Quarterly investor letter September 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**

Agency—who controls it and why it is so important?

Dear fellow shareholders,

Twenty years ago, sitting at my desk, as part of the UK equity team at the then named Britannic Asset Management, I came across an excellent publication called the Analyst. Its sub-title was 'Identifying outstanding companies'. Given my evolving belief in investing in good quality businesses, it struck a chord with me. One article by Andrew Barrett, which referenced heavily Benjamin Graham's edict to invest with a 'Margin of Safety', has greatly influenced my thinking over the past couple of decades. There also exists a 'reading principle', whereby one should prioritise re-reading seminal papers and books that have stood the test of time. As we all change over time, it makes sense to revisit and review sources that confer timeless wisdom and ideas, rather than focusing on the fads of the day. This process can often change one's perspective and help to think about things in a different way.

So having re-read and thought about this Margin of Safety paper, we offer some thoughts. A new idea emerged from this process— 'the agency of investing'; who controls it and why it is so important. To illustrate this idea we put forward two different agents of change - **'Market agency'** and **'Company agency.'** We are looking at this, of course, from the perspective of investment returns. Under the 'market agency' model a re-rating of the share price in relation to earnings and cashflows creates a positive return; whilst a de-rating produces the opposite, negative return. 'Company agency,' as the name suggests, sees companies control much more of the investment return, through reinvesting at high rates of return and the creation of shareholder value. The 'Munger principle' we often quote speaks to this—that the share price reflects the underlying returns of a business over the long term. In this principle the longer one invests in a company the less a re-rating or de-rating, i.e. market agency, will influence the total return of the investment. The following graphs help to show why Quality is so important to us, why we are not 'deep value' investors and also why valuation discipline is important.

Chart 1 illustrates buying a good quality business with an expensive valuation. As you can see from this approach, during the first three years of the investment, the investor is at greater risk of the shares de-rating because they were expensively valued at the time of purchase. In all these charts, it is important to note the direction in which the 'Intrinsic value' line is headed. Here, it is rising over time. Indeed, by Year 3 the value the business has effectively caught up with the higher purchase valuation and a subsequent 'Margin of Safety' is delivered as the intrinsic value continues to grow towards year six. So who has agency? Is it the market or the company? The answer is that both influence the total return. Importantly, the Quality investor here is handing some agency to the market in the early years. The investor is hoping that a sharp de-rating does not occur in the first three years. Such a de-rating would increase the time it would take for the company to compound its returns and generate a positive real return for the investor. The investor may of course be fortunate that no such de-rating takes place. However, ex ante—at the beginning of the investment period, such a strategy is influenced by both **market and company agency**.

Chart 1

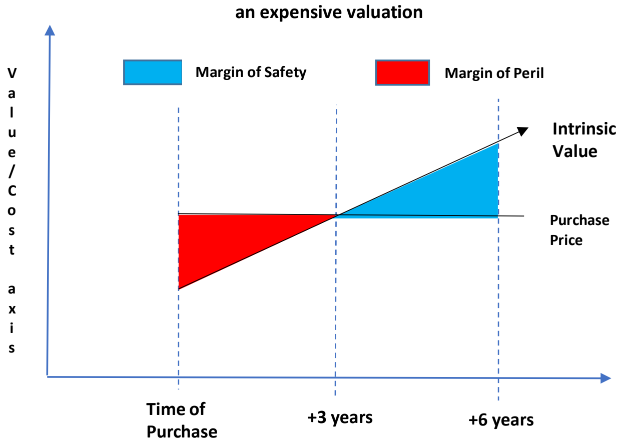
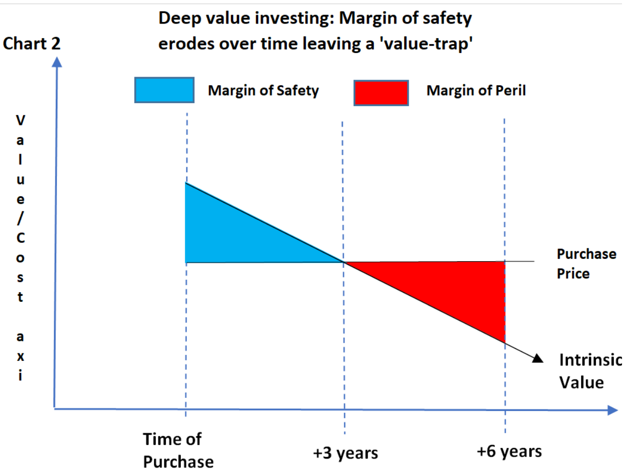


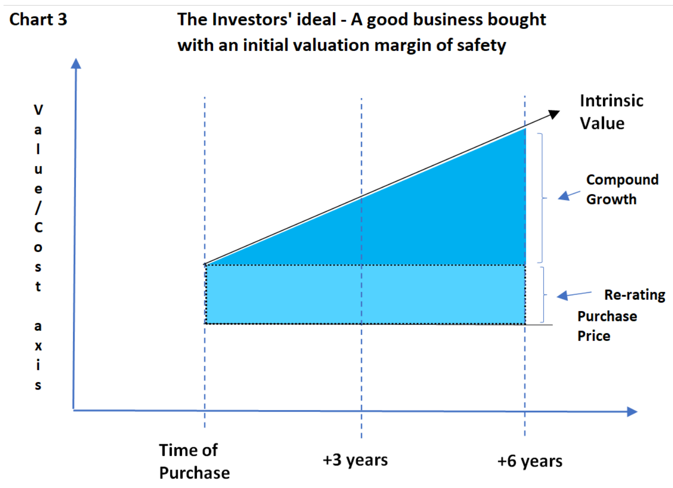
Chart 2 represents 'deep value investing'. A valuation margin of safety exists at purchase, but the business itself is weak. The philosophy of deep value investing centres on the belief that the investor can successfully identify undervalued companies. At purchase, often very little thought is given to the quality of the business. The investor then waits until the market realises that they are right and re-rates the shares. At which point this stock is sold and the capital recycled and reinvested in another 'undervalued' business. In this example it is pretty obvious that in order to make a positive return, **market agency** is at work. The challenge over the last decade for deep value investors, has been that the market has not been prepared to re-rate many of these businesses. In a low growth environment, lower quality businesses are left fighting for scraps and survival, as they often operate in sectors of 'perfect competition.' Time is not on the side of the investor here. As the 'intrinsic value' line heads downwards, by year 3 the margin of safety has been eroded and all that is left being held is a value-trap!

Chart 2



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.

Chart 3 represents a **'Quality value'** approach. It is what we seek to achieve. Our approach focuses on identifying resilient, quality businesses, whilst not overpaying for them at purchase. If we can affect this strategy, as the intrinsic value line rises over time it becomes harder for the market to ignore the value the company is creating. This can produce both a re-rating and strong growth in shareholder value through the reinvestment of capital.



In this process, whilst market agency could be said to be contributing to the return through the re-rating, the company is effectively forcing the market's hand. By creating so much value the company is demanding that the market reappraise the stock. If we imagine a continuum, then this 'Quality value' approach sits very much towards the **Company Agency** end of the spectrum. As a further point, the lighter blue section of the graph represents the extent to which the re-rating contributes to the Margin of Safety. What is clear, is that over time as the intrinsic value grows, the darker blue, 'compound growth' element contributes an ever larger part to the overall Margin of Safety. This is consistent with the Munger Principle we mentioned earlier.

KONE: We reduced our exposure to KONE in mid-August. At that point, KONE's total share price return had annualised at 16% CAGR over the last five years. It had materially outperformed the FTSE All Share's return over the same period, both from a Sterling and Euro perspective. (FTSE All Share 2% CAGR Sterling, -3% CAGR Euro.) There are growth tailwinds in KONE's markets with the average life of elevators in Europe requiring more replacement expenditure; and growth in Chinese and Asian markets remaining strong. However, as the share price was trading at €70 on €2 of earnings, it meant it was trading on a P/E of 35 years.

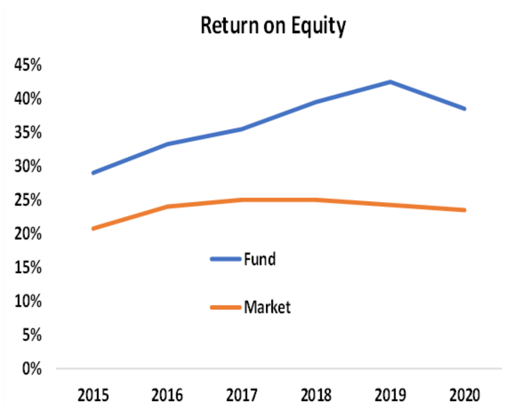
Given its low retention ratio, this resulted in a Retained Return on Equity (RROE) of only 7%. Consequently, it was trading c.5 years expensive. Our reverse Discounted Cashflow analysis suggested a required earnings per share growth rate of 22%, annually, in order to support a 12% annualised total return over the next five years. Historically, cashflows have grown at 14% so there would appear to be a gap and a rising risk of the market de-rating the shares. Given the growth runway in KONE's markets there is a chance the company will grow cashflows by more than it has done in the past five years. However, as per our 'agency' discussion earlier, the higher valuation rating was transferring increasing agency risk to the market.

As such, we reduced our weighting in KONE from 3.5% to 2%. This allows us to benefit from continued growth, whilst being able to allocate further capital in the future, should the company be de-rated.

Seeing the woods for the trees: Are we overpaying for quality?
It is often difficult to see the woods from the trees in the investment world. Over the course of our careers the market has become increasingly myopic in its investment horizons. It appears to us that the vagaries of Mr. Market get played out over increasingly smaller time frames. All of which sometimes makes it difficult to take a step back and get a true perspective. That is why, taking an admittedly small step when we launched our fund in 2015, we encouraged our investors to focus on the output from our quarterly letters, rather than the monthly factsheet. The letters have given us greater freedom to set out how we do things and the thinking behind what we do, whilst encouraging our fellow investors to look to the longer-term.

As we have consistently mentioned in previous papers, we seek to invest in good quality businesses whilst not overpaying for the privilege. The Return on Equity and Free Cash Flow Yield graphs show two important metrics and how they have changed over the life of the fund.

Firstly, our fund has consistently invested, since launch, in companies earning a materially higher return on equity (ROE) than the market (FTSE All Share ex Fins). If financials had been included in the graph, it would have lowered the overall market's ROE further. This would certainly seem to be consistent with our mantra of buying good quality companies – were one to take ROE as one measure of quality.



Source: Castlebay 30/09/2020

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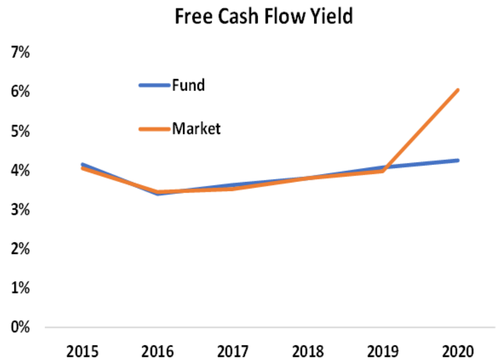
Secondly, the Free Cash Flow Yield graph shows that from a valuation perspective our fund has consistently been attractively valued compared to the market. In other words, we have not overpaid for the privilege of owning our higher quality businesses – that is until this year. In 2020 there appears a material divergence in valuation between our fund and the market.



There are two components to the Free cash flow yield:

$$\text{Free Cash Flow yield} = \frac{\text{Market Free Cash Flow}}{\text{Market Capitalisation}}$$

Free cash flow is a backward looking figure based on cash flows earned in the past year. This is now coming under pressure given Covid-related downgrades to earnings and cashflows. We have suggested over recent months that this gap in free cashflow yield, between the market and our fund, would start to narrow as events caught up with this free cashflow figure.

Quality Table End Jun 20	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

For example, is BP, which earned £20bn in cashflow from operations in 2019, going to repeat that feat this year? A figure half that amount would be considered a good outcome in this environment. Such impacts to large constituents of the market will indubitably reduce the free cash flow of the market and with it the free cash flow yield.

Have we seen this occur already? Our two most recent Quarterly letters appear to answer this question – helping us see the wood for the trees. As you can see from the Key Metrics Table End June 2020, the free cashflow yield of the Market was 6.2%, materially cheaper than our fund.

Quality Table End Sep 20	Castlebay Fund	Market
Return on Equity	37%	23%
Operating profit margin	21%	12%
Net debt to equity	57%	84%
Cash conversion	107%	94%
Free Cash Flow yield	3.9%	4.5%

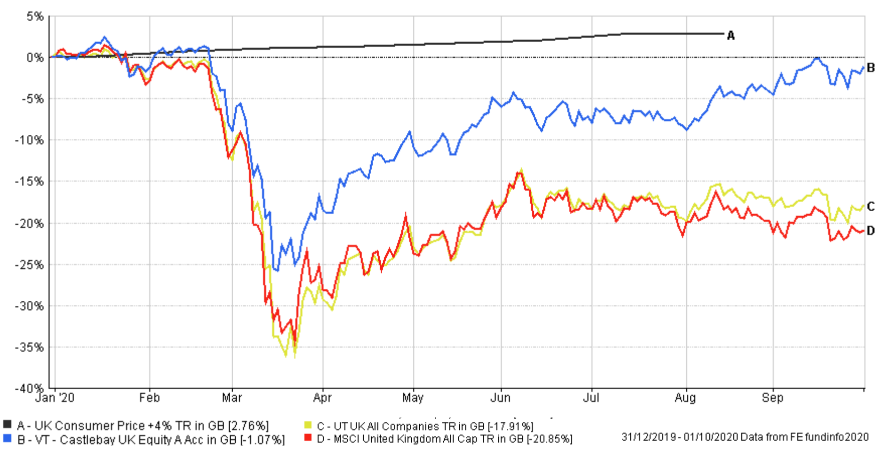
Source: Bloomberg as at 30/09/2020

However, since last quarter this free cashflow yield has declined to 4.5%. Given that the market has fallen 3.5% during the same time, the decline in free cashflow yield shows how cashflows have come under pressure.

Conversely, our fund's free cashflow yield has declined by 2.5% - i.e. from 4% to 3.9%, whilst the fund has seen its NAV per share rise by over 5%. In other words, at a time when the market continues to see declining earnings and cashflows, our businesses have experienced upgrades – perhaps an indication of their resilience, at this time.

As you can see from the performance profile in the adjacent graph, in 2020 the fund has fallen circa 1% compared with the market's decline of 21%.

As the denominator of the free cashflow yield declined due to the market's weakness, this naturally put upward pressure on the market's free cashflow yield—until falling cashflows brought the market's valuation much more into line with that of our fund.



Are we overpaying for quality?

Looking at both the Key metrics tables above, it is worth noting that at circa 4%, the Free Cashflow yield of the fund remains at an attractive level. Further, the Covid sell-off has allowed us to become fully invested for the first time, whilst increasing the underlying quality of the businesses in our fund. As such, the fund has maintained its 'Quality value' discipline in this challenging environment.

Thank you for your continued support through these difficult times. We hope your loved ones are well.

Kind regards

David F Ridland

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