Quarterly investor letter December 2019

Castlebay Investment Partners

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**

Investing using Mental Models
Behavioural Finance: Can we avoid being fooled by randomness?

Dear fellow shareholders,

This letter is the fourth in our series of **Investing using Mental Models**. We all apply mental models in our daily lives and our previous three letters discussed the effects of over-confidence, anchoring and diversification of risk. In our final letter of the series we discuss '**Hindsight bias & Randomness**'. The study of many of these human biases has given birth to a whole new discipline in finance and investing—behavioural finance, which highlights the effects that these biases can have on investors. We have designed our investment approach to limit the negative effects of our own biases, when we invest on behalf of our fellow shareholders.

Hindsight Bias

When analysing past performance in investing, Hindsight bias should be always be monitored. In effect this bias describes the fact that 'you didn't know it all along, you just think you did!'. The great financial crisis in 2008/2009 provides a good example of hindsight bias. Lower quality companies that had been priced for bankruptcy rallied the most as quantitative easing was introduced at the beginning of 2009. It is easy to look back and assume that this was always going to be the case. However, our investment philosophy is predicated on providing a greater probability of investing success ahead of time, when looking at a wide range of potential outcomes. That is why we like to invest in companies with so called 'strong balance sheets'. In many cases our companies have more cash than debt in their businesses. When this occurs the business is referred to being in a 'net cash position'. One could argue that a balance sheet with low or no debt has not been 'optimised' so as to enhance/maximise returns for shareholders. However, we prefer what we term as sustainable balance sheets. For example, the 'worst event' in the past does not predict a future event that then becomes the new 'worst event'. So we prefer balance sheets to have ballast for navigating future storms. This helps businesses to have greater flexibility to alter course during periods of difficulty. If there is low or no debt, then during a credit crunch, businesses will likely be less impacted by creditors recalling loans; forced sales of assets or the raising of capital on unfavourable terms, all to escape insolvency.

The investment log that we keep also helps to prevent hindsight bias. We set out clearly why we have bought or sold companies in our fund at the time of the respective trades. This helps us to assess more accurately, the positive and negative investment decisions made, when analysing previous decisions. Using such a structure helps limit the potential to oversubscribe skill to a situation where we may have been right, but for the wrong reasons. Importantly, such a process helps us continue to evolve and develop our investment process.

Randomness

The world is a complex dynamic system. As humans, our brains have trouble comprehending that much of this world is composed of random, non-ordered events that don't follow a natural sequence. Nassim Taleb's book, 'Fooled by Randomness', eloquently describes this random world. We are "fooled" by random effects when we make the mistake of attributing a causality to things that are actually outside of the domain of our control. Randomness is often disguised as non-randomness. i.e. luck is often presented as skill, in a similar way to hindsight bias. If we think about businesses, it is why we believe it is so important to invest with a margin of safety. The creation of our Investment Universe is designed to focus our investment efforts only on high returning, quality companies that have demonstrated, over many years, that they can maintain their competitive advantages. This should reduce the element of luck: where a business temporarily earns supernormal profits, 'skilful management' is feted, the share price is re-rated on elevated earnings—only for competition to come in and prove the advantage is only temporary in nature.

Taleb goes on to say that "if we don't course-correct for this fooled-by-randomness effect – our faulty sense of pattern-seeking – we will tend to see things as being more predictable than they are and act accordingly." This does not mean that all success is luck or randomness. There is a difference between 'it is more random than we think' and 'it is all random.' Our investment models and checklists have helped greatly offset the deleterious effects of these behavioural biases, limiting the extent to which we are fooled by randomness.

Our fund celebrates its fifth anniversary at the end of the month, thank you for your support and we look ahead to the next five years.

Yours,

David F Ridland

The value of investments can fall as well as rise & you may not get back what you invest.
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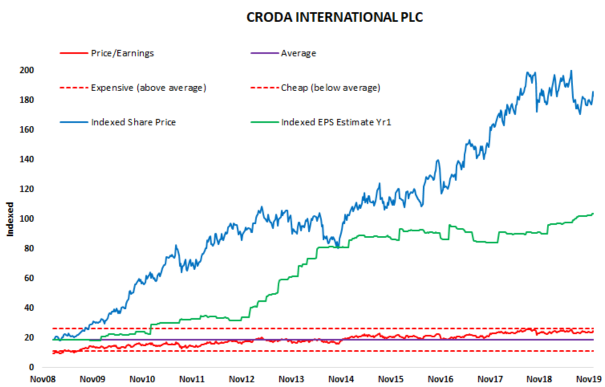
In focus: Croda & Capita

Croda International plc is the holding company for a group of companies that manufacture a diverse range of chemicals and chemical products, including oleochemicals and industrial chemicals. Croda supplies its items to companies that specialize in the personal care, pharmaceutical, plastics, food processing, nutrition, fire prevention, engineering and automotive industries. The unifying theme of Croda's products, is that it '**coats things'**. In consumer care it produces the active ingredients that help to cover the skin of the user, helping to smooth the skin. In agricultural crop care, their formulations help companies to develop efficient, complex and safe products that help farmers achieve superior yields.

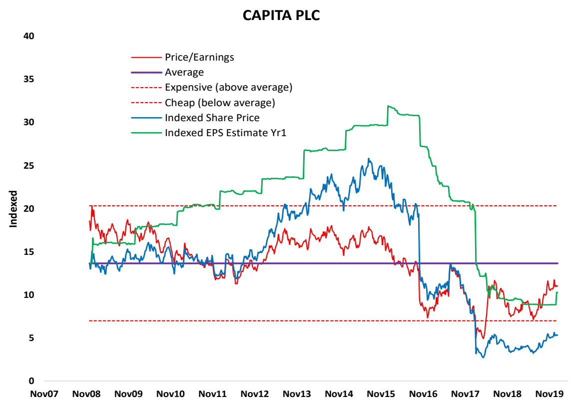
Croda derives many of its sales from oleochemicals—products made from natural oils. As such it acquires much of its raw materials from sustainable sources. The company has structured its business into three main units: **Consumer Care** which makes ingredients for the personal care, health care and agricultural industries; **Life Sciences** which is involved in the manufacture of excipients such as fillers and preservatives; and **Performance Technologies** which includes lubricants, coatings and polymers, polymer additives, oilfield chemicals and home care ingredients. Croda does have a fourth division, **Industrial Chemicals.** It makes process additives—basic fatty acids, glycerine and other by-products. However, this division is playing an increasingly immaterial part in the future prospects of the business.

The investment case for Croda is predicated on it being a 'consistent compounder'. For example, its tangible book value per share has grown at 25% and 24% over the last five and ten years respectively. Shareholder equity has grown at 19% annually over the last five years. Given their niche coating products and active ingredients, particularly in Personal Care, we believe that the barriers to entry will likely remain high in the future. Their '**moat'** comes in two main forms – Intangibles and High Switching costs. As long-term investors we are comfortable with a valuation margin of peril (c20%) which given a retained return on equity in excess of 20% makes the shares roughly a year expensive. Also their recent slight decline in incremental cash returns on average gross equity, is due to slower short term growth, not declining operating profitability. As we have mentioned in the past, shareholder value is preserved and created much more effectively when management focus on returns, eschewing unprofitable short term growth.



Rising political risk, led us to reduce our position in Capita at the beginning of 2019. As the political polls in the UK narrowed, the probability of a renationalising Labour government coming to power increased. As a result of this rising risk, we halved our exposure to both Serco and Capita at this time. Frustratingly, both companies then performed strongly over the course of the year. However, we remain sanguine about this for two reasons. Firstly, we did not sell out of our positions entirely and so benefited in part from their subsequent performance.

Secondly, it is generally better to judge one's decisions through the lens of 'the decision making process' rather than focusing merely on outcomes. We identified the risk, determined an appropriate exposure in both stocks and then took action. In our shareholder letter, in which we espouse the dangers of hindsight bias, it would seem peculiar to assume that the election result was a foregone conclusion. We must resist the clarion call that 'we knew the outcome all along'. We didn't.



Following the re-election of the Conservative and Unionist Party in mid-December, we increased our position in Capita. Whilst the shares had performed well in the year to December, as mentioned, the company continues along its path back to prosperity as operations are restructured.

The valuation remains supportive despite the recent strength in share price and we believe the turnround in the business will continue to bear positive returns for us as share holders.

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Attribution & Cost analysis

Attribution analysis

As we approach our fifth anniversary, since the launch of the fund at the beginning of the 2015, the fund continues to see the benefits of our businesses compounding their high returns. It is encouraging to note that 2019 was positive from a Net Asset Value growth perspective, with the fund (A Acc) increasing by 23%. By comparison, our benchmark 'Consumer Price Index (CPI) + 4%', increased 5% (to mid November) and the UK Market (MSCI UK) increased by 18%.

Top 5 Contributors 2019	%
DUNELM GROUP	3.5%
AVON RUBBER	2.7%
DOMINO'S PIZZA GROUP	1.6%
SERCO GROUP	1.5%
BRITISH AMERICAN TOBACCO	1.4%

Bottom 5 Contributors 2019	%
IMPERIAL BRANDS	-0.5%
ROLLS-ROYCE	-0.5%
RECKITT BENCKISER	0.3%
BIOVENTIX	0.3%
CRANEWARE	0.3%

Source: Bloomberg 31/12/2019

It is interesting to note, with the exception of Avon Rubber, that the top contributors in 2019 were companies that had previously been weak due to their respective issues. This provided investment opportunities. Dunelm had some short term indigestion following the purchase of the online business WorldStores in late 2016. However, it has subsequently confounded the doom and gloom that exists in the retail sector, by focusing on the evolving 'click and collect' retail culture. The founding family remain significant shareholders in the business (owning half of the equity) and the CEO, Nick Wilkinson, is able to allocate capital and manage the business with an eye to the long term.

Avon Rubber has continued to grow with contract wins and the 3M ballistic (protective wear) acquisition. Trading remains positive at Domino's despite some unrest between the management and some franchisees; and Serco is finally coming through the other side of its restructuring, reflected in growing investor confidence and contract wins.

Both Tobacco investments of BATs and Imperial Brands ended the year strongly, with Imperial posting a marginal decline in attribution over the year and BATs a top 5 contributor. We will discuss the issues investors face in Tobacco in our next letter.

Cost Analysis & Turnover

Transparency and a Focus on costs are two of our partnership guiding principles. As we always do in the final letter of the calendar year, we provide a breakdown on the costs of investment during 2019. As you know, we pay all ongoing fund costs from our Annual Management Charge and the table below details the costs of Discretionary and Fund flow commissions and the transaction taxes associated with purchases.

VT Castlebay UK Equity Fund	2019 costs
Discretionary commission	£5,421
Fund Flow Commission	£13,470
Total Commission Paid	£18,892
Commission as % of NAV	0.05%
Transaction Costs	£36,759
Total Costs of investment	£55,651
Total Costs as % of NAV	0.15%
Turnover 2019	**19%**

Source: VT 31/12/2019

Discretionary commission is incurred through our decision to buy or sell a position purely from an investment perspective. Fund flow commissions are generated from investors subscribing or redeeming shares in the fund. The total cost of these transactions amounted to 0.05% of the average fund NAV. The transaction costs include stamp duty, the PTM levy and other market custody fees and added to the dealing commissions cost the fund 0.15% in the year.

Turnover highlights the rate of change within the fund and is calculated by dividing the amount of purchases or sales (whichever is less) into the average value of the fund. In 2019 our official Turnover was 19% and our annualised rate (since launch) is 12%. Our 2019 turnover was inflated by fund flows, which resulted from investors rebalancing their portfolios. Calculating our turnover based on our discretionary sales of businesses in our fund, would have resulted in a turnover of 5% for the year—a truer reflection of our underlying turnover rate. However, we believe it is important to maintain consistently our previous approach to turnover, which in 2019 results in a slightly higher level than in the past.

Quality Table

Our quality table continues to highlight the superior quality characteristics of the companies in which we are invested compared to the wider market, excluding financials. The free cashflow yield of our fund is at a small premium to the market. However, this is explained in part by the way in which the free cash flow yield is calculated. As the free cash flow part of the equation reflects historic annual free cash flows, this part stays static until the next financial year is completed. Since we launched the fund, dividends and cash flows have compounded at double digit rates. When figures are updated to reflect the free cash flow generated in 2019, we will then see how this effects the yield in relation to that of the market.

Quality Table	Castlebay Fund	Market
Return on Equity	42%	24%
Operating profit margin	23%	15%
Net debt to equity	60%	90%
Cash conversion	100%	94%
Free Cash Flow yield	3.7%	4.0%

Source: Bloomberg as at 31/12/2019