

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 3 - Out of confusion comes opportunity!

Dear fellow shareholders,

The market is confused. As war continues to rage in the Ukraine and interest rates have risen rapidly in response to rising prices, in part as a result of the conflict, we believe the market is confusing so called 'long duration assets' with 'persistency of return assets'. This has presented a compelling opportunity for the long-term investor, prepared to look through the short term volatility and noise with which the market is currently preoccupied.

Welcome to the third letter in our series – Investing through uncertainty. The purpose of this series of letters is to help the reader gain a greater understanding of the **environment in which we have to save and invest**. It also allows us to set out how we can help to navigate through it, gaining 'security through compounding', from our different approach to investing.

Long duration assets, mentioned in the opening paragraph, is exemplified by 'the Teslas' of this world. Tesla has fallen 43% from its November share price peak last year and yet the shares are still trading on nearly a century of current earnings. Much faith is being placed in Elon Musk and his company. Over previous years when the cost of money was effectively zero, these uncertain future cashflows gave apparent support to the share price. As interest rates have risen and so too the cost of money, the value today of these cashflows is materially reduced. After this recent share price fall we can hardly say that the shares now appear cheap when they are still trading on ninety-four years of earnings! Contrast this with many of our businesses which have delivered persistently strong returns on equity and invested capital, over the years. Such businesses, as we have written about previously, have wrongly been described as 'bond proxies'. Given this misperception though, it is of little surprise that with interest rates rising they have been sold—like the UK Gilt market, since the beginning of the year. These sale proceeds have been used to fund the rotation into lower quality, cyclical, 'deeper-value' stocks.

However, this provides a very interesting opportunity. As our quality table highlights, our companies as a function of their free cashflows are being offered to us at a 4.7% yield. In spite of the ten year Gilt yield having risen to 2.5%, this still provides both a good nominal and relative yield. Over the seven and a half years that we have been running the fund, this 4.7% yield sits at the top end of the range. Ultimately, investing is pursued through a relative asset allocation policy. Even sitting on cash is an active decision, particularly when inflation at 10% is so quickly eroding away the real value of this cash!

Quality Table	Castlebay Fund	Market
Return on Equity	44%	18%
Operating profit margin	21%	12%
Net debt to equity	57%	88%
Cash conversion	86%	88%
Free Cashflow yield	4.7%	4.7%

Source: Bloomberg as at 30/06/2022

We don't know when this rotation will correct. Our analysis in last quarter's letter suggests it can't continue indefinitely though, as share price movements were so divorced from fundamental reality, particularly in the first quarter of the year. That's why it is an opportunity for the long term. Markets eventually obey the natural 'law of equilibrium' when it comes to valuation. What is more often ignored is that investment returns in relation to changes in valuation, over time, are predominantly a function of the fundamental returns businesses make. Cheapness on its own is not enough, as companies can become value traps when their capital returns fall below the cost of making those returns—and value is destroyed.

There is an old adage that investing is 'simple but not easy'. Investing would be simple if it weren't for our human responses to events. Responses that we shall explore more in this letter. These responses bring another dimension to investing and have to be managed alongside the fundamental analysis of the investee businesses which we own. So as we 'invest through uncertainty', in our complex dynamic world, how do humans respond to this changing system? In simple terms, humans respond either through **fear or greed**. Take the formation and bursting of asset bubbles not just recently but over the centuries; from the Tulip mania in 17th century Holland to the Global Financial Crisis of 2008—the effects of which are still being felt today!

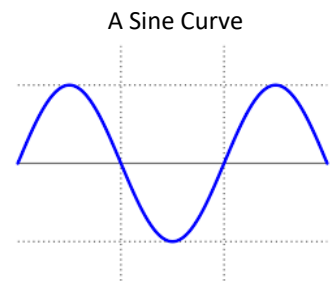
Bubbles can occur across many different asset classes. They tend to form through the fear of losing out which turns quickly to a fear of simply 'losing', as the bubble bursts. Before the agrarian revolution, our distant hunter-gathering ancestors had a simple choice when dealing with danger. It was one of either fight or flight. At the most basic human level, our paleolithic relatives felt their cortisol hormone go into overdrive, accompanied by adrenaline, when they came across danger or stress. It compelled them into **action** – to run away from the sabre tooth tiger. There was no time to sit and calmly reflect. They either escaped or were lunch! Fast forward to today, no tiger prowls in front of us – yet we are still hardwired to deal with such a threat in the same way. So asset bubbles form through human hubris often building up to a crescendo over time. Sudden corrections occur when reality sets in and that fear of losing out quickly turns simply to the fear of losing. Behavioural psychologists tell us that humans fear a loss roughly twice as much as we anticipate a gain. In light of this research it becomes more easy to understand why the Global Financial Crisis saw such a precipitous fall in confidence and markets.

We are wired for action when stress rises and so it would seem entirely sensible to act when either a real or perceived threat presents itself – such as a stock market crisis, economic volatility or political uncertainty. Action, both physical and mental makes us ‘feel better’. Dopamine is released in our brains to make us feel good about taking action, achieving a goal in the moment. Except that often, such action is not sensible. Often, it is entirely the wrong thing to do.

So in the context of our series looking at investing through uncertainty there are two important variables at play, which don’t necessarily work to support each other. Firstly, in a dynamic world, unexpected things happen at unexpected times—like Covid for example. Secondly, the way in which we deal with such situations as humans has to be considered as well. In his excellent book *Leaders Eat Last* Simon Sinek develops the point of delayed gratification. This delay of pleasure, is akin to our ‘investing for the long term’. It is not easy as it fights against our human impulse to take action now—to resist our longing for that dopamine hit. This incidentally, is the same hit we experience with a sugar rush when eating and drinking. It feels good at the time but is often soon overtaken by the pangs of regret!

In understanding this human condition we look for frameworks which tilt the probabilities of positive outcomes in our favour. This is why long term incentive structures are important to ensure that company managements’ interests are aligned with ours. These plans should prioritise decisions taken for the long term benefit of the business, customers and shareholders. More often, particularly if the incentive plan is misaligned, decisions can be taken for that quick win. Take the sine curve below. In heavy cyclical industries the cycle from peak to trough is generally more pronounced.

In the summer of 2007 the diversified miner Rio Tinto got into a bidding war to purchase the aluminium producer Alcan. This was a time of hubris, near the end of the commodity super-cycle of the noughties. On the sine chart opposite they bought Alcan for \$38bn right at the top of the cycle. All the miners were making money and there was a fear of losing out. Rio collected \$40bn of debt on its balance sheet in part to fund the acquisition, half of which needed to be refinanced the next year as the global financial crisis hit. Had they resisted the urge to jump on the bandwagon, they would have gone into the downturn in a much stronger financial position. The nadir of the sine curve would have been a much better time to create genuine long term value creation through acquisition. Yet so often in very cyclical sectors this proves impossible for management teams to effect.



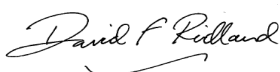
Countering such short term behaviour is why we are engaging increasingly with our investee companies when it comes to long term incentive plans? It’s because these plans create the framework for management to resist the siren calls of short term expediency. Particularly, as their cortisol stress levels rise in response to the increasingly loud cries of their short-term focused shareholders. For one, we are petitioning companies to have a material part of their long term award schemes focused on Return on Invested Capital (ROIC). It’s a useful framework, but not a panacea. For example, Unilever’s 25% ROIC component to its plan didn’t stop the CEO Alan Jope and his board bidding an egregious price for Glaxo’s healthcare division. So frameworks are fine, even to be encouraged, but we still need to watch out for primordial human responses, dopamine seeking executives and the consequences that may follow!

Avon Protection. Readers of our last few investor letters will be aware that we have talked about Avon Protection at some length. In the last quarter we heard that after nineteen years with the company and over five years as CEO, Paul McDonald is stepping down this year. We won’t go over the challenges noted previously, except to make the point that as investors we must still encourage capital allocators acting on our behalf to take calculated risks. They will not always pay off. Yet, part of the greatest challenge following the Global Financial Crisis and the easing of monetary policy, with the material reduction in interest rates, was that it created the conditions for a ‘liquidity trap’. Returns on investment became so low that many management teams didn’t feel the rewards were sufficient to offset the risks of investment. It is little wonder that economic growth was therefore impacted under these conditions. Paul McDonald’s legacy is one of a much more geographically diversified business with improved core technologies. The respiratory and helmet divisions are well set for future growth in an increasingly uncertain world. We thank him for all his work and wish him well for the future.

Activity during the second quarter was focused on maintaining our desired exposure to our companies as subscriptions came into the fund, as we remain fully invested. In conclusion, we believe that recent short term price movements have created a separation of valuations from fundamentals, providing a very interesting investment opportunity over the medium and long term for our fellow investors.

Thank you once again for your continued support.

Yours sincerely,



**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.**

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