

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

The Nifty-Fifty, technology bubbles and how our UK Equity fund is different!

Dear fellow shareholders,

There is rising debate, whether Mark Twain ever actually penned the phrase ‘**history never repeats but it rhymes**’, to which he is so often attributed. One thing is for certain, from wherever this famous quotation originated, the sentiment holds true. Perhaps this is because humans appear hard-wired into making the same old mistakes. The circumstances may differ, changing over time, but human frailties persist. This lends a ‘rhyming’ quality to the events of today when compared to the past.

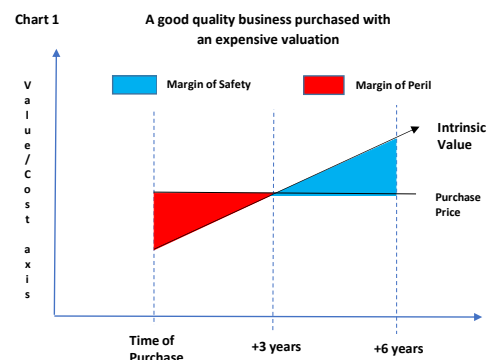
In this vein we have read recently several articles referencing the Nifty-Fifty of the early 1970s and how some companies are at risk of a similar de-rating given current valuations. The Nifty-Fifty represented around fifty US companies, the perceived quality of which saw them re-rated to very high levels, in the early part of the 1970s. These stocks peaked in December 1972, with companies like Polaroid trading on over 90x Price/Earnings. Comparison is then made with their performance against the S&P 500, over the subsequent decades, to conclude that good companies don’t always make good investments. As with all generalisations and aphorisms there is certainly an element of truth, but one must also be careful to guard against over-extrapolating such ideas. Some of the Nifty-Fifty, three decades on, outperformed the S&P on an annualised share price return basis - names such as Johnson & Johnson, Coca-Cola, Eli Lilly and Merck. So it is interesting to note, that for some high quality businesses the seemingly ‘rich’ valuations of December 1972, did not fully reflect the potential value-creating aspects of their businesses.

In aggregate the Nifty-Fifty had a simple average valuation (each company equally weighted) of 45x price/earnings. Interesting also to note, that all these four US companies mentioned all had December 1972 valuations above this average valuation, yet all outperformed the subsequent 12% annualised return of the S&P over the next thirty years. Yes, there were many of the fifty that lost investors money from that high point, or underperformed the market, but it was not a universal outcome by any means.

In terms of the valuation metric used here, we like to look at P/E valuations in a slightly different way; one which we think puts the valuation position in a better perspective. The Nifty-Fifty’s valuation of 45x, is simply the Price per share divided by the earnings per share, the latter forecast to be earned in the coming year. So another way of looking at this is to say that, on average in December 1972, you were paying for 45 years of earnings. This is instructive, as it is effectively saying that you are so confident in these businesses that you can look four and a half decades into the future in order to support the prices of the companies. One might argue that this displays a high degree of hubris.

Further still, in 2000 at the height of the Tech Media & Telecoms (TMT) bubble, with many companies either making no earnings or earning very little, investors were being asked to make even more heroic assumptions about the futures of these businesses. Remember also, that the phenomenon of Moore’s Law and the associated rapid innovation cycles, make technology businesses inherently less predictable. So in 2000, many tech companies had over a century of forecast earnings reflected in stratospheric market capitalisations. Here the ‘story’ of a tech-enabled future was blinding shareholders to the reality of finance; and as we wrote in our last letter, with Chart 1 below, **market agency risk** increases the probability of a valuation de-rating, materially impacting short and medium term returns. In the case of the tech-boom of 2000, the re-rating rose to unsustainable levels, resulting in a three year bear market.

As we bring this story to the present day, the valuation profiles of several of the US tech giants are ‘rhyming’ with the Nifty-Fifty and TMT eras. For example Tesla is trading on 155 years of forecast earnings; earnings which have to nearly double this year to prevent this valuation rising even higher. Polaroid has got nothing on Tesla! Yet one key difference should be noted when comparing today’s market leadership with the Nifty-Fifty. Today the US market has been led by literally a handful of companies, far nearer five than fifty. For balance, it is true that companies like Microsoft and Apple, both on around 30 years of earnings, are cheaper than the Nifty-Fifty average. However, Amazon maintains a P/E of nearly 80x. Whilst the picture remains mixed, there is clearly some material valuation risk amongst these companies.



So what about the UK market and our fund in particular? The UK has had its winners and losers over the last year as lock-down has changed the shape of the economy. However, overall the valuation picture looks much more supportive.

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.

In the UK and elsewhere, over the last five years, there has been much talk in the financial media about high-quality businesses acting as 'bond-proxies'. The idea being that the predictable and dependable cashflows of these businesses, acting almost like bonds, has resulted in a re-rating, akin to the Nifty-Fifty discussed already. It is suggested that this re-rating will come under pressure as gilt yields rise - as this is the rate at which their long-term cashflows are discounted.

The higher the discount rate the lower the value of any discounted cashflow valuation model. As the vaccine roll-out for Covid-19 has progressed, the diagram shows the rise in this discount rate from around 0.2% to 0.8%. It is still low by historic standards.

However, this analysis misses one vital aspect of the equation. **The listed equity capital of these companies are 'real assets' not 'nominal assets', like bonds.** As equity owners we take on greater risk than bond holders, accessing only the residual value created by companies. However, we also accrue the rewards of successful businesses. The reinvestment of cashflows that go on to make high incremental returns, create a virtuous circle of value creation.

Bond yields have also risen in anticipation of a strong bounce back in economic growth, leading to rising prices. Here again our businesses have an advantage. When cost bases start to rise with inflation, companies with pricing power, 'price makers', are better able to maintain their profitability. Customers are generally more willing to accept higher end-market prices. Commodity type businesses and businesses in 'perfect competition', tend to be 'price-takers'. Here rising cost bases tend to squeeze profitability. Whilst more economic activity may help demand and volumes, revenues and profits remain much more difficult to predict for such companies.

A note on the cash conversion figures in the Quality Table. Both the cash conversion rate of our fund and especially the market, remain artificially high. Covid-19 and its economic impact have distorted the working capital profile of many businesses. Most businesses spend money to make it - i.e. they pay for inventory before adding value and then receiving money once the finished goods are sold. When the economy went into shutdown last year, much of this initial investment in working capital was not made. This increased the cash conversion rate to above 100%. We would expect this ratio to revert to more normal levels over time and reflect the greater cash generating capabilities of our companies, in relation to the market.

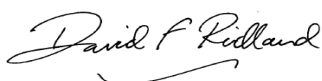
Quality Table End Mar 21	Castlebay Fund	Market
Return on Equity	38%	22%
Operating profit margin	19%	8%
Net debt to equity	50%	107%
Cash conversion	123%	140%
Free Cashflow yield	3.7%	4.0%

Source: Bloomberg as at 31/03/2021

As free cashflow figures start to reflect the reality of 2020, the fund's valuation in relation to the Market has come much more into line. We prefer to focus on free cashflow yields as opposed to P/E valuations in the normal course of events. **However, with our earlier discussion in mind, our fund's P/E of 23x is around half the average compared to the Nifty-Fifty. To put things further into context, our fund's free cashflow yield of 3.7% compares with Tesla's current free cashflow yield of 0.4%.**

Labels such as 'bond-proxies' and 'Nifty-Fifty' can be convenient pigeon-holes in trying to order a disordered world. However, they can also be misleading. As we remember that 'history rhymes' with the past, we have no doubt that short-term speculation in share prices will lead to wild swings between different investment approaches. Yet, we would reiterate that we are not looking to invest for the next six months but for the next several years, alongside investors of a similar time frame. The temptation is to try and time such a style rotation. We view this as a risky proposition. Instead we will maintain our exposure to our long-held, high quality businesses. Companies whose valuations, as the quality table shows, are increasingly coming into line with that of the market. Compared to the market, our fund invests in businesses of twice the quality, with half the debt. Now that seems like good value to us!

We hope you and your family are keeping well and thank you for your continued support.



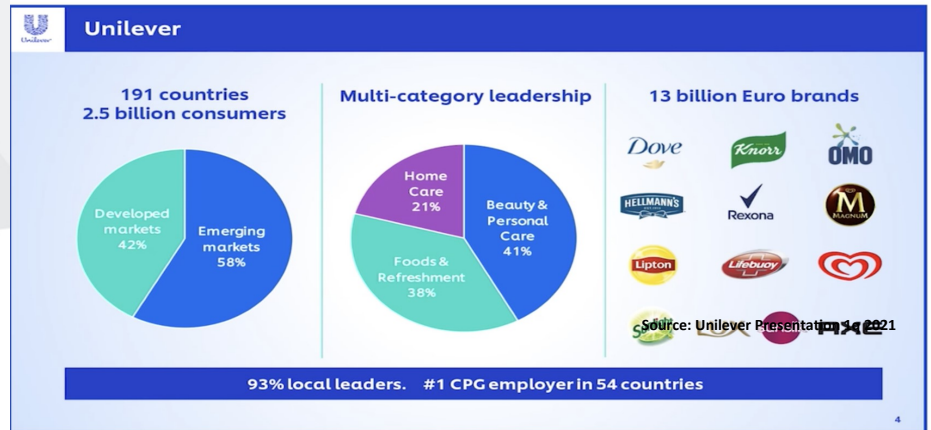
**The value of investments can fall as well as rise & you may not get back what you invest.
Past performance cannot be relied upon as a guide to future returns. This newsletter should not be construed as investment advice.**

Unilever: Pareto’s 80:20 Law and then some!

We have recently carried out a deep-dive review of Unilever—looking at how the business has been developing over recent years, its competitive positioning and how it is dealing with the changing landscape of its end markets. Unilever is one of our top five positions in the fund and as such we were also reviewing whether this level of exposure in the fund remained appropriate.

This excerpt from one of Unilever’s recent presentations highlights their increasing exposure to Emerging markets as well as how the Beauty & Personal division is now the largest part of the business.

However, as the graphic shows, it is the ‘billion Euro brands’ that best illustrates the 80:20 principle. Unilever sells over 400 products globally. Yet, the 13 products which each generate yearly revenues in excess of 1 billion Euros, led by Dove and Knorr, account for around half of total revenues.



These global brands drive the business performance, whilst the other smaller brands often give Unilever access into growing markets, allowing them to sell products at different price points. That said, Unilever has the potential to dispose of more of its non-core products to reinvest, through innovation, in its more profitable lines. Unilever is also very aware of the threat of ‘disintermediation’. Whereby, the traditional distribution channels—such as supermarkets, are bypassed by ‘direct-to-consumer’ relationships through on-line retail. 2020 saw its own on-line revenues rise rapidly, such that they now constitute nearly 10% of total revenues. Given the changing face of retail it is likely that this percentage will rise further.

Unilever’s ability to reorientate sales towards on-line channels as the Covid-19 crisis unfolded, highlights a very important aspect in regards to Unilever—adaptability. It is why we see it as an important investment in our fund. Its 5% weighting in our fund reflects its resilience, an important characteristic that we developed in our last investor letter (Q4 2020). Our confidence that Unilever can innovative, evolve where required and prosper, is high. As long as it continues to allocate capital effectively and invest in the development of its brands; its focus on the long-term sustainability of its business, should allow it to retain a leading position in our fund.

Portfolio activity in the quarter

The only activity in the portfolio during the period was the investment of fund flows into existing portfolio holdings.