Quarterly investor letter December 2022

Castlebay
Investment Partners

Security through compounding: Knowledge, Returns & Trust

Remember the second rule of investing as we seek 'Antifragile' companies!

Dear fellow shareholders,

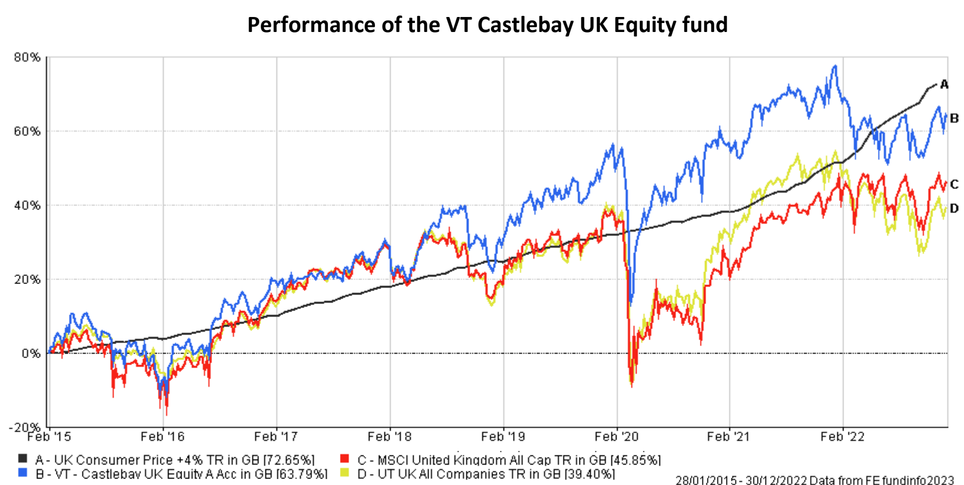
Looking back on 2022 it has been an extraordinary year in many ways. The aftermath of Covid, War in Ukraine, rising inflation and interest rates have all have grabbed the attention of investors. The first quarter saw 'lowly valued' sectors such as Oil & Gas rally strongly, as supply restrictions caused by the Ukraine conflict saw the oil price surge above $100 a barrel.

The cost of money, which for so long following the Great Financial Crisis (GFC) of 2008 was essentially free, suddenly rose as interest rates increased to counter surging inflation. The liquidity pumped into the financial system in the aftermath of the GFC didn't lead to inflation though, as the banks scrambled to repair their balance sheets following large asset write-downs. The rate at which money travels around the economy, known as 'velocity', was essentially broken. **More recently though, now that the banks are in a 'relatively' healthier financial position, excess money more easily flows into the economy, causing inflation**. The economic patient both corporate and individual has been given, over the last couple of decades, ever larger amounts of stimuli by the central banks. Now global debt is 2.5 times the size of the global economy and the cost of paying for this debt is rising!

Sector performance in the UK over 2022 was unsurprisingly dominated by the energy sector including Oil & Gas, with companies like BP and Shell leading the narrow market leadership charge. Narrow in the sense that only eight of the thirty-eight UK sectors actually delivered a positive return during the year, with Oil & Gas's 42% total return nearly twice that of the nearest competitor. Tobacco, Pharmaceuticals and Banks also made positive returns during the year.

Under these circumstances with our stated aim of investing in 'Quality companies', companies like Shell are not even in our Investment Universe and therefore can't be found in our fund. A quick look at their Return on Equity history, shows why. Going back from its last reported financial year in 2021, Shell has made a Return on its Equity (ROE) of 12%, -12%, 12%, 8%, 7% and 3% over the last six years respectively. Recent profitability over the last year will have been higher due to the spike in oil, but we don't invest on the basis of one year. We look for companies to earn a consistent ROE in excess of 20% over time. Shell and its peers fall well short of this hurdle.

Upside and downside capture ratios describe the extent to which a fund 'captures' the return on a given index or benchmark. As our investors and readers will already know, our purpose of generating 'security through compounding' over the long term, sees us focus on preserving and growing capital in real terms. That is why we normally compare performance in relation to the Consumer Price Index + 4% annualised on a rolling three year basis. However, we also understand that over time investors will look to see whether they would have been better investing in a tracker fund rather than in our active UK equity fund. One potential investor asked us to carry out such an analysis.



We think the output is interesting and so here are some observations from the analysis. Firstly, some principles to highlight: 1) if a stock at 100p halves in price to 50p, it needs to double in order to return to its original price. This may seem an obvious point to make, but the guiding principle that emerges from this mathematical certainty is that protecting capital on the downside in many cases is as important, if not more so, than trying to 'shoot for the stars'!

2) It is therefore no coincidence that one of Warren Buffett's most famous credos to investing is **Rule 1: Don't lose money; Rule 2: Don't forget rule 1!** He understands as well as anyone how difficult it is to derive positive investment returns when recovering from a large sell off in price. If we can limit such declines then it makes life much easier. The market rises and falls from week to week over time, driven by short term factors such as fear and greed.

Our analysis separates out the 'up' weeks from the 'down' weeks, then combines the returns together to derive the total return. This leads to some interesting insights. **Our fund essentially performed much better than the market on down weeks and not quite as well during the weeks that the market made a positive return**. In support of Warren Buffett's credo, limiting the downside has helped the fund's A share class to produce a return of 18% above that of the market, since inception— 8 years at the end of January 2023. Protecting capital more during times of market weakness, is likely due to the greater stability of the cashflows and earnings that our businesses generate. They are doing something different to that of the wider market and we like that difference; whether that's in the form of the superior products or the services they provide their customers.

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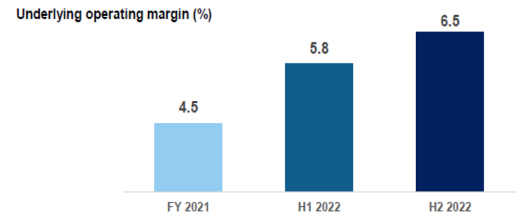
Compass delivered its full year results on 21st Nov 2022. Its performance is a good example of the theme of 'bifurcation' - where the strong get stronger and the weak get weaker. The food catering industry has seen massive disruption over the last three years. Yet their results show them delivering an improvement in their fourth quarter performance in relation to pre Covid levels. ‘Business and industry’, the last of its divisions to recover, rose above 2019 levels as fewer people working from home, helped the recovery.



Source: Compass Group at Nov 22

In line with 'the strong getting stronger' theme, a new business growth rate of 6% is also higher than the pre Covid run rate of 3%. Inflation, job shortages and supply chain issues are all factors in helping to make Compass's proposition more attractive. The operating profit margin is also continuing its recovery to the pre-Covid level of 7.4%, with its full year margin coming in at 6.2% - and as the chart above shows, the fourth quarter is continuing the recovery trend at 6.5%.

And what of the predicted recession? Well, Compass is a global company with a good spread of businesses, which through the upheaval of Covid has become even leaner. As the author Nassim Taleb writes, this is ‘Antifragility’ at work—whereby disruption actually strengthens an entity! The outsourcing food service sector was greatly impacted by Covid lockdowns, as business practices were materially altered. It has been the ability of Compass to adapt to this unforeseen event that we believe has strengthened its business model, as its rising margins and new business wins show. It is much more important not to predict the next Covid event, but rather to ensure beforehand that we own a group of resilient businesses that have the ability to adapt, evolve and prosper in the face of any unexpected disruption. That is the anti-fragile way. Increasingly we are seeking to ensure it’s also the Castlebay Way!

Quality Table: The premium in Quality of our businesses remains intact in comparison to the market, as evidenced by our Return on Equity and Operating Profit Margin figures. It is true that the market’s operating margin has increased slightly to 13% from 12% over last quarter. However, we would caveat the sustainability of this rise in profitability as much of it is driven from seemingly peak profits in more cyclical sectors. How sustainable will these profits be and by extension their margins? 2023 should give us a clearer idea as we move towards the summer. What remains the case is that we believe we have a collection of really good businesses which are being offered to us at a very attractive free cashflow yield valuation.

Quality Table	Castlebay Fund	Market
Return on Equity	41%	18%
Operating profit margin	20%	13%
Net debt to equity	64%	88%
Cash conversion	82%	85%
Free Cashflow yield	4.6%	4.7%

Source: Bloomberg as at 31/12/2022

Our companies are not only resilient but can continue to benefit from the economic uncertainty and inflationary environment, as they do something different which people value. This in turn allows the businesses to reinvest to create greater value in the long term, even if the market’s eye has been distracted by ephemeral news stories over the last year.

Cost analysis

Transparency is one of our main tenets at Castlebay. Since we launched our fund in January 2015, we have paid the ongoing fund costs which are normally passed on by fund managers to their investors. These costs paid by Castlebay amounted to £75,300 during the course of the year. We also publish the transactional costs associated with the fund which are not included in the ongoing fund costs.

The transaction costs reflected a year in which turnover was 0% which we will discuss on the next page. The commission paid is broken down into discretionary and fund flow commission. Discretionary commission is where we make an investment decision to buy or sell a holding in the fund based on our investment analysis. Fund flow commission is caused by investing as subscriptions come into the fund and redemptions go out. By its very nature these costs are not at our discretion.

VT Castlebay UK Equity Fund	01/01/22 - 31/12/22
Discretionary commission	£1,843
Fund Flow Commission	£32,857
Total Commission Paid	£34,700
Commission as % of NAV	0.03%
Transaction Taxes	£289,938
Total Costs of investment	£324,638
Total Costs as % of NAV	0.24%
Turnover 2021	**0%**

Source: AJ Bell 31/12/2022

The fund attracted strong fund flows in the calendar year and the majority of the transaction costs were in stamp duty. These costs as a percentage of the average fund Net Asset Value (NAV) added 0.24% in costs to the total cost of investment.

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Turnover:

Fund turnover was 0% in the year, taking our average turnover since launch (JAN15) to 11% from 12%. We calculate turnover as purchases or sales (whichever is less) divided by the average Net Asset Value (NAV) of the fund using the NAV at the start and end of the year.

There were no sales carried out in the fund during the year as we focused instead on allocating fund inflows to our favoured existing holdings which became more attractively valued during the year. We view low turnover as evidence of our approach to investing in quality businesses for the long term and not short term share price speculation. However, we also recognise that this is an out-turn of our approach and not the focus. If one of our invested businesses is no longer attractively valued, or the quality pillars have deteriorated, we will act and sell part or all of the position. You will see from the table that we have consistently demonstrated a long term approach to investment with continued low turnover in each of the eight years of the fund's life.

VT Castlebay UK Equity fund	
AVE TURNOVER	**11%**
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.

Source: Castlebay

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

We wish you all the best for the year ahead.

Best wishes

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