Quarterly investor letter June 2016

Our guiding principles:

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

Investment and the changing relationship with Europe

Dear fellow shareholders,

Recent events have been dominated by the vote of the United Kingdom to determine its future relationship with the European Union. It is not our place, in general, to comment on political events, except when they impact materially on underlying economic conditions. The Referendum debate has centred on three main topics: Trade; Migration and Sovereignty. At first it would appear that Trade and Migration are the two dominant factors at play. However, we would argue that it is actually sovereignty that has driven the greatest changes both in economic benefits and costs.

First some background: The European Union started life as an economic trading organisation in the 1950s. Following the Second World War there was an impetus to create a supranational foundation that would 'make war unthinkable and materially impossible.' Initially the European Coal and Steel Community was created. Following the Treaty of Rome in 1958, the European Economic Community (EEC) was established. All these entities focused predominantly on trade— the economic imperative. It was only following the Maastricht Treaty of 1992 that the European Union was formed and a political dynamic was constructed over the established economic framework.

The desire for further political and fiscal integration has defined the changing nature of the European Union and the sovereignty of its member states over the last two and a half decades. Perhaps the greatest factor driving this change has been the creation of the Euro currency in 1999. The harmonisation of 'Euro participating countries' has had far-reaching consequences, as exchange rates were locked at fixed rates and the fiscal rules for entry into the Euro were largely ignored. When Ireland entered into the Euro, its central bank interest rate halved overnight. Given how much cheaper the cost of money had become, it should surprise few that a debt fuelled property bubble resulted, which impoverished many in the ensuing financial crisis.

A single currency has effectively reduced the sovereign power of the member countries to rebalance their respective economies when required. Historically, a country's currency would devalue, helping it to become more competitive in times of need. Without such a mechanism for the 'Euro' countries, they must endure instead an internal devaluation. The southern Mediterranean states exemplify this point. Portugal, Spain, Italy and Greece have struggled economically over recent years. Their respective internal devaluations have resulted in falling living standards and youth unemployment rates as high as 50%. Operating under the free movement of labour, it is little surprise that young workers from mainland Europe have sought work and higher living standards in the United Kingdom. The free movement of labour is a noble aim, in theory. In practice, it is only sustainable in a more evenly balanced economic system—the prospect of which is further eroded within the single currency block.

In the short term, Sterling has weakened materially since the vote for the United Kingdom to exit the European Union, due to the economic uncertainty it has caused. It should be noted, that our focus is on investing in high quality companies, that can withstand exogenous as well as self-inflicted shocks. We have therefore retained a sanguine outlook on events both leading up to and following the vote on 23rd June. In talking with our fellow investors before the vote, we highlighted that the companies in our fund in aggregate generate only 23% of their revenues within the UK. Thus, in the short term our companies should see their non-sterling revenues and profits translated back into the weaker Sterling, thereby giving their Sterling denominated earnings a lift. Such factors tend to even themselves out over time. If the European Union responds to the UK's exit by pushing on with further integration, as per the Five Presidents' Report, then Britain could well maintain its superior economic growth profile. Under such a scenario Sterling, over time, would likely strengthen against the Euro.

Company	Sector	Position
Rotork	Industrials	5.6%
Intercontinental Hotels	Leisure	5.1%
Victrex PLC	Basic Materials	5.1%
Aveva Group	Technology	5.0%
Petrofac Ltd	Energy	5.0%
Rio Tinto PLC	Basic Materials	4.8%
Wood Group PLC	Energy	4.8%
Capita PLC	Support Services	4.5%
Admiral Group PLC	Financials	4.2%
Kone Oyj	Industrials	4.2%
Reckitt Benckiser	Consumer	4.1%
Serco Group PLC	Support Services	4.0%
Rolls-Royce	Industrials	3.6%
Page Group	Industrials	3.5%
Tesco PLC	Consumer	3.5%
AstraZeneca PLC	Healthcare	3.2%
BATs	Consumer	2.9%
Colgate	Consumer	2.7%
BAE Systems PLC	Industrials	2.8%
BHP Billiton PLC	Basic Materials	2.4%
Unilever PLC	Consumer	2.3%
Imperial Brands PLC	Consumer	2.1%
Croda	Basic Materials	1.7%
Cash	Cash	12.9%
Total		**100.0%**

Quality Table

Key metrics	VT Castlebay UK Equity	Market
Return on Equity	34%	25%
Operating Profit Margin	20%	14%
Net debt to equity	54%	77%
Cash conversion	123%	87%
Free cash flow yield	3.5%	3.6%

The unexpected 'Leave' result in the Referendum further validates why we try to limit our forecasts in an uncertain world. More importantly, we do not construct our investment philosophy and process based on a false confidence we can predict the future. Instead, we analyse what has happened in the past to our companies, try to understand how returns have been generated and determine if such dynamics are likely to persist.

In times of market dislocation and uncertainty we repeat our mantra: to invest in high quality companies at reasonable valuations. To that end we continue to update our Key Metrics Table above and thank you for your continued support.

Yours sincerely,

David F Holland

The value of investments can fall as well as rise and you may not get back what you invest.

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"Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns"

Charlie Munger

Investment Universe:
We agree with the sentiments echoed by the great Charlie Munger, which is reflected in our investment philosophy—to invest for the long term in high quality companies at attractive valuations.

We assess whether a company is attractively valued versus its own long term average valuation. This approach is predicated in our belief that not all company valuations are created equal. The different returns that companies earn, make comparing Price/Earnings and other valuation metrics across companies and sectors problematic. For example, if two companies earn a Return on Capital Employed (ROCE) of 40% and 10% respectively are they both the same value if they trade on 10 years' of earnings? We think the answer to this question is no!

To our minds, investment is a balance between Quality and Valuation. As such we have developed a clearly defined investment universe, focused on several factors which we believe define companies that are of high quality. In the long run it is difficult for companies to generate share price returns which are materially different from the returns their underlying businesses earn. Therefore several of our 'Quality factors' focus on company profitability and returns. Strength of balance sheet is also important and is one reason that no Banks appear in our universe. It is true that the business model of Banks is one of leverage. However, even eight years after the Financial crisis, we believe bank balance sheets are still too large. Investors invest in the residual value between assets and liabilities—known as shareholder equity. For Banks it only requires a small increase in non performing loans (the assets of banks) to endanger greatly this slice of equity.

Castlebay Investment Universe									
UK Companies									
Admiral Group	British American Tobacco	Michael Page Intl	Rotork	Wood Group	Diageo	Hargreaves Lansdown	Renishaw	Spirax-Sarco	Dillistone Group
Aveva Group	Capita	Petrofac	Serco	A.G Barr	Domino's Pizza Group	Hilton Food Group	Restaurant Group	STHREE	Nichols
Astrazeneca	Croda Intl	Reckitt Benckiser	Tesco	Aggreko	Dunelm Group	Howden Joinery Group	Sage Group	James Halstead	Brooks MacDonald
BAE Systems	Imperial Brands	Rio Tinto	Unilever	Avon Rubber	Elementris	IMI	Servelec Group	Craneware	RWS Holdings
BHP Biliton	Intercontinental Hotels	Rolls Royce	Victrex	Burberry Group	Fidessa Group	RELX	Shire	Jarvis Securities	
International Companies									
Colgate Palmolive		Accenture	Brown Forman Corp	Domino's Pizza	Johnson & Johnson	Nike Inc	Pepsico		
Kone OYJ		AXFood	Coca Cola	Indus de Diseno Textile	Microsoft Corp	Novo Nordisk	Roche Holding		

Our quality table on the first page illustrates the high returns, with lower than average debt, generated by the companies in which we are invested for the long term. Banks, conversely, generate significantly lower returns with higher levels of debt and therefore do not meet our quality requirements. Lower returns for greater investment risk doesn't appear a worthwhile trade-off for us!

Our investment universe consists of 49 UK and 14 International companies from the whole UK and International equity markets. The benefit of defining an investment universe is that it enables us to react quickly to changes in the valuations of companies which have already passed our quality criteria and in which we have already carried out extensive analysis. It also creates a greater level of transparency for our fellow investors, in what we might own in the future, at the right valuation.

Where we have made mistakes in the past, it has been to focus too much on the valuation and not enough on the quality of the company in which we invested. We believe the development of our investment universe will prevent us from making similar mistakes in the future.

Victrex manufactures PEEK or Polyether ether ketone to give it its full name. It is a thermo-dynamic plastic that has many thousands of applications both in industrial and medical industries. Victrex was established in 1993 following a management buyout from ICI. As a speciality chemical company, it has earned very high margins historically. As the excerpt from our Victrex model highlights below, over the last five years its Operating Profit Margin has been above 40%. As the originator of PEEK, Victrex maintains a leading market share in the manufacture and supply of it into the market place. Evonik and Solvay are its two main competitors. Whilst both these companies are larger than Victrex in overall size, Victrex's focus on PEEK and its many applications has allowed it to maintain its competitive advantage over many years.

Victrex PLC

Sector: Materials Industry: Chemicals Sub-Industry: Specialty Chemicals

Ratios											
For the Fiscal Period Ending	**30/09/2005**	**30/09/2006**	**30/09/2007**	**30/09/2008**	**30/09/2009**	**30/09/2010**	**30/09/2011**	**30/09/2012**	**30/09/2013**	**30/09/2014**	**30/09/2015**
Return on Equity - Decomposition	28.8%	31.7%	32.0%	25.1%	10.5%	28.5%	32.6%	28.2%	24.7%	24.4%	23.6%
Operating Profit Margin	**34.1%**	**36.8%**	**39.1%**	**38.7%**	**24.2%**	**39.5%**	**43.5%**	**42.8%**	**42.4%**	**40.5%**	**40.3%**
Asset Turnover	0.9x	0.8x	0.7x	0.7x	0.5x	0.8x	0.8x	0.7x	0.6x	0.6x	0.6x
Interest Burden	102.4%	102.4%	101.5%	100.8%	100.1%	100.1%	100.4%	100.5%	101.0%	101.8%	100.4%
Tax Burden	67.8%	69.0%	70.0%	71.0%	71.0%	72.0%	75.6%	76.1%	77.1%	78.1%	78.5%
Leverage Ratio	1.4x	1.5x	1.6x	1.3x	1.3x	1.3x	1.3x	1.2x	1.2x	1.2x	1.2x

Whilst there is some cyclicality to its industrial end markets, Victrex's products have two important aspects that continue to support its high margins. Firstly, they often support a critical function in the construction of the end products of which they are a part. This is due to the excellent mechanical and chemical resistance properties of PEEK. Secondly, whilst playing a vital role in the production process, their cost to the customer in the making of these end products often constitutes a small part of the overall cost. Consistency and quality of product are often of greater importance to their end customers than price. Another aspect of Victrex's business model that supports its profitability is the relationship it has with its customers. Often its customers come to Victrex and ask in which other applications PEEK could be used. Such engagement with their end market participants obviously helps to develop a strong commercial relationship, further protecting their competitive position.

The value of investments can fall as well as rise and you may not get back what you invest.