Quarterly investor letter June 2020

**Our guiding principles:**

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

## The first five years of the fund...from Tommy Cooper to Harold MacMillan!

Dear fellow shareholders,

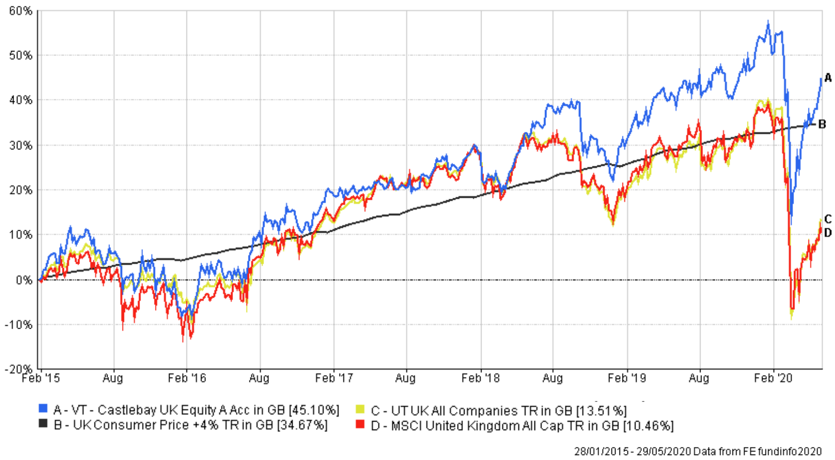
The fund celebrated its fifth anniversary during the first quarter of this year. As such, it had been our plan to look back and reflect on the first half decade of the fund's life. However, an unwelcome visitor arrived on our shores at the same time, to dominate our thoughts. Whilst many countries are still fighting a rising rate of the COVID-19 infection, the UK has managed to bring down its infection rate considerably. Time will tell how long this lasts and whether there is a second wave of infections. For now though, attention is turning towards economic considerations and how to get the UK back on its feet again.

It is interesting to note that the Bank of England is now forecasting that Britain is on course for a 'V-shaped' economic recovery. Andy Haldane, the chief economist at the Bank, noted recently that 'the coronavirus recession was likely to be less than half as bad as the Bank feared in May.' Risks do remain, however, as the UK economy still faces an unprecedented slow-down. As the employee furlough scheme closes at the end of October, unemployment is likely to rise. This could threaten the extent of any economic recovery—as two thirds of the UK economy is based on consumption.

As the picture in the UK does start to improve, it is worth reflecting belatedly on the fund's fifth birthday. We aim to highlight some of the things we have learned along the way and to note, as is our normal practice, times when I have made mistakes. In our minds, five years is still a short period in investing terms. However, we will set out some observations that we believe reflect the benefits of our investment philosophy and approach.

Firstly, a general observation. **Patience can be rewarded in investing, but not always.** Throughout the life of the fund we have endeavoured to be patient when investing in higher quality businesses, by not overpaying for the privilege. We have documented many examples such as Unilever, Colgate-Palmolive, Diageo and Intertek—to name a few, where we have waited for the market to present us with better valuation opportunities. The other crucial aspect of patience though, centres on the power of compounding. Once we have invested in these quality businesses, time generally works in our favour. It helps to compound returns and generate superior value-creation for investors, which the market eventually recognises. It is interesting to note this phenomenon at work, in the performance chart below.

This chart looks at the end of May 2020 performance, in order to compare it directly with the Consumer Price Index - the figures of which are produced with a delay. Here you can see that over the first three years of the fund, performance largely reflected that of the market, our peers and the 'UK Consumer Price Index (CPI)+4% p.a.' return. It is only after this period that the superior compounding returns of our businesses was reflected in stronger performance. Encouragingly for us as active managers, the fund's performance, both as of writing and as at the end of May 2020, has negated the impact that the Covid crisis has had on the market.




In other words the fund's blue line 'A' is higher than the market's pre-Covid February 2020 high (Red line 'B'). In this low return world, the MSCI's market return of 10.5%, since the end of January 2015, is only 1.2% above the total rise of inflation (CPI) over the same period. Another way to look at this is to compare the CPI+4% return of 34.7% against the 9.3% return of CPI. The vast majority of the return has therefore come from the '+4%' risk premium—which is designed to compensate investors for investing in UK equities, a so called 'risk asset'. For our patient investors, over the last five years, the businesses in our fund have helped to protect investors from both inflation and the risk premium. The market has only just covered rising prices.

We noted earlier that patience in investing is often rewarded, but not always. So why is this the case? In investing we believe there are many businesses which don't improve over time. Companies operating in perfect competition often see any super-normal profits quickly eroded away. These types of firms often end up destroying value by generating growth, where the costs exceed the returns on capital. As such, investing in a 'cheap' company can end in a negative outcome.

**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.**

The investment turns into a value-trap and the cheap valuation erodes, to reflect a deteriorating underlying business. It is clear that in these cases, time is not on the side of the investor. The longer one waits the more value can be destroyed. The temptation to invest more capital, in 'averaging down', can lead to further losses. In summary, patience can be rewarded by investing in good quality businesses and allowing returns to compound over the long term; whilst eschewing the siren calls of cheap, low quality companies.

**How have we learned from my mistakes?**

Tommy Cooper once told the story of the gentleman who went to his doctor and said 'I think I've broken my arm in several places, what should I do?' 'Well,' said the doctor, 'you shouldn't go to those places!' This section of the letter isn't merely an excuse to recall one of the great comedian's quick fire gags; it's linked—however tangentially, to how we try to deal with mistakes. Once a mistake has been made, we try not to go there again! Over the years our approach has evolved to help with this endeavour. For example, our investment checklist provides a good system to help reduce the risk of making the same mistake twice. It can never guarantee success, but we can observe that our error rate appears to have reduced over time. Our investment universe is another way in which we seek to avoid investing in lower quality businesses that may be attractively valued. It was borne out of my investment in Tesco. I overestimated the quality of the business, based on its leading market share position and superior operating margins. The introduction of our multi-factor screening was designed to reduce the risk of investing in businesses that destroy value—where the cost of making their returns exceeds the returns on equity and capital employed. We have sold several businesses on this basis over the years. Companies like Shire Pharmaceutical, Wood Group and Mitie Group were all identified as 'mis-allocators' of capital—where management had overpaid in acquiring assets. Subsequent share price performance supported this analysis, with the sale of these stocks preserving capital for our shareholders.

**Finding resilient businesses**

Given the extent to which Covid-19 has dominated the news recently, it is worth remembering that it is only five short months ago that the World Health Organisation (WHO) named the disease. Nine months ago no cases had even been officially reported. To say that it came out of 'left-field' is an understatement; and yet to paraphrase Harold MacMillan 'events, dear boy', can blow not just governments off course, but companies. It is why we seek resilient businesses that can withstand events that, as Covid-19 illustrates, often come out of nowhere. It is one of the reasons that we have consistently presented our quality table in our literature. It highlights that our businesses are doing something different to the market—in a good way. The are making superior returns on equity through operational excellence, whilst employing nearly half the leverage of the market. This generally means that they can deal better with the bumps in the road that occur. In our experience, it is usually balance sheet issues that cause companies most concern. When the sky is blue, management teams can be tempted to increase leverage too much in order to produce, as business schools would teach them, 'optimal returns'. However, resilience points to businesses that can deal with the complex, dynamic uncertainties of our economy, ahead of time. They fix the roof when the sun is shining and only borrow money for the extension, if it can be afforded, even if the next storm appears unexpectedly.

Resilience is often reflected in our metric of 'standard deviation of Return on Equity', which is one of the factors used in our Investment Screening. The lower the figure the more stable business returns tend to be. This is also often reflected in a narrower valuation range of Price/Earnings multiples. As long term investors, we have never focused on the volatility of the fund's Net Asset Value (NAV) price. Yet, experience leads us to a conclusion that challenges a well established tenet of finance. The orthodoxy of finance states that there is a direct relationship between 'risk and return;' i.e. in order to make a higher return one has to take on greater risk. Risk is defined (badly in our view) by the extent that the fund price moves up and down (volatility). Investing in higher quality businesses has allowed the fund to produce superior returns, but which have been less volatile than the returns of the market. Such an outcome challenges directly the financial wisdom of this 'risk and return' theory.

| Quality Table | Castlebay Fund | Market |
|---|---|---|
| Return on Equity | 38% | 24% |
| Operating profit margin | 22% | 13% |
| Net debt to equity | 46% | 87% |
| Cash conversion | 94% | 78% |
| Free Cash Flow yield | 4.0% | 6.2% |

**Source: Bloomberg as at 30/06/2020**

Throughout the first five years of the fund, David MacNeil and I have always emphasized the importance of the relationships we have with our fellow investors. It is your understanding of our philosophy and process that ensures Castlebay can continue to invest in the business, seek to get better and continue to create value for our shareholders.

David and I would sincerely like to thank you for your ongoing support and patient investing.
Kind regards

David F Ridland