Quarterly investor letter December 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**

Bank of England Fan charts, a 'rice reward' and the real secret to compounding!

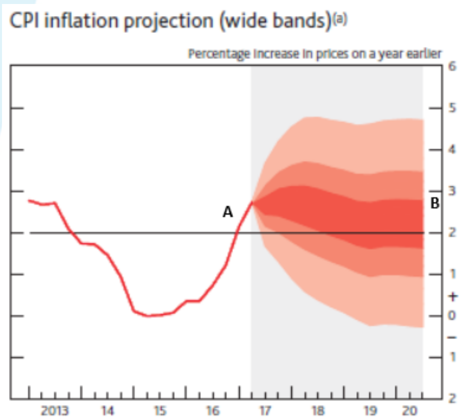
Dear fellow shareholders,

Legend has it that chess was invented in India. Its creator proudly presented it to the Emperor, who was so impressed he exclaimed—'name your reward!' "Oh Emperor, my wishes are simple. Give me but one grain of rice for the first square on the board, two for the second, four for the next and so on for all sixty-four squares. That is all I ask." The Emperor baffled by such a seemingly small prize for such a wonderful game, immediately agreed. However, less than a week later his treasurer explained to him that no such prize could be paid. Not even half the chess board was covered before the land ran out of rice. Realising he had been duped, the Emperor did what any self-respecting ruler of that age would have done—he 'got rid' of the inventor, making his problem disappear!

There are several lessons that can be taken from this story. Regular readers will know we talk often about the powers of compounding and the chess board exemplifies this doubling, compounding principle well. Perhaps another lesson for the investor is not to get too greedy. A couple of rows of the chess board would have given the inventor plenty of rice and the time to enjoy it—rather than meeting his untimely end! The investing analogy maybe akin to trying to get rich quickly, rather than gathering wealth in a measured way over time. It is this aspect of 'time' that is often missed when any investment talk falls upon the power of compounding. For example, the 90 year-old Warren Buffett is often cited as the world's most successful investor. His net worth is currently over $80 billion, which puts him amongst the most wealthy individuals on the planet. Yet, it is the fact that the vast majority of this wealth, over 95% of it, has been accumulated over the last couple of decades, that should make us think. There are many good investors out there, but it is Buffett's time in the saddle that has made him the wealthiest of them all.

The excellent investment writer, Morgan Housel, from the US Collaborative Funds, translates this very well in his blog and book, **The Psychology of Money**: *'Once you accept that compounding is where the magic happens and realise how critical time is to compounding, the most important question to answer is not "How can I earn the highest returns?" It's, "what are the best returns I can sustain for the longest period of time?"'*

If 2020 has taught us anything, in this COVID-19 pandemic, it is the folly of executives trained at 'business school' seeking to 'optimise' returns, often through the use of excess leverage. Such 'optimisation' may work for a few years, until something comes, surprisingly, from around the corner and destroys this strategy. Therefore, **persistency of approach** is a vital element to any investing strategy. Its importance can't really be overstated enough. Richard Oldfield wrote a fascinating book about investing entitled, **Simple but not Easy**. Investor psychology - how we as investors think, makes up a large part of the 'not easy' part of investing. It is why we continue to develop ways in which to protect our investing approach from my own biases. It is no use setting an investment process in place that works well for the first three years, if in year four it is obliterated and thrown on the scrap heap! So even before we started investing in our fund, how did we ensure we could give compounding its greatest chance? To answer this, we call on the Bank of England's forecasting fan charts to show how we continue to think about this.



Source: Bank of England

The graph represents a Bank of England forecast for Consumer Price Index inflation made in 2017. The fan represents the Bank's expected range of future inflation made at point 'A'. Obviously, at point B looking back the path inflation actually took can be seen. When we launched our fund in 2015 we believed our investment approach, developed over the previous years, would give us the greatest prospect of delivering positive real returns when we arrived at point B, three years later—i.e. buying good quality businesses for the long-term at reasonable valuations. This was important because of this 'persistency of approach' discussed above. This in turn gave us the greatest chance of staying the course. It allowed us to benefit from the positive effects that the compounding of high returns reinvested in our businesses, has had on our investors' real wealth.

As Charlie Munger wisely notes 'the first rule of compounding is never to interrupt it unnecessarily.' This is why we created our Investment Universe and consistently produce our 'Key Metrics Table'. Owning high quality businesses gives us the greatest chance of owning them for the long term and therefore 'not interrupting the power of compounding.' Once this part of our process is in place, our main focus becomes ensuring that these businesses continue being 'good businesses'. It is in this way that our analysis led us to conclude that **Rotork plc's** business was deteriorating. We detail the rationale for its sale later on in this letter.

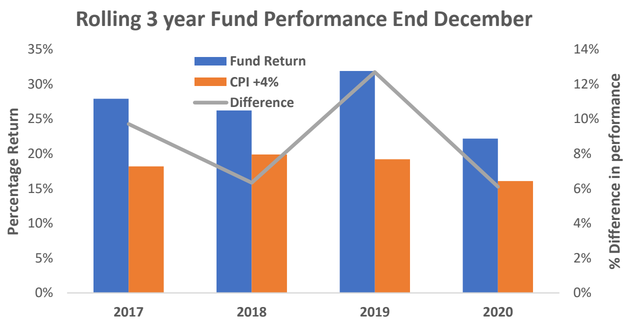
A comment on performance over a longer-term

At the end of January 2021 the fund will be six years old. When we launched the fund back in 2015, we set out to deliver 'real returns' - positive returns in relation to inflation, that would protect and grow the wealth of our investors. We used the Consumer price index as a measure of inflation; adding 4% annually to this return to reflect investing in equities—so-called 'risk assets'. So we set out to exceed CPI+4% annualised over rolling 3-year periods. The rolling time period was designed to smooth out short-term market noise and timing vagaries.

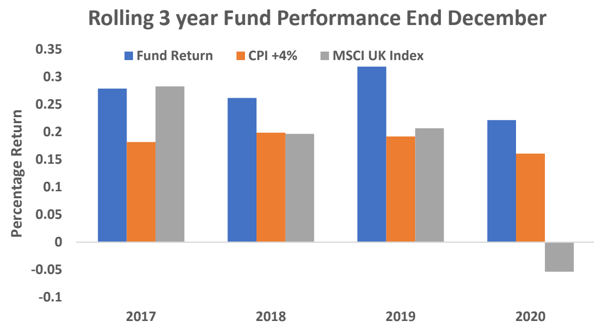
28/01/2015 - 31/12/2020 Data from FE fundinfo2021

The graphs below analyse how we have done against this measure and also in relation to the MSCI UK equity index. After all, as champions of active management we have to ensure we exceed a passive market approach, net of respective fees, over the medium to long-term.

Each period, in the graphs adjacent, represents 3 years to the end of December. Please note that as the fund launched on 28th January 2015, the first column ending December 2017, represents a 35 month period and not 36 months. Either way, it is encouraging that on all these four, 'rolling 3-year periods', the fund has exceeded CPI+4%. Whilst I have made many mistakes during the life of the fund and tried to learn from them; we believe our focus on owning high quality businesses with pricing power, has greatly helped the fund to deliver these returns. Who knows what the future brings? All we can do is try and get better at identifying and monitoring good allocators of capital and allowing our fund to benefit from the compounding of returns over time.



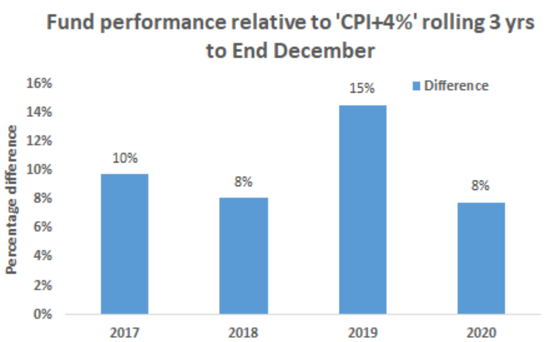
Since launch, the fund has also outperformed the MSCI UK total return index as well as our peer group of funds, within the UT UK All Companies.



It is true that from a performance perspective, we have a positive story to tell. We also continue in our real desire to keep getting better at what we do. Yet in truth, the real test comes for both our investors and ourselves when the performance figures aren't so strong over a given period. Can both parties keep to the 'persistency of approach' we discussed earlier and not be blown off course? For it is in such conditions that our resolve will most be tested. We will continue to call on our Key Metrics table—our table of constancy, to demonstrate that underlying business performance may be stronger than the market is reflecting. Our investment universe should continue to protect us from reaching too far down the quality spectrum and our incremental returns analysis to monitor if management continues to allocate capital well. All the above is nothing though, without being constructed upon sound long-term investing relationships. Relationships that allow us to try 'to deliver the best returns over the longest period of time.' For that, as we approach our fund's sixth year anniversary, both David MacNeil and I consider ourselves very fortunate.

Thank you for your continued support.

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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Castlebay Investment Partners

rotork

We have owned Rotork, a global leader in the manufacture of actuators, for several years. The original investment was based on our philosophy of investing in good quality businesses whilst not overpaying for the privilege. However, recently both Rotork's revenue growth and returns (pre Covid-19) have been declining. Sales per share growth, for example, has only been growing at 2% annually over the last five years. Whilst recent operating margins have seen a welcomed increase, the trend over the last decade has still been one of decline. More importantly, incremental returns on capital have fallen below our hurdle rate of 20%. Capital intensity has also increased materially, meaning the operating cycle is producing less cash in relation to its assets.

Rotork's balance sheet remains strong with a net cash position. However, the investment case of value creation through a positive spread (Return on Capital—Cost of Capital), is coming under increasing threat as returns decline. Whilst the shares have risen by over 65% since their March lows, partly due to their robust balance sheet, we have found in the past that our analysis of business returns, often gives us a good early warning signal of future trouble.

In summary, the declining returns of the business put at risk the compounding principle we noted earlier. Firstly, as returns move towards the cost of making those returns, so the probability rises that value is destroyed by a management team looking to reignite growth. Secondly, if a business starts to lose its competitive advantage –as evidenced by its decline in margins and returns, it moves increasingly towards a position of 'perfect competition'. Here one's ability to predict future returns markedly declines. Companies become increasingly 'price takers' not 'price makers'. All of which increases the risk that our persistency of approach is undermined along with the compounding of shareholder equity value. We sold Rotork's position in the fund, in its entirety, in mid-December.

Cost Analysis & Turnover

At the end of each calendar year we publish the **costs of investment -** not included in the ongoing fund costs Castlebay pay from their management fee, so our fellow shareholders know the total costs of investment over the past year.

The transactional costs are detailed in the table with £33k paid in dealing commission and transaction taxes of £132k, during the course of the year. These costs as a percentage of the average fund Net Asset Value (NAV) added 0.30% in costs to the ongoing fund charge. The fund turnover was 15% in the year (calculated as purchases or sales (whichever is less) divided by the average fund NAV) and resulted in our average turnover increasing from 12% to 13%, since the fund launched in January 2015. We remain very focused on ensuring we keep costs as low as possible and were pleased to negotiate lower, dealing commission to 5 basis points, following the growth of the fund in recent years.

VT Castlebay UK Equity Fund	01 Jan20 -31 Dec20
Discretionary commission	£10,332
Fund Flow Commission	£22,613
Total Commission Paid	£32,945
Commission as % of NAV	0.06%
Transaction Taxes	£131,908
Total Costs of investment	£164,852
Total Costs as % of NAV	0.30%
Turnover 2020	**15%**

Source: Valu-Trac as at 31/12/2020

Quality Table

A note on the quality table and in reference to Morgan Housel's point mentioned earlier. We should not become fixated upon how high we can make the Fund's ROE percentage, in relation to that of the market's. Yes, we want to see a healthy spread, but Mr Housel's wise words should help to focus our attention on their persistency. If we are more confident in the long-term prospects of a business, earning a 30% ROE, in relation to a less certain 40% ROE company, we should pay attention to this. The '30% business' will produce far superior returns over time, if like Warren Buffett, it is better able to stay the course.

Quality Table End Dec 20	Castlebay Fund	Market
Return on Equity	39%	22%
Operating profit margin	21%	11%
Net debt to equity	53%	102%
Cash conversion	110%	99%
Free Cash Flow yield	3.7%	4.2%

Source: Bloomberg as at 31/12/2020

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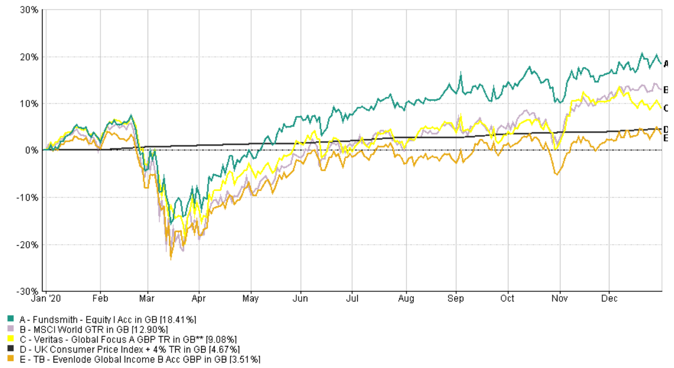
International funds

The theme of operational resilience was applicable for International businesses as much as our UK buisnesses in 2020. Technology companies like Microsoft, Facebook, Alphabet and Pay pal all enjoyed strong trading during the year as consumers increased their consumption of digital content or online shopping and assisted to strong returns in our International funds.



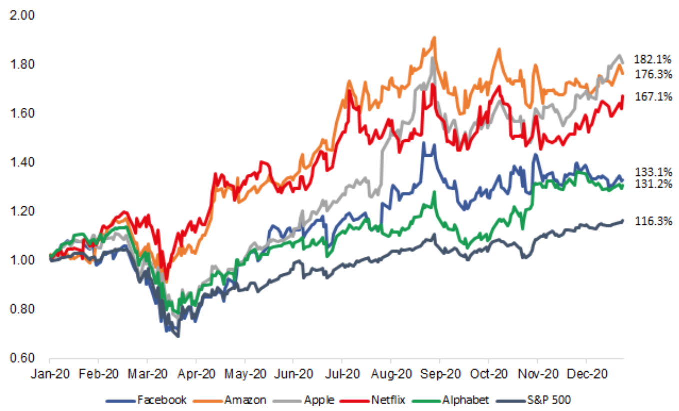
31/12/2019 - 31/12/2020 Data from FE fundinfo2021

After the heavy falls in equity prices globally in March, markets did recover, however none more so than in the US where the S&P 500 finished the year with a positive return of 16%. Headline market returns often do not tell the full story however, and in the US the return of the S&P (the broad US market) was heavily influenced by the strong performances of tech giants including **F**acebook, **A**mazon, **A**pple, **N**etflix, **G**oogle (now Alphabet) whose performances in the year were between 31% and 82%. If these 5 businesses were excluded from the US market, then the index return would have been slightly negative on the year.

20/11/2017 - 31/12/2020 Data from FE fundinfo2021

Tesla was admitted to the S&P 500 on 21st December, having risen 730% in the year, and is now has a market value which is larger than the combined market values of Toyota, Volkswagen, General Motors, Ford, Honda and Nissan, an astonishing fact given they sold just under 500,000 cars in 2020 compared to 41 million cars by Toyota, GM, Ford, Honda and Nissan!

To gain entry to the S&P 500, "a company's most recent quarter's earnings and the sum of its trailing four consecutive quarters' earnings must be positive" as well as meeting other requirements according to S&P Global. It has been suggested by some auto analysts that Tesla has only managed entry to the S&P by selling tax credits (payments to Tesla by other auto manufacturers who make too few electric vehicles to satisfy regulators. The irony of this situation is that Tesla is worth more than most of the industry it relies on for the subsidies that are the only reason it has been able to report five consecutive quarters of profits.



FAANG stock prices return only indexed to 31DEC20

Source: Pendora@medium.com DEC20

Whilst these businesses have their merits from a consumer perspective, it is worth bearing in mind that if investors buy shares in these businesses at very elevated levels, they risk having to wait quite some time for the business to "earn" the right to justify the valuation in future and risk a large short term decline in share price. In the case of Tesla it might be that once the bubble bursts, investors will never earn back their cash by holding on.

Emerging Markets

We recently sent recommendations to sell the holdings of Somerset Emerging Markets and Newton Asian Income funds with the proceeds reinvested in the Matthews Asia Dividend and Bambublack Asia ex-Japan funds. We described in our recommendation, the process by which we allocate capital to our third-party managers and the time we try to give them as long-term investors.

31/12/2019 - 31/12/2020 Data from FE fundinfo2021

The defensive characteristics we expected from Newton Asian did not come through in the performance and we did not realise as soon as we should that Ed Lam of Somerset was focusing on the income element of the businesses, at the expense of the underlying quality which impacted the performance of his assets.

We believe a post-pandemic economic environment will favour quality businesses as we see a continued bifurcation process - where the strong capitalise from the weak getting weaker.

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Bambublack and Matthews are specialist boutique Asian equity managers who invest in quality businesses with high returns on capital and strong cash generation.

Both managers are part owners of their respective business and are aligned to the long term best interests of their fellow investors. They invest with conviction for the long term and each strategy has been consistently applied with strong performance over the long term.

Fixed Interest

We remain in a period of historic low interest rates. The pandemic and economic consequences mean that this will likely remain the case for the foreseeable future. Governments and central banks have continued to print more money and increase borrowing to try to support businesses and their respective electorates.

There have been murmurings of "negative rates" reaching our shores. The concept of negative rates feels a bit like "Alice through the looking glass" with banks charging their customers for depositing money instead of paying interest and banks paying mortgage customers to take loans. It all feels counter intuitive to what happens in normal times……… We continue to tread cautiously in this area with a mix of fixed interest securities we believe will protect us from the rising threat of inflation.

Alternatives

The Lazard global listed infrastructure fund remains our sole position in this area which invests in a range of listed infrastructure related investments. Investing in listed infrastructure investments means that there is more liquidity than similar funds which invest in physical infrastructure projects. Liquidity allows us to sell our position if or when we need to do this. However, this comes at a cost. During periods of extreme market declines, the fund will experience draw downs similar to equities. In 2020 that was the case, with a decline of 26% when the market troughed at -35%. Yet, there was a marked recovery by the end of the year, finishing the year with an overall decline of -7%.

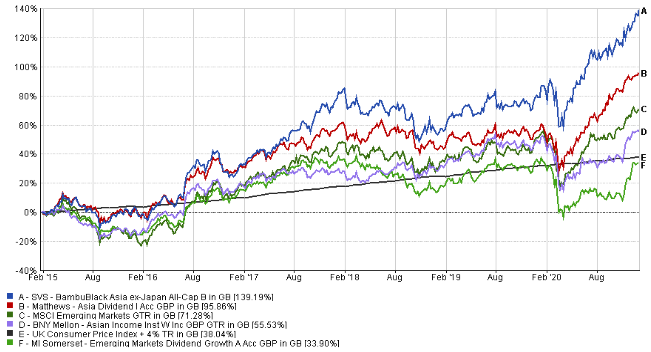
As long-term investors, these short-term movements are not of great significance. Most important is the aim of protecting our invested capital by more than inflation over longer time frames. The second graph below that the manager is achieving this aim. Even through the difficult 'Covid period' for markets.

Conclusion

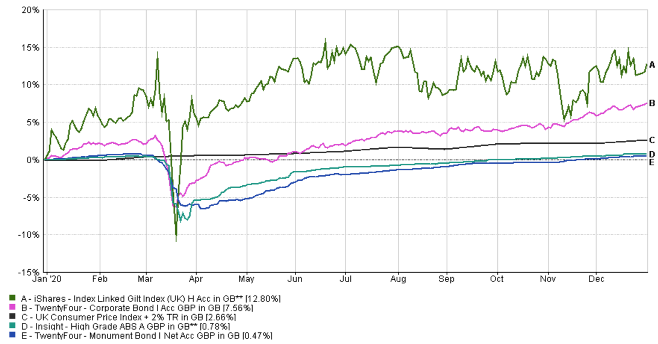
The year 2020, will no doubt be a year etched in the memories of most, for a long time to come. From an investing perspective we have learned a lot through the course of the year and been able to lean on our past investing experiences during the Asian crisis (1997), technology, media & telecom boom and bust (1999) and the global financial crisis (2008). There is no doubt that continued learning and improvement is a critical requirement for the future success of our approach to investment.As we near our 9th year in business we are very grateful for your continued support. It really does mean a lot to us all at Castlebay. If you would like to discuss any aspect of this letter, or your portfolio, please do let me know.

Best wishes

David



28/01/2015 - 31/12/2020 Data from FE fundinfo2021



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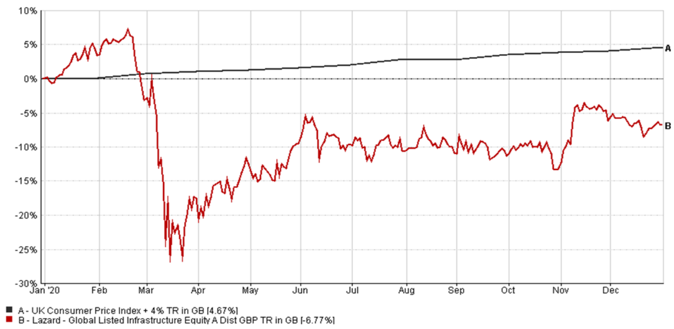

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