phrase 'I have nothing further to add' became a catchphrase over the years. Now, Charlie has been laid to rest, you can almost hear the famous retort ringing out. His wit and his wisdom will be sorely missed. We are fortunate though that his thinking lives on, helped by the recent republication of ***Poor Charlie's Almanack,*** along with all his other recordings from a long, successful investing life.

Buffett once said that 'in a bear market stocks return to their rightful owners.' Our investment approach means that our fund doesn't look like 'a market', such as the UK market. However, over the last three years our collection of Quality businesses has had its own bear market. It appears to us that many of our companies' shares have returned to long term shareholders—the rightful owners. The fast money that always looks to make a 'quick buck' has moved elsewhere.



Source: Castlebay Wayfinder, Workspace

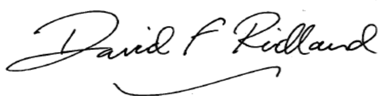
This has provided a compelling investment opportunity due to the operational excellence demonstrated since Covid, by our companies; and also the extremely attractive valuations on which these businesses are now being offered to us. The Castlebay fund valuation graph above and our Quality table continue to show just how compelling an opportunity currently exists. Our fund continues to generate three times the return on equity in relation to the market; produce consistently higher and more stable margins; yet still is trading on a more attractive free cashflow yield of 4.7%.

Quality Table	Castlebay Fund	Market
Return on Equity	42%	14%
Operating profit margin	21%	16%
Net debt to equity	67%	79%
Cash conversion	95%	97%
Free Cashflow yield	4.7%	4.5%

Source: Valu-Trac, Workspace as at 31/12/23

Thank you for your continued support and we wish you a healthy and prosperous 2024.

Yours sincerely,



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Cost analysis

Since we launched our fund nearly 9 years ago, we have paid all the 'ongoing fund costs' as a rebate from our investment management fee. This cost increases as the fund grows and to the end of December 2023 the rebate for the year amounted to just over £108k, paid by Castlebay.

VT Castlebay UK Equity Fund	01 Jan23 -31 Dec23
Discretionary commission	£2,402
Fund Flow Commission	£14,156
Total Commission Paid	£16,558
Commission as % of NAV	0.01%
Transaction Taxes	£71,965
Total Transactional costs	£88,523
Total Costs as % of NAV	0.05%
Turnover 2023	**8%**

Source: Valu Trac 31/12/23

We have also published details of the transaction costs which are not included in the 'ongoing charges figure' and are paid by our fellow shareholders. Transaction costs arise when additional money is invested in the fund and is invested in existing or new shareholdings, or when investors divest some or all their shareholding and fund positions are reduced. These costs would be incurred if fund investors bought or sold their own shareholdings instead of the fund.

The total commission paid for investing the money into and out of the fund amounted to £14k and the discretionary commission (investment related decisions) amounted to £2k. Stamp duty was incurred for the majority of the purchases and accounted for an additional £72k. The total Transaction costs amounted to £88.5k or 0.05% of the value of the fund.

Turnover

Transactions also occur if we want to make changes to the portfolio, based on our investment analysis and we either add to or reduce existing positions, or sell positions to add new positions. The level of transactions in a portfolio can be measured by the Turnover figure. There are several ways of calculating turnover, with ours calculated as Purchases or Sales, (whichever value is less), divided by the average Net Asset Value of the fund.

You will see from the table that our turnover in 2023 was 8% with our annualised turnover now at 10%. This compares with our peers, in the UK All Companies sector, which have an average turnover of around 80% each year. What this means in practice is that our competitors are selling 80% of the companies in their portfolios each year and buying new ones in their place. Each of these transactions incur commission costs and stamp duty for UK stock purchases. This strikes us as more akin to gambling on stock prices than investing. We prefer to invest in companies, not share prices; and this is reflected in an implied average holding period of a decade for the businesses we own.

VT Castlebay UK Equity fund turnover	
Average Turnover	**10%**
Turnover 2023	8%
Turnover 2022	0%
Turnover 2021	7%
Turnover 2020	15%
Turnover 2019	19%
Turnover 2018	12%
Turnover 2017	16%
Turnover 2016	5%
*Turnover 2015	10%

* since launch 28/01/15. Turnover is calculated as purchases or sales (whichever is less) divided by the average NAV of fund.

The table illustrates a consistently low level of turnover in the fund over the last 9 years.

We remain focused on ensuring that all costs incurred in the fund by Castlebay are tightly controlled and fair to all parties.

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