Castlebay Investment Partners

Security through compounding: Knowledge, Returns & Trust

Dear fellow shareholders,

It's all in the 'P' not 'E'!

It is an oversimplification when looking at investing styles in the market to think simply in terms of Growth v Value. Yet, market strategists often speak about everything that isn't 'Value' being 'Growth' and vice versa. We believe it is helpful, as we've mentioned before, to think about the types of investing from a supply and demand perspective. When the supply of growth is scarce any company that can deliver growth, is often well rewarded by the market. So in the years following the Global Financial Crisis (GFC) of 2008, ultra low interest rates created low levels of growth—the so called liquidity trap. As growth was scarce, 'Growth investing' as a style became more popular. The ultra low cost of financing, added to the interest in growth companies supported ever higher valuations. The UK market, amongst others, has gone through a particularly challenging period over the last three and a half years. We have had to deal with Covid and its aftermath; conflict in Ukraine; and inflation returning to the economy after a thirteen year hiatus. In the years following the GFC, we became used to low economic growth. No amount of liquidity pumped into the system at that point caused inflation, as the banking sector was urgently trying to repair its collective balance sheet, by de-leveraging! Economists would conclude that the 'velocity' - the rate at which money circulates around the economy, was broken at this time. This stopped the 'quantitative easing' driving up costs.

After 2020 that was no longer the case. The capital pumped into the UK economy, to deal with Covid, combined with imported higher energy prices following the invasion of Ukraine, drove up inflation. Suddenly, 'growth' was easier to come by, its supply increased, you might say. As interest rates rose to counter this sharp rise in inflation, investors started to focus on a different type of company—'deep value.' In effect, capital started to flow away from 'long duration' US technology businesses as the cost of supporting the valuations of these growth companies became more expensive. For example, if you are valuing a business on its future cashflows, the 'discount rate' at which its cashflows are discounted back to a present value today, starts to increase as interest rates rise. This means that the cashflows and by extension the value of the business gets smaller. If the discount rate rises high enough then the present value falls below the current market value. Not many investors hold onto businesses in the expectation of a negative investment return! At the same time, this makes nominally cheaper companies look more attractive to investors.

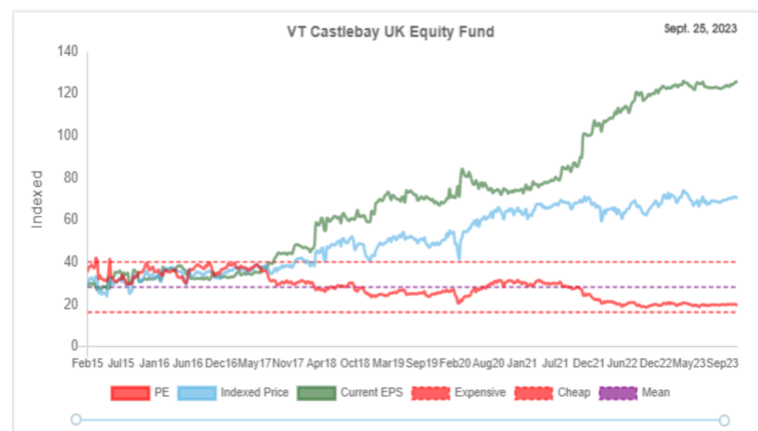
Particularly from the beginning of 2022 we have seen a strong rotation into businesses like Shell and BP—both due to their low valuations and a rising oil price, resulting in part to the Ukraine conflict. The challenge for our fund over this period has been to maintain the discipline of our 'Quality value' investment approach. The 'Quality' part has precluded us from owning many of these businesses due to their low returns on capital and equity. This is something with which we are comfortable. We know, given the nature of human psychology and markets, that there will be times when investors vote against our businesses. Times when low quality companies, which can't find their way into our Investment Universe, will have their time in the sun. However, it was not until we carried out a recent analysis that we realised quite how strongly that sun was shining and the nature to which our businesses were being cast in the shade.

The table below looks at the change in Price/Earnings (P/E) rating over the last 3 years both for our fund and the MSCI UK equity index. Here are some observations: 1) **Our fund's aggregate P/E rating has been derated by -33% during this time period**. This compares to the MSCI UK's re-rating of 3%, over the same three-year period. 2) **The earnings growth of our businesses has been superior at 69%,** compared to the MSCI UK's earnings growth of 38%.

Geometric returns	Castlebay Fund	MSCI UK
P/E rating change %	-33	3
Earnings growth %	69	38
Total return %	13	42

Source: Valu-Trac, Workspace

So, **all of the performance differential is explained by the valuation de-rating** of our fund in relation to the market—**it's all in the 'P' for price, not the 'E' for earnings**. In other words, our higher quality companies have been performing much better operationally than the market as a whole, but this has been ignored by investors. The end of 'free money' in 2022, with interest rates rising from historically low levels, led to a head-long rush into these low quality, 'deep value' companies – not the sort that find their way into our Investment Universe! You might say though, what about the valuations of our companies at the start of the period? Were they excessively high and therefore the de-rating justified? We would make a couple of points in response to these questions, whilst looking at the chart which shows our fund's valuation in P/E terms, since its launch in January 2015.



Source: Castlebay Wayfinder, Datastream, Valu-trac

A look at the red valuation line shows that valuations were not excessive before Covid struck in 2020. Since then the fund's valuation has become steadily cheaper. Now, even in comparison to the market decline in March 2020, valuations are even more attractive! It's not our job to say to our fellow investors when they should invest or even increase exposure to our fund – that is for them to decide. All we can say, is that recent market trends have left our quality companies at historically attractive valuations, underpinned by higher and more consistent earnings and cashflow growth. That looks pretty attractive to us!

The value of investments can fall as well as rise & you may not get back what you invest. Past performance cannot be relied upon as a guide to future returns.
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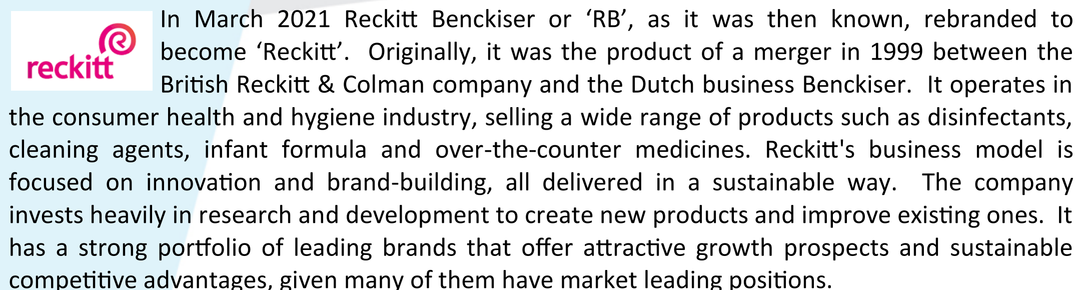
Below we update our Quality table, or our table of constancy, as we like to call it. It further underlines how much higher quality our companies are than the market – higher ROE, stronger and more stable Operating margins; and in relation to the free cashflow generation – much cheaper.

We can't say at any given time how our companies are going to perform in the future. Frankly, there are too many uncertainties in life to avoid becoming a hostage to fortune. However, it does seem that the quality of our companies is being greatly overlooked. They have delivered superior earnings and cashflow growth in a more consistent manner, over the last three years. Yet performance has diverged materially from that of the market. As fellow shareholders of the fund we acknowledge keenly the impact of this period of performance. However, we can not control the vagaries of the market. Instead, we remain focused on what we can control—maintaining a consistent investment philosophy and process.

Quality Table	Castlebay Fund	Market
Return on Equity	42%	14%
Operating profit margin	21%	16%
Net debt to equity	66%	79%
Cash conversion	93%	92%
Free Cashflow yield	4.7%	4.2%

Source: Valu-Trac, Workspace as at 29/9/23

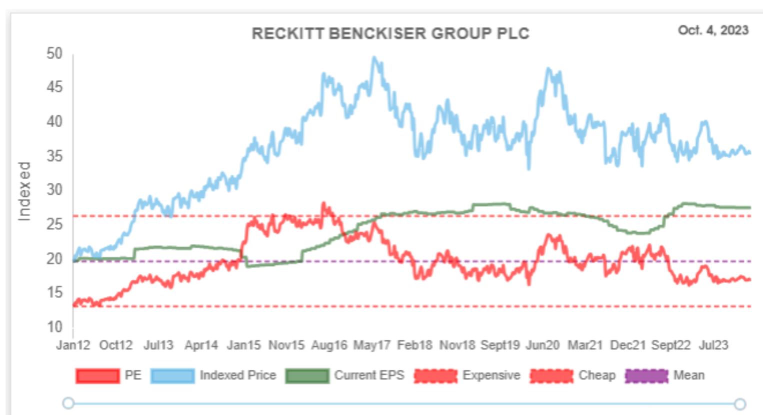
We are confident that given the greater long term returns on capital; superior operational performance and very attractive valuations of our companies, that in time these factors will be more fully recognised by the market.



In March 2021 Reckitt Benckiser or 'RB', as it was then known, rebranded to become 'Reckitt'. Originally, it was the product of a merger in 1999 between the British Reckitt & Colman company and the Dutch business Benckiser. It operates in the consumer health and hygiene industry, selling a wide range of products such as disinfectants, cleaning agents, infant formula and over-the-counter medicines. Reckitt's business model is focused on innovation and brand-building, all delivered in a sustainable way. The company invests heavily in research and development to create new products and improve existing ones. It has a strong portfolio of leading brands that offer attractive growth prospects and sustainable competitive advantages, given many of them have market leading positions.

Reckitt's globally recognised brands help consumers lower their search costs and provide products that they can trust. This is particularly important as over half the company's operating profits come from its consumer health and infant nutrition divisions.

Reckitt has a good economic moat based on **intangible assets**, reflecting both the strength of its brands and its entrenchment in retailers' supply chains. Reckitt has amassed leadership in an array of categories spanning household products (hygiene segment), consumer health and infant nutrition. Its competitive strength comes from its focus on niche categories such as auto dishwashing (34% global share), surface and disinfection (33% global share with Lysol and Dettol), intimate wellbeing (36% market share in condoms and lubricants) and sore throat (29% global share with products such as Strepsils). Overall, the company owns the number-one or number-two brands in around 15 narrowly defined categories at a global level. We believe that this makes it a key supplier for retailers in those categories.

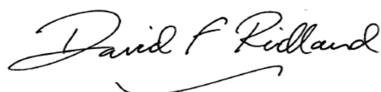


Source: Castlebay Wayfinder, Workspace

As with our Fund valuation graph, Reckitt's graph tells a similar story of a de-rating over several years. This is in part a reflection of the acquisition that they made of the infant formula maker, Mead Johnson, in 2017 for c$17bn. They overpaid for it and it is fair to say that it has been a drag on returns on capital for the following years, due largely to a multi-billion pound impairment charge that the business took. The sale of the 'Chinese Infant Formula Child Nutrition' part to Primavera Capital helped to recover some capital and is allowing the business to focus on areas of strength in other markets. This issue largely explains the derating of the shares, over the last few years. However, more recently incremental returns have been heading in the right direction. Their superior gross and operating profit margin profiles, in relation to their competitors, shows that the business continues to be run well operationally. We continue to monitor the capital allocation of the business, to ensure that any growth that is acquired, creates long term value for shareholders. So in conclusion, the investment case centres on an operationally well run business, growing through innovation and brand strength, all of which we believe is currently being undervalued by the market.

Thank you once again for your ongoing support. We hope you found this letter of interest.

Best wishes



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