

Our guiding principles:

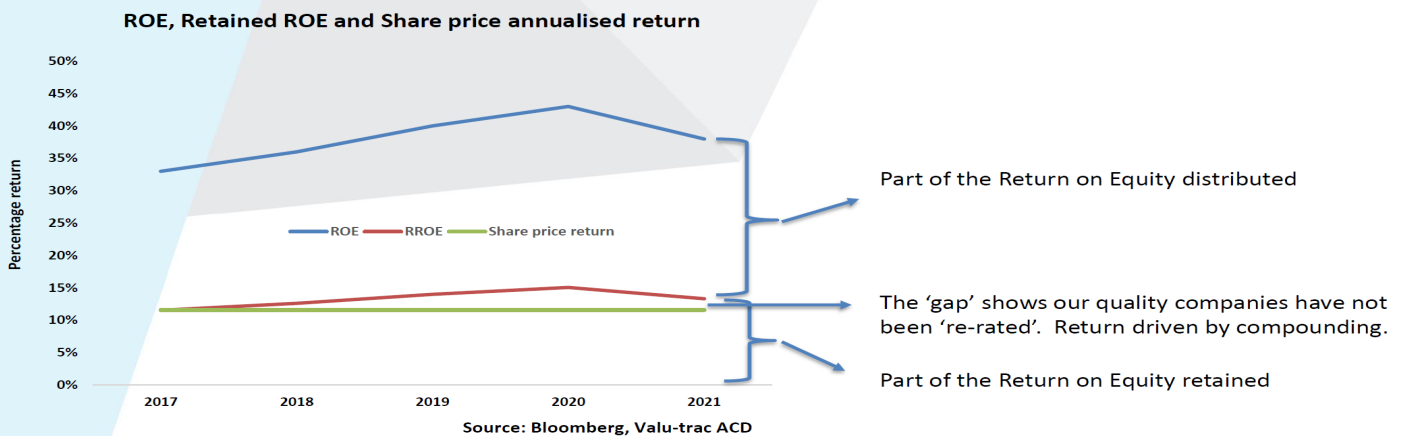
- Transparency & alignment of best interests with our fellow investors
- Adherence to our investment philosophy and process
- Independence of thought to avoid the market herd
- Focus on costs: management fees capped, low stock turnover

Dealing with inflation and our Investing Proof of Concept

Dear fellow shareholders,

Pixar, the Californian based computer animation studio, often create short animated films that use a new, difficult or untested technique. In their short film *Geri's Game* they used techniques for animation of cloth and of human facial expressions. The feedback from that process was later used in the *Toy Story Film Series*. Similarly, Pixar created several short films as 'proofs of concept' for new techniques for water motion, sea anemone tentacles and a slowly appearing whale. All this was done in preparation for the production of *Finding Nemo*. Other industries of course also use the principle of proof of concept: from Engineering in the design stage; to Business Development ahead of a new product launch. In the investing world such a process, although less common, can also be used. In truth, the same underlying principle is deployed. Invest a small amount of time, energy and resource before investing fully in a project. Once the go ahead is given, the large investment is then made. Yet often once investment is made there is often little analysis carried out to measure its success and to outline any change of course required. The 'sunk cost fallacy', dictates that human nature often ploughs on regardless, given the large amount of money and time previously invested in a project—even when the abandonment of it would lead to a better outcome.

At Castlebay, we launched our UK Equity fund based on the Charlie Munger principle, which we have discussed previously. Our investment careers, before the fund launch, had proved the Munger concept—'that in the long term the share price of a business follows the underlying returns that it makes.' So if we look back now, has the fund followed this concept over the last five years? A period which in many investors' eyes would be considered the long-term. We believe that the graph below shows that it has. Let's look at the three lines in turn. Firstly, the blue line is the average Return on Equity of the fund over the last half decade. If we were to compare this line to



that of the UK market, it would show that our companies have been materially more profitable, throughout this whole period. This should come as little surprise given our mantra—to invest in good quality businesses. Of course, due to the established nature of these businesses and their revenue growth profiles, not all of these returns are reinvested in the businesses. A portion of them are distributed to shareholders in the form of regular dividends and special dividends. For these 'distributed returns' the company can not obviously make a subsequent return on that capital. Instead, it is the retained earnings on which future returns are made. We term this the 'Retained Return on Equity' (RROE) and it is described by the red line in the graph. In order to prove the Munger concept then, it is this red line that should be closely matching the annualised share price return of the fund—the green line.

For clarity, it should be noted that the green line smooths out the more varied returns from year to year, to look at the total geometric annualised return. However, this in no way takes away from the proof of the Munger concept.

Another point worth noting is the charge that 'Quality investing', in a low growth environment, has benefited from a re-rating. If this were the case for our fund though, one would expect the green line to be above the red line. In other words a re-rating of the companies would have enhanced the return above that of the fundamental compounding returns produced by the retained return on equity. 'The gap' which we highlight to the right of the graph actually shows that our quality companies have not been re-rated. The return has been driven by the compounding of shareholder equity.

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.

We talked in our previous letter about rising bond yields, which are often the consequence of higher inflation expectations. They in turn pre-empt a tightening of monetary policy—increasing interest rates, in order to control these increase in prices. Recently, there has been more evidence that inflation is returning. As such it is worth looking at this and how the companies in our fund would cope in such a scenario.

Firstly, to ask a simple but important question. What is inflation? Inflation is simply the year on year rise in prices, which in the UK is mainly enumerated through either the Consumer Price Index (CPI) or the Retail Price Index (RPI).

So in 2021, prices are compared with those of 2020. Given that the Covid pandemic struck the UK in the first quarter of 2020, this base year was depressed as large parts of the economy were effectively shut down. So as the country now slowly emerges from the social and economic lock-downs, a rise in prices should be expected. How much and for how long will inflation manifest itself? In short, we have no clear idea. However, importantly our investment strategy is not based around getting such a call correct. Instead, our businesses provide us with ways to win in an inflationary environment, allowing us to continue to invest in them and benefit from the compounding of their shareholder equity returns.

We like to use a simple mental model when thinking about all the companies in the UK economy and elsewhere. The vast majority of businesses, around 90%, operate in what we would term ‘Perfect Competition’. This means that any excess profits that they may make in any given year are quickly competed away, as competition is attracted towards these excess returns. We have tried, albeit not always successfully, to avoid these businesses in the past.

Instead, our investment universe is designed to lead us towards the 10% of the economy that is ‘doing something different’. These businesses normally operate in monopolies, oligopolies or in niche areas and markets. In all instances they do something different, whether it is providing a superior service or product. Their competitive advantages could be through the development of brands which people trust or through patents protecting their revenues and profits.

Whatever the construct of their advantages, in an inflationary environment, it more often allows them to increase their prices as their cost bases rise. This in turn, allows these quality businesses to maintain their profitability and returns as inflation takes hold.

As investors, the added benefit is that these competitive advantages lead to a greater consistency of returns. This in turn makes it easier to allocate capital when the market may be voting against these businesses in the short term. It is all very well to say that when the price of our favoured assets falls that we will invest more. The acid test comes when such companies quickly fall 30 percent or more. It is at those times when one’s confidence is most tested. Such a time arose at the beginning of 2020. We took the rest of the cash we had in the fund and invested in companies like Diageo, Intertek, Estee Lauder and Accenture, all of which had fallen precipitously. For all of these businesses we were confident that their underlying operational excellence would endure.

During our regular meetings with investors we are often asked about our view on the UK market. It is reasonable to say that over the last few years the UK market has traded on lower valuations than over developed equity markets. Political and economic uncertainty have prevented a more constructive view of the UK market being taken. However, now that we stand on the other side of the Brexit process and the leading vaccine rollout program provides some greater clarity on a return to normality, the UK market is becoming increasingly prominent in the minds of asset allocators. So in global terms, the UK looks like an attractive market.

As our Quality table also shows, our fund compared to the UK market (excluding financials) offers twice the quality (ROE and Operating profit margin) with half the leverage and now sits on a more attractive free cashflow yield of 3.7%.

We continue to invest for the long term. However, we note that whilst we are still living through challenging times, from an investment perspective the opportunities being presented to us are very attractive.

Thank you for your continued support throughout these difficult times.

Kind regards

Quality Table End Jun 21	Castlebay Fund	Market
Return on Equity	39%	20%
Operating profit margin	20%	7%
Net debt to equity	51%	110%
Cash conversion	123%	140%
Free Cashflow yield	3.7%	3.4%

Source: Bloomberg as at 30/06/2021



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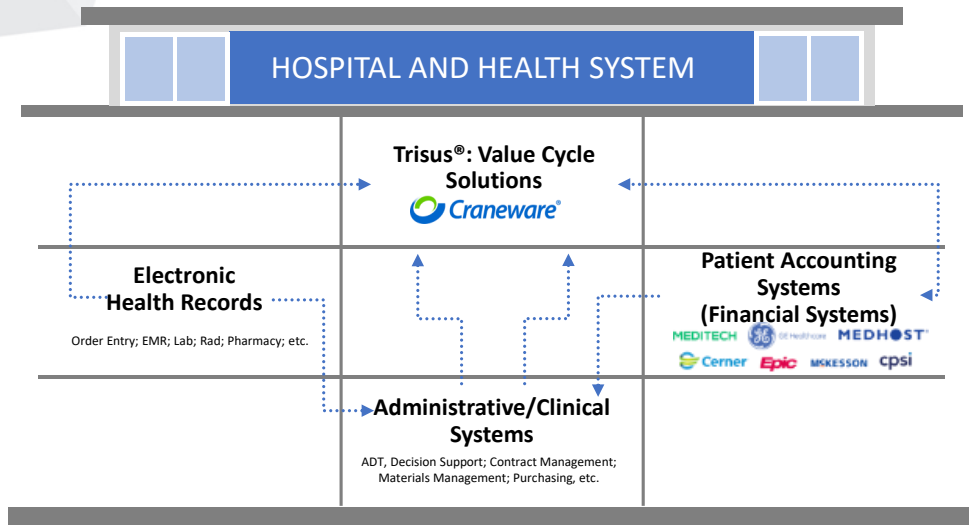
Craneware: the business and a new opportunity

There is a saying that in a gold rush, it is the person selling spades who makes most of the money. In the US healthcare market it is Craneware who is selling these spades. It offers Software as a Service (SaaS), designed at saving US hospitals money, by allocating resources more effectively. This healthcare resource-pool is vast—as spending on US healthcare of \$3.7trn is larger than the whole of the UK economy!

To extend our goldrush analogy, 60% of US healthcare spending is aimed at the clinical side. This is the part that attracts prospectors from all around the world, spending vast sums of money developing drugs that it is hoped strike a rich seam of future revenues and profits. Given the risks involved in drug development, like the majority of gold prospects, the failure rate is high. The remaining 40% of spend on US healthcare is on Administration and Overheads.

It is in this relatively less exciting area where Craneware is developing its business. In this context ‘dull’ is good. It generally attracts less competition. This in turn has given Craneware the chance to develop a series of award winning applications. Its own consultants help integrate these applications into the one in three US hospitals, where they currently have contracts.

Over recent years Craneware has developed its Trisus cloud platform. This is an important evolution in the business model of Craneware. Historically, its award winning applications worked to make their client hospitals more efficient in specific areas.



Source: Craneware

The Chargemaster Toolkit, for example is an automated management solution for capturing the cost of procedures and providing proper reimbursement for providers. Similarly, the Pharmacy ChargeLink, is a software solution to enhance charge capture, pricing, and cost management.

However, the development of the **Trisus: Value Cycle Solutions platform**, now takes these individual applications and merges them together on one remote cloud-based platform, creating a **network effect** of growing, value-enhancing information. As data continues to be fed into this network, so its value should continue to grow. This value is not merely useful for the existing clients of Craneware. It is quite possible that its reach spreads to the other US hospitals as they see greater budget savings manifest themselves amongst Craneware’s clients.

Recent corporate activity may also develop further this network effect. Craneware has recently announced the \$400m acquisition of Florida-based Sentry Data Systems. Sentry Data Systems’ SaaS solutions simplify the complexity of pharmacy procurement, utilisation and regulatory compliance. All these aspects help to maximise cost savings, improve patient outcomes and ensure precise regulatory compliance. Sentry also provides business intelligence and SaaS analytics solutions as well as consulting services.

Sentry generates \$92m in revenue and around \$23m in cashflows, which is broadly comparable to Craneware’s own metrics—meaning the acquisition roughly doubles the size of the company. The cash consideration will be funded from the Group’s existing cash resources, a new debt facility of up to \$140 million and the net proceeds of an equity placing. Yet Craneware’s strong balance sheet means the debt they have taken on to part fund the deal is very manageable, given the strong, visible cashflows the business currently generates.

The strategic rationale makes sense as the acquisition will help to accelerate the build out of the Trisus Platform and the network business model. As such we invested more in Craneware shares to offset the effects of the equity issuance and maintain our current stock position weighting of 4%.

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