Castlebay Investment Partners

Quarterly investor letter June 2021

Our guiding principles:

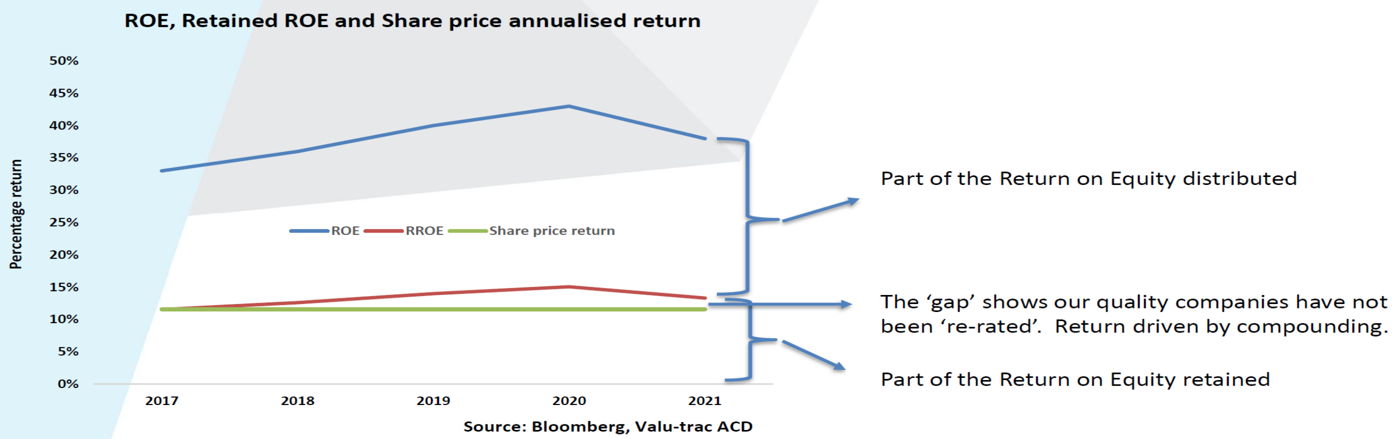
- **Transparency & alignment of best interests with our fellow investors**
- **Adherence to our investment philosophy and process**
- **Independence of thought to avoid the market herd**
- **Focus on costs: management fees capped, low stock turnover**

Dealing with inflation and our Investing Proof of Concept

Dear fellow shareholders,

Pixar, the Californian based computer animation studio, often create short animated films that use a new, difficult or untested technique. In their short film ***Geri's Game*** they used techniques for animation of cloth and of human facial expressions. The feedback from that process was later used in the ***Toy Story** Film Series.* Similarly, Pixar created several short films as '**proofs of concept'** for new techniques for water motion, sea anemone tentacles and a slowly appearing whale. All this was done in preparation for the production of ***Finding Nemo***. Other industries of course also use the principle of proof of concept: from Engineering in the design stage; to Business Development ahead of a new product launch. In the investing world such a process, although less common, can also be used. In truth, the same underlying principle is deployed. Invest a small amount of time, energy and resource before investing fully in a project. Once the go ahead is given, the large investment is then made. Yet often once investment is made there is often little analysis carried out to measure its success and to outline any change of course required. The 'sunk cost fallacy', dictates that human nature often ploughs on regardless, given the large amount of money and time previously invested in a project—even when the abandonment of it would lead to a better outcome.

At Castlebay, we launched our UK Equity fund based on the Charlie Munger principle, which we have discussed previously. Our investment careers, before the fund launch, had proved the Munger concept—'that in the long term the share price of a business follows the underlying returns that it makes.' So if we look back now, has the fund followed this concept over the last five years? A period which in many investors' eyes would be considered the long-term. We believe that the graph below shows that it has. Let's look at the three lines in turn. Firstly, the blue line is the average Return on Equity of the fund over the last half decade. If we were to compare this line to



that of the UK market, it would show that our companies have been materially more profitable, throughout this whole period. This should come as little surprise given our mantra—to invest in good quality businesses. Of course, due to the established nature of these businesses and their revenue growth profiles, not all of these returns are reinvested in the businesses. A portion of them are distributed to shareholders in the form of regular dividends and special dividends. For these 'distributed returns' the company can not obviously make a subsequent return on that capital. Instead, it is the retained earnings on which future returns are made. We term this the 'Retained Return on Equity' (RROE) and it is described by the red line in the graph. In order to prove the Munger concept then, it is this red line that should be closely matching the annualised share price return of the fund— the green line.

For clarity, it should be noted that the green line smooths out the more varied returns from year to year, to look at the total geometric annualised return. However, this in no way takes away from the proof of the Munger concept.

Another point worth noting is the charge that 'Quality investing', in a low growth environment, has benefited from a re-rating. If this were the case for our fund though, one would expect the green line to be above the red line. In other words a re-rating of the companies would have enhanced the return above that of the fundamental compounding returns produced by the retained return on equity. 'The gap' which we highlight to the right of the graph actually shows that our quality companies have not been re-rated. The return has been driven by the compounding of shareholder equity.

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We talked in our previous letter about rising bond yields, which are often the consequence of higher inflation expectations. They in turn pre-empt a tightening of monetary policy—increasing interest rates, in order to control these increase in prices. Recently, there has been more evidence that inflation is returning. As such it is worth looking at this and how the companies in our fund would cope in such a scenario.

Firstly, to ask a simple but important question. What is inflation? Inflation is simply the year on year rise in prices, which in the UK is mainly enumerated through either the Consumer Price Index (CPI) or the Retail Price Index (RPI).

So in 2021, prices are compared with those of 2020. Given that the Covid pandemic struck the UK in the first quarter of 2020, this base year was depressed as large parts of the economy were effectively shut down. So as the country now slowly emerges from the social and economic lock-downs, a rise in prices should be expected. How much and for how long will inflation manifest itself? In short, we have no clear idea. However, importantly our investment strategy is not based around getting such a call correct. Instead, our businesses provide us with ways to win in an inflationary environment, allowing us to continue to invest in them and benefit from the compounding of their shareholder equity returns.

We like to use a simple mental model when thinking about all the companies in the UK economy and elsewhere. The vast majority of businesses, around 90%, operate in what we would term 'Perfect Competition'. This means that any excess profits that they may make in any given year are quickly competed away, as competition is attracted towards these excess returns. We have tried, albeit not always successfully, to avoid these businesses in the past.

Instead, our investment universe is designed to lead us towards the 10% of the economy that is 'doing something different'. These businesses normally operate in monopolies, oligopolies or in niche areas and markets. In all instances they do something different, whether it is providing a superior service or product. Their competitive advantages could be through the development of brands which people trust or through patents protecting their revenues and profits.

Whatever the construct of their advantages, in an inflationary environment, it more often allows them to increase their prices as their cost bases rise. This in turn, allows these quality businesses to maintain their profitability and returns as inflation takes hold.

As investors, the added benefit is that these competitive advantages lead to a greater consistency of returns. This in turn makes it easier to allocate capital when the market may be voting against these businesses in the short term. It is all very well to say that when the price of our favoured assets falls that we will invest more. The acid test comes when such companies quickly fall 30 percent or more. It is at those times when one's confidence is most tested. Such a time arose at the beginning of 2020. We took the rest of the cash we had in the fund and invested in companies like Diageo, Intertek, Estee Lauder and Accenture, all of which had fallen precipitously. For all of these businesses we were confident that their underlying operational excellence would endure.

During our regular meetings with investors we are often asked about our view on the UK market. It is reasonable to say that over the last few years the UK market has traded on lower valuations than over developed equity markets. Political and economic uncertainty have prevented a more constructive view of the UK market being taken. However, now that we stand on the other side of the Brexit process and the leading vaccine rollout program provides some greater clarity on a return to normality, the UK market is becoming increasingly prominent in the minds of asset allocators. So in global terms, the UK looks like an attractive market.

As our Quality table also shows, our fund compared to the UK market (excluding financials) offers twice the quality (ROE and Operating profit margin) with half the leverage and now sits on a more attractive free cashflow yield of 3.7%.

Quality Table End Jun 21	Castlebay Fund	Market
Return on Equity	39%	20%
Operating profit margin	20%	7%
Net debt to equity	51%	110%
Cash conversion	123%	140%
Free Cashflow yield	3.7%	3.4%

Source: Bloomberg as at 30/06/2021

We continue to invest for the long term. However, we note that whilst we are still living through challenging times, from an investment perspective the opportunities being presented to us are very attractive.

Thank you for your continued support throughout these difficult times.

Kind regards

David F Ridland

**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.**

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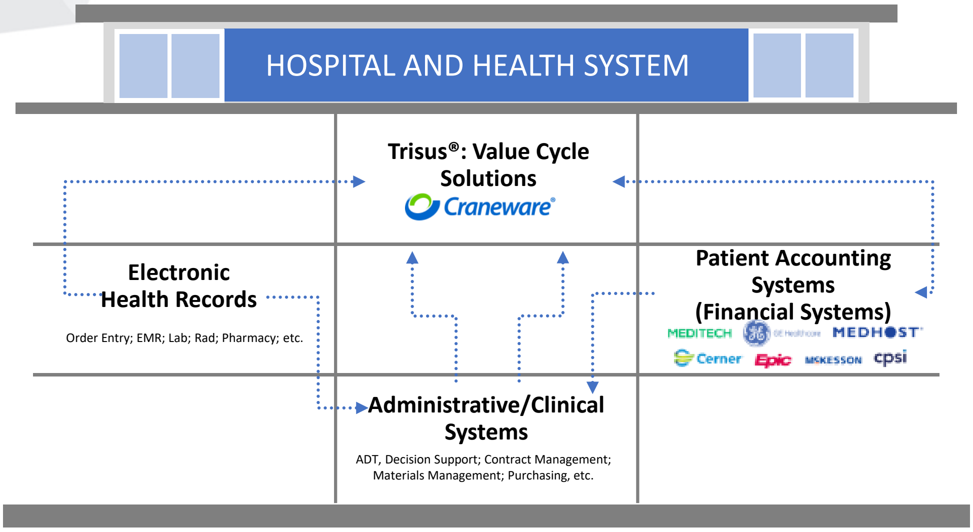
Craneware: the business and a new opportunity

There is a saying that in a gold rush, it is the person selling spades who makes most of the money. In the US healthcare market it is Craneware who is selling these spades. It offers Software as a Service (SaaS), designed at saving US hospitals money, by allocating resources more effectively. This healthcare resource-pool is vast—as spending on US healthcare of $3.7trn is larger than the whole of the UK economy!

To extend our goldrush analogy, 60% of US healthcare spending is aimed at the clinical side. This is the part that attracts prospectors from all around the world, spending vast sums of money developing drugs that it is hoped strike a rich seem of future revenues and profits. Given the risks involved in drug development, like the majority of gold prospects, the failure rate is high. The remaining 40% of spend on US healthcare is on Administration and Overheads.

It is in this relatively less exciting area where Craneware is developing its business. In this context 'dull' is good. It generally attracts less competition. This in turn has given Craneware the chance to develop a series of award winning applications. Its own consultants help integrate these applications into the one in three US hospitals, where they currently have contracts.

Over recent years Craneware has developed its Trisus cloud platform. This is an important evolution in the business model of Craneware. Historically, its award winning applications worked to make their client hospitals more efficient in specific areas.



Source: Craneware

The Chargemaster Toolkit, for example is an automated management solution for capturing the cost of procedures and providing proper reimbursement for providers. Similarly, the Pharmacy ChargeLink, is a software solution to enhance charge capture, pricing, and cost management.

However, the development of the **Trisus: Value Cycle Solutions platform,** now takes these individual applications and merges them together on one remote cloud-based platform, creating a **network effect** of growing, value-enhancing information. As data continues to be fed into this network, so its value should continue to grow. This value is not merely useful for the existing clients of Craneware. It is quite possible that its reach spreads to the other US hospitals as they see greater budget savings manifest themselves amongst Craneware's clients.

Recent corporate activity may also develop further this network effect. Craneware has recently announced the $400m acquisition of Florida-based Sentry Data Systems. Sentry Data Systems' SaaS solutions simplify the complexity of pharmacy procurement, utilisation and regulatory compliance. All these aspects help to maximise cost savings, improve patient outcomes and ensure precise regulatory compliance. Sentry also provides business intelligence and SaaS analytics solutions as well as consulting services.

Sentry generates $92m in revenue and around $23m in cashflows, which is broadly comparable to Craneware's own metrics—meaning the acquisition roughly doubles the size of the company. The cash consideration will be funded from the Group's existing cash resources, a new debt facility of up to $140 million and the net proceeds of an equity placing. Yet Craneware's strong balance sheet means the debt they have taken on to part fund the deal is very manageable, given the strong, visible cashflows the business currently generates.

The strategic rationale makes sense as the acquisition will help to accelerate the build out of the Trisus Platform and the network business model. As such we invested more in Craneware shares to offset the effects of the equity issuance and maintain our current stock position weighting of 4%.

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International Equities

International equities have also been strong in the first six months of the year, with the MSCI World up nearly 12%, led largely by energy and technology businesses. Our Quality value investment philosophy extends to the third-party managers, to which we allocate capital from our balanced portfolios. The Chawton; Evenlode and Fundsmith funds all share a similar approach to our own, with a focus on owning a small number of high-quality businesses which generate significant cash flows and do not require high levels of capital investment.

In recent times, it feels more important knowing what businesses to avoid than in what to invest. Technology valuations have become further extended throughout the pandemic, as working and video calling from home have become widely adopted. Social media (and the Reddit trading platform/chat room) has been instrumental in the demise of several hedge fund managers who invest to profit from declining share prices (short-selling) of businesses. They have been hit by a coordinated wave of share buying which has increased share prices and resulted in significant financial loss to the “professional” investor. The best example of this was a company called Game Stop which until its Reddit infamy was a fairly sleepy computer game retailer in the US.

As a result of a concerted, coordinated campaign from Reddit users to buy the shares and send the share price higher, the stock increased 1000% in two weeks, decimating the short sellers in the process. There are several other examples which resulted in similar fates to those betting on continued declining share prices.

Crypto currencies have been in favour with speculators, creating and decimating the wealth of amateur and professional investor alike and then there is the ‘SPAC’ phenomenon. ‘SPACs’ or Special Purpose Acquisition Companies, are routinely raising billions of dollars at launch, predominantly in the US. The nature of these investment vehicles is that they are blank cheques, investors do not know what they are going to end up owning and the managers of these vehicles are richly remunerated almost immediately. The whiff of speculation is unmistakable!

We avoid the latest fad or craze and instead stick to what we know and understand. It is also incumbent on us to try our very best to preserve your and our capital, which requires us to stick to our playing field and circle of competence. We want and expect our third-party managers to do likewise with their own respective funds and continue to check that this remains the case going forward.

One manager we have spent a lot of time with is Michael Crawford who joined our investment team in March. Michael manages the Chawton Global Equity income fund. He established Chawton in February 2019 and soon after launched his own fund. We met Michael before he set-up Chawton. He is one of the most similarly minded investors to us that we have met, since we started Castlebay in 2013. The aim of him joining our investment team is to make us better and to provide cover in the event David becomes incapacitated at any time in the future.

Emerging Markets

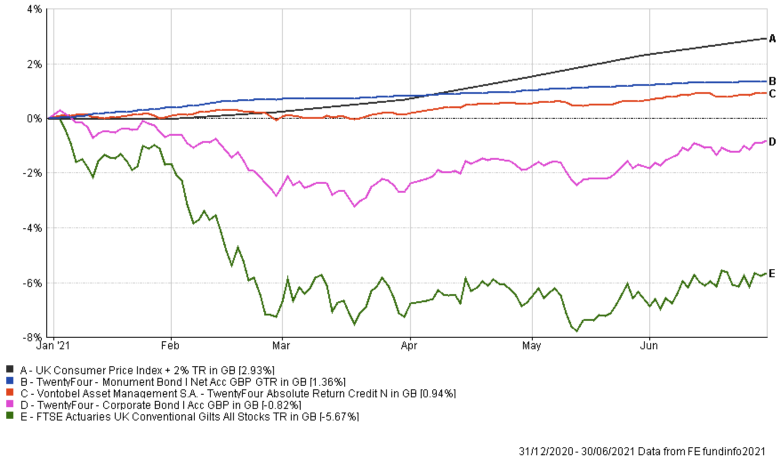
This area of investment has not been immune to the overtures of the ’technology boom’ we are once again witnessing - following the Tech boom in 1999. This time it could be different and in many ways it is different. Like the late 1990s, investors are investing on the potential, rather than the fundamentals, of these technology businesses. There are also large technology companies, which are successful and in many cases do make money. However, based on metrics we look at, they are just too expensive.

This area of global markets remains attractive because of the growing prosperity; the adoption of technology and rising industrialisation, as well as the growing, younger population, which will serve their economies well into the future.

Fixed Interest

The spectre of rising inflation has resulted in weakness in the bond markets in the first half of this year. It is worth explaining the definition of inflation as the year on year increase in prices. So after a prolonged period of economic hibernation for many businesses in 2020, rising inflation was always on the cards. What we and all other investors don't know is the extent to which inflation will be sustained going forward. Despite these concerns, our fixed interest securities have managed to hold their own so far.

The positions we've held in the fixed interest space have managed to hold up well, especially compared with the FTSE UK Conventional Gilts All Stocks index and have a greater ability to protect the invested capital from rising inflation going forward.



Alternatives

Infrastructure investments can be closely linked to rises in inflation due to the monopolistic nature of their businesses. For example, Italian tollroad operator Atlantia is able to increase the tolls they charge in line with inflation. Companies such as Atlantia are able to do this due to the contractual arrangements they have with governments. Such arrangements are not found in all infrastructure contracts where price rises may be capped. The manager values the companies in which they invest by using normalised interest rates in order to protect investors against likely rising interest rates over a three to five year period and the Fund aims to outperform inflation by 5% per annum over a market cycle.

In an asset class like this, liquidity is important. The team's investment universe only includes those stocks listed on stock exchanges. Through investment in such equities, the Fund is able to offer investors liquid access to an asset class many perceive as illiquid. The concept of listed infrastructure is a relatively new one, so for many it is still seen as an investment directly in bricks and mortar, rather than something that can be a listed stock in a company like any other.

Infrastructure can often be seen as boring and unexciting. Exactly the type of asset we like and actively seek!

Conclusion

We continue to see the effects of the pandemic in health and wealth terms and there remains significant uncertainty in the months and possibly years ahead of us. We will continue to focus on our playing field and believe that in the long run, our approach of investing in high quality businesses, at the right prices, for the long term will continue to serve us well.

We want to thank you sincerely for your continued support in our ninth year of Castlebay and look forward to many years ahead.