Castlebay Investment Partners

**Our guiding principles:**
- **Transparency & alignment of best interests with our fellow investors**
- **Adherence to our investment philosophy and process**
- **Independence of thought to avoid the market herd**
- **Focus on costs: management fees capped, low stock turnover**

## Investing through uncertainty: Part 1 - Inflation

Dear fellow shareholders,
After the drought comes the rain. After the 'economic lock-down' comes inflation. The question is—for how long may it last? Are rising prices temporary or longer lasting in nature? A recent Financial Times article highlighted the changing shape of the inflation problem. It noted that the Bank of England is now forecasting that inflation will peak in April at 5%, just as the old retail price index (RPI) measure recently hit a 30 year high! In Europe however, the European Central Bank estimates that inflation likely peaked last November, whilst the US Federal reserve anticipate the level of price rises in 2022 to be half that of 2021. The Fed had better be right, as data just out says December's inflation figure hit 7% - the highest since Ronald Reagan was President in 1982! All around the financial press, there is great divergence of opinion about how prices may change, largely as an after-effect of Covid-19. The pandemic has perhaps further raised uncertainty; and not just in regards to the changing nature of prices. Such uncertainty often undermines investor confidence. To counter this we need **a plan**, a structure - to help deal with our complex dynamic world.

As such we thought it would be useful to embark on a new series over the next few investor letters— 'Investing through uncertainty'; looking at various aspects of uncertainty and how we seek to navigate them as we invest. Given the comments on inflation we shall start by looking at Price uncertainty - namely as inflation rates ebb and flow, how our companies can deal with the impact to their cost bases and the changing demand patterns from their customers and clients.

As the latest surge in prices in the UK is still being felt, the inflation of the last twelve months may yet be reflected in the public's expectations of rising prices. In this manner, further price rises may become self-fulfilling. As we look at this changing situation through our investing lens, a question naturally rises in our minds. Should we try to invest by trying to predict the changing picture of inflation? In short, our answer is no. Instead, we would like to turn this proposition on its head. We should accept that in our complex world we can't predict the way in which prices are going to move—be there inflation, disinflation or even deflation. Instead, **we should look for businesses that are resilient in as many of these scenarios as possible**. As Nassim Taleb describes in his book 'Antifragile', entities that exhibit this titular characteristic are actually strengthened by stress. We can think of several of our businesses where their competitive positions have been strengthened through the Covid crisis. Pagegroup, to name one, used the market dislocation to invest in hiring more experienced staff which has culminated in a material improvement in its productivity. Businesses like Pagegroup and others, have both the strength to survive the stress and the adaptability to take advantage of the opportunities this stress creates. It is all very well to try and benefit from the creative destruction inherent in our capitalist system, but you have to survive as a business first. Only then can you hope to reap the rewards. Put another way—**we look for businesses that possess both resilience and optionality.**

We see a consistent number of characteristics inherent in our companies that help underpin their resilience. Strong balance sheets that are **not** overly stretched by business school-taught 'optimisation', are a common feature in our investment universe. If a management team does not have to worry about the financial health of their company, it usually leads to much better capital allocation decisions. After all, the best opportunities to deploy capital, often occur in the eye of an economic storm. In an inflationary environment when cost bases are rising, financial leverage can create a lethal cocktail. This is particularly the case, when the cost of finance increases to ameliorate the excess demand that is pushing up prices, just as demand starts to soften through this monetary policy action.

Companies with lots of debt on their balance sheets may enhance their returns during the good times. However, when there is unexpected turbulence, often caused by price instability, their capital structure will often mean their focus is turned to one of survival rather than opportunity. Indeed, the combination of operational leverage and financial leverage is often injurious to investment returns. This is why an investment checklist, which forms part of our investment process - **our plan**, seeks to omit companies that have both high operational and financial leverage.

As we have talked about previously, companies with low margins and returns, operating in 'perfect competition' often come under pressure during inflationary periods. As their costs rise they often struggle to pass on their own price rises to their customers, as rising interest rates impact consumption. Conversely, a characteristic that helps our companies in both times of inflation and deflation is that of 'pricing power'. If a company's products or services possess this wonderful feature, prices can be increased as costs rise, thereby protecting margins and returns.

As I started my investment career on the Japan desk during the 'lost decade' of the 1990s I know well the devastating impact that deflation can have on a society, as well as investment returns. In the knowledge that prices will be cheaper next week, consumption can often be continually delayed. Companies can also suffocate under their debt financing as revenues and profits decline and their debt burden rises. This is why producing something special, even essential, can put the producers in a much stronger position from which to survive and prosper.



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## Activity

During the quarter we sold our remaining exposure in **KONE**. This was due in part to its extended valuation, but also with our newly refreshed Investment Universe, due to competition for capital. As the fund is now fully invested, any new stock entering into the Universe has to compete directly with one of our holdings in the fund - effectively a 'Stock versus Stock' competition. The US auto parts retailer, **AutoZone inc** is one such company and in our view it is a 'master capital allocator', trading on a much more supportive valuation relative to **KONE** but being at least its equal in terms of quality. Due to the very strong performance of **Novo Nordisk** which has partly been reflected in its more expensive valuation, a reduction in its position to 2% funded the remaining balance for our **AutoZone** purchase.

### Master capital allocators

William Thorndike wrote a book back in 2012 entitled '*The Outsiders—Eight unconventional CEOs and their radically rational blueprint for success.*' As Sir John Templeton once famously said 'if you want to have a better performance than the crowd, you must do things differently from the crowd.' In the Outsiders all of the CEOs, including Warren Buffett, have taken a very different perspective towards capital allocation than other management teams. The effect? Stellar share price performance over a long number of years. Yet, had the book been written a decade later, we would argue that AutoZone would have a strong case for inclusion.

AutoZone is the number one retailer and distributor of auto parts in North America. Founded, as America celebrated its Independence Day in 1979, it opened its first store in Forest City, Arkansas. Now they have around 6,500 stores across every state in the US, stores in Mexico and Brazil and 12 distribution centres across the Americas. Its competitive advantage comes through its best in class stock availability, specialised customer service which develops goodwill from both its DIY retail customers and commercial customers alike. Its working capital management is excellent. Due to the consistency of AutoZone's product-sourcing demand, its suppliers can factor their own accounts receivables meaning AutoZone can support its own large accounts payable. It does this to such an extent that in spite of its very large stock inventory, its working capital requirement is negative. What this essentially means is that it sells its stock to its customers—who pay cash, before it has to pay its suppliers. This has a very important effect on how the business is managed. It means that AutoZone can effectively fund its store openings whilst generating cash. So that even though it prioritises reinvestment in the business it can spend whatever is left, buying back its issued shares, whilst maintaining an investment grade credit rating. The effect of this strategy over the last couple of decades has been stunning. Their shares in issue have declined by nearly 90% over this period. Thus, the impact on the earnings per share has been to increase it nearly ten fold! This combined with the underlying growth in earnings has created a strong compounder of shareholder value and share price performance. A performance we expect to continue given the ethos of the company and the misunderstood threats to its business model from electric vehicles and online competition. Visibility for the business is strong as its market is not in new vehicles but with cars aged 7-12 years old. Thus, changes to the car market will only affect AutoZone over a longer time period. We believe the online threat is also manageable as AutoZone itself has developed a successful e-commerce platform. Most importantly though is its excellent in-store customer service and knowledgeable employees, providing further protection and **resilience** to its business model. We invested a 3% position in the fund during December.

2021 was a very challenging year for both the management team at Avon and fellow investors in the company. However, as is often the case at these times, a valuable lesson has been learned from which we can continue to benefit in the future. It is realise that when you are in a hole, more often than not the best thing to do is to stop digging. Paul McDonald, the CEO of Avon Protection has recognised that to continue investing in the body armour division, acquired from 3M, would be akin to keeping on digging. This is due to the lack of '**design authority'** in product development, for the US Defense Logistics Agency (US DLA). So they have stopped digging, following a strategic review. Incremental capital will be allocated to the remaining core divisions of respiratory protection and helmets. This makes sense to us as the presence of 'design authority' in the respiratory and helmets divisions greatly facilitates product development and creates a surer path towards commercialisation. 'Design authority' effectively allows Avon to be the ones who create the design parameters within which future products are created. In its armour division this has not been the case, which has impacted sentiment greatly towards the stock. Following the company's strategic review we added to our position in December, as we continue to invest on a longer term horizon and recognise the interesting growth opportunities for the remaining core divisions.

### Quality Table

The Quality table highlights some of the key indicators we study when we analyse the Quality characteristics of the businesses in our fund and investment universe. The Return on Equity of our fund remains at a premium to the market. It is also interesting to note that during the past two 'Covid years', the fund's operating profit margin has been more resilient than the market's. As noted, our preference is to invest in businesses with strong balance sheets and our net debt to equity measure is again more attractive than the market on average. Finally, it is encouraging to note that the higher quality companies in our fund are valued similarly to the market, due to their strong free cashflow generation.

| Quality Table | Castlebay Fund | Market |
|---|---|---|
| Return on Equity | 42% | 19% |
| Operating profit margin | 20% | 7% |
| Net debt to equity | 59% | 89% |
| Cash conversion | 111% | 110% |
| Free Cashflow yield | 3.9% | 4.0% |

Source: Bloomberg as at 31/12/2021

**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. This newsletter should not be construed as investment advice.**

next **The changing face of retail and optionality**

At the beginning of December the fund took a 3.5% position in Next. It represents the changing face of retail with a multi-channel, multi-strategy approach which we believe gives this well-run business good investment **optionality**. In the age where our analogue world is increasingly being digitised, we regularly talk about the 'winners in technology', in the broadest sense. Next has a long history of innovation from the investment in its infrastructure platform through the development of its catalogue business nearly four decades ago. Whilst its store portfolio has seen capital allocated away from it over recent years, it still provides an important bridge in consumers' 'omnichannel' retail choices. As we have seen with our investment in **Dunelm**, the 'click & collect' service often creates convenience for the consumer and ease of service for the retailer—a win-win scenario. Next stores offer a similar service, acting as both a pick-up and return destination. It takes an insightful management team to think in such a long-term strategic manner. This is particularly the case when the re-orientation to its on-line business - helping it to be a winner in technology, had a short-term impact on their store revenues. Lord Simon Wolfson, as CEO, heads just such a team.

As we mentioned earlier in regards to companies with **'optionality'**, we believe Next is just such a company. So what do we mean by this term? The evolving nature of their business from a traditional retailer selling Next branded products provides this optionality. They have developed their 'Labels' division—where third party retailers use Next's website to offer Clothing, Home and Beauty goods. Their enlightened thinking centres on ensuring, as the company states, "we are our branded partners' most profitable third-party route to market" (Next's July interim 2021 report). Lord Wolfson knows that the success of Label rests on treating its 'Label Brands' as valued clients rather than suppliers. These are not just words, they have taken action by lowering the commission rate on clothing, in each of the last three years. Next are creating another win-win scenario; 'the optionality' comes from creating a marketplace for brands and benefitting whoever the winners may turn out to be. The falling commission rate, as they benefit from scale economies, only makes their platform more attractive for both existing and potential new retail brands.

The 'Label' strategy has been running for nearly 8 years now, but a more recent and exciting development is the creation of 'Total Platform'. This creates another string to Next's bow, by creating stand-alone websites for client brands and their creative designs. Next effectively takes care of everything else, from technology, warehousing, logistics and infrastructure. Such brands include Laura Ashley, Reiss and GAP. Executing well for these new brands on Total Platform is critical for the success of this new venture. That is why they are taking its development slowly by focusing on a few well-known names. However, the equity stakes taken in these reinvigorated businesses mean that the risks appear skewed to the upside. Evidence of yet more optionality that management has created for the business.

**Cost Analysis & Turnover:**

At the end of each calendar year we publish the costs of investment -not included in the ongoing fund costs we pay from our management fee. This is so our fellow shareholders know the total costs of investment over the year. The transactional costs are detailed in the table with £23k paid in dealing commission and transaction taxes of £139k, during the course of the year. These costs as a percentage of the average fund Net Asset Value (NAV) added 0.18% in costs to the ongoing fund charge. The fund turnover was 7% in the year (calculated as purchases or sales {whichever is less} divided by the average fund NAV), reflecting the way in which we aim to invest. It resulted in our average turnover declining from 13% to 12%, since the fund launched in January 2015. We remain very focused on ensuring we keep costs as low as possible and were pleased to negotiate a lower dealing commission rate to 5 basis points in 2020, following the growth of the fund in recent years.

| VT Castlebay UK Equity Fund | 01 Jan21 -31 Dec21 |
|---|---|
| Discretionary commission | £7,639 |
| Fund Flow Commission | £14,892 |
| Total Commission Paid | £22,531 |
| Commission as % of NAV | 0.03% |
| Transaction Taxes | £138,883 |
| Total Costs of investment | £161,414 |
| Total Costs as % of NAV | 0.18% |
| **Turnover 2021** | **7%** |

| VT Castlebay UK Equity fund | |
|---|---|
| **AVE TURNOVER** | **12%** |
| 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.

Thank you once again for your continued support and we hope that you find this series of letters of interest.

David F Ridland

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