Quarterly investor letter December 2015

Castlebay Investment Partners

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

A year in review and what we have learned

Dear fellow shareholders,

It is a truism to say that 2015 was an eventful year. All years are thus so. Like all previous periods there are events that occur that are particularly memorable: the Greek debt crisis; Chinese stock market weakness and economic slowdown; the Paris terrorist shootings and the European migrant crises. Such events have obviously effected stock market returns to varying degrees. In the calendar year since the fund launched (at the end of January 2015), we have generated returns in excess of the UK market (as detailed in our factsheet) but not our preferred measure of inflation +4%. The greater point is to try and understand what we did well and not so well during the period under review. While it is important to review and assess the year that has just concluded, a year is merely the time it takes the earth to orbit the sun. Our investment horizon spans several of these orbits, where we are investing in companies over their business cycles.

As such, when we look back and learn from past actions, we must be wary of highlighting our successes and our shortcomings through too myopic a lens. For example, following OPEC's decision in November 2014 to maintain its oil production amid a slowing in Chinese demand, the resulting weak oil price caused much volatility and weakness in the oil and gas sector. Using both our quality and valuation approach to investing, positions in stocks such as Petrofac and Wood Group have been amongst our highest returning companies in 2015. However, the true nature of these investments will only be revealed over subsequent years. If, as we expect, the returns these two companies can produce can be maintained in the future, then both a re-rating of the shares and a compounding of retained earnings should result in significant upside for our investors. We are not investing based on an explicit oil price forecast, but in the belief that both businesses can survive the downturn and then prosper when the oil market returns to more of an equilibrium between supply and demand. The old adage rings true—it is not just the type of company one buys that matters, but also the price one pays. Distressed valuations in Q1 2015, provided us with a good opportunity to deploy more capital in the oil & gas services sector.

The mining sector has also been very weak in 2015, falling nearly 50%, as commodity prices have reached multi-year lows. This has in part been due to a slowdown in demand from China—the leading global consumer of hard commodities. Our investments in BHP Billiton and Rio Tinto have consequently fallen in value over this time period. Negative sentiment and short-termism have played an important part in these share price falls. It is interesting to note that Rio Tinto, the share price of which has fallen by a third over 2015, is still generating more free cash flow than it pays out in its dividend. In other words, in spite of depressed spot commodity prices, the business is effectively deleveraging its balance sheet even after paying its dividend to shareholders. The market myopically focuses on the large downgrades to earnings resulting from weaker commodity prices. We prefer to view historic cash generation through its business cycle and the free cash flow yield that it current market value reflects.

As a result of the vicissitudes of business life, we will own businesses in our fund which are facing issues. It is our job to determine whether such issues are temporary or permanent in nature. If we believe they are temporary, then the market may well offer us an opportunity as it falls out of love with the stock. As Christmas gives way to New Year sales in the UK high street and the prices at your favourite shops decline, will you want to buy more goods or fewer? It should be the same in investing, as long as the product or service still works as you expect! Serco is just such a company. It is a company which is facing up to its own issues, to the extent that we increased our position at the end of November. We talk more about it over the page as it is one of our stocks in focus.

Rolls Royce is another company within the fund which has been weak during the year and which could be described as a turnaround story. Rolls Royce has had a series of profit warnings as the migration from its legacy engines to its new models has led to a decline in short-term demand. Interestingly though, underlying cash flows have been stronger than accounting earnings. Their dominant position in civil aerospace engines for the wide-bodied aircraft will also increase earnings' visibility once clients transition fully to the new Trent engines. Rolls Royce's strong balance sheet also gives us confidence that it can emerge safely from this difficult trading period. Should new management be able to address a rather bloated and inflexible cost base, then profitability could be further enhanced. Once again the success or otherwise of this investment will be revealed over coming years.

Company	Sector	Position
Wood Group	Energy	5.1%
Petrofac	Energy	5.0%
Kone Corp	Industrials	4.6%
Capita	Support Services	4.5%
Admiral Group	Financials	4.4%
Astrazeneca	Healthcare	4.4%
Victrex	Basic Materials	4.3%
Shire	Healthcare	4.0%
Rotork	Industrials	4.0%
Tesco	Consumer	3.8%
Rolls Royce	Industrials	3.8%
Aveva Group	Technology	3.7%
Michael Page	Industrials	3.6%
InterContinental	Leisure	3.5%
Serco Group	Support Services	3.4%
BAE Systems	Industrials	3.1%
British American Tobacco	Consumer	2.9%
Colgate Palmolive	Consumer	2.9%
Rio Tinto	Basic Materials	2.8%
BHP Billiton	Basic Materials	2.5%
Imperial Tobacco	Consumer	2.5%
Unilever	Consumer	2.5%
Reckitt Benckiser	Consumer	2.4%
Croda	Basic Materials	2.2%
Cash		14.3%
Total		100.0%

Quality Table	VT Castlebay UK Equity	Market
Return on Equity	34%	26%
Operating Profit Margin	20%	13%
Net debt to equity	38%	86%
Cash conversion (free cash/net profit)	123%	95%
Free Cash Flow Yield	3.8%	3.9%

Our quality table highlights our focus on investing in high quality businesses at attractive valuations for the long term and gives us confidence to continue holding or adding to our existing companies during periods of market or individual stock weakness.

We wish you the best for 2016 and thank you for your ongoing support.

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

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Fund Cost analysis:

The first guiding principle of our partnership is 'Transparency and alignment of best interests with our fellow shareholders'. The majority of firms in the fund management industry have charging structures which we believe are opaque, difficult to quantify and are at times misleading. As our fund approaches its first anniversary we have disclosed in the table below the transaction costs borne by the fund and therefore our investors in addition to the Annual Management Charge. Unlike most of our peers, we pay the ongoing costs of the fund from our AMC and the costs highlighted in the table are for the transactions or 'portfolio turnover' within the fund for the calendar year from launch (28th January 15) to 31st December 2015. These costs are rarely disclosed by fund managers and vary depending on how frequently a fund manager trades. The more a manager trades, the higher the turnover ratio will be.

$$\textbf{Turnover Ratio} = \frac{\textbf{(purchase of securities + Sale of securities) - (subscription of units + redemption of units)}}{\textbf{Average Fund Value}}$$

We have calculated the Portfolio Turnover rate in accordance with the guidance in the FCA's handbook for Collective Investment Schemes/Coll4 Annex 2.

Turnover has been negative since launch because the combined purchases and sales have been less than the subscriptions into the fund. In practice we have voluntarily sold only two companies since we started managing money in July 2013. We have not yet been fully invested, however low turnover has been a hallmark of our investment approach for much of our careers. There have been various studies regarding the level of portfolio turnover in funds in the UK and in the past decade the average turnover in UK funds has ranged between 70-96%. In effect this means all the companies are sold and new ones bought in a fund every 12 to 17 months. Aside from debating whether this constitutes speculation rather than investing, the effect this has on costs is material, but usually not disclosed. We calculate that such high turnover adds on average an additional 1-1.5% onto costs each year for the funds of our peers.

The adjacent table highlights all additional costs of investment in our fund to our shareholders. Such costs include Voluntary commission—where we have taken the active investment decisions to buy or sell a stock for the fund, out with investing new cash for our new shareholders. Total Commission includes both the cost of voluntary commission and where new subscriptions have been invested. We **do not** accept any 'free services' like market data, research or corporate access in return for these broker commissions. Transaction taxes reflect the 0.5% levied as stamp duty on the purchase of UK equities. The total additional cost of investment for the first calendar year of the fund (28/01/15-31/12/15) is calculated as 0.29%, the majority of which has been paid to HMRC in stamp duty.

VT Castlebay UK Equity Fund	End Jan'15-End Dec '15
Portfolio Turnover Rate	Negative
Voluntary Commission	£953.91
	0.01%
Total Commission Paid	£8,465.75
	0.08%
Transaction Taxes	£23,438.73
Additional Cost of Investment	**0.29%**

In order to ascertain the total cost of investment in our fund, the additional 0.30% should be added to the Annual Management Charge (AMC) of our A (1%), B (0.8%) and C (0.6%) share classes. As the partnership pays the ongoing charges, the AMC is the same as our Ongoing Charges Figure (OCF). There is an anti-dilution levy which will come into effect following our first fund anniversary at the end of January 2016. This is designed to protect existing fund investors from additional costs as the fund changes in size from any inflows and outflows in the future.

We believe we are in a very small minority of managers who subsume all the ongoing costs of the fund from our management fee and provide a full disclosure of all costs of being invested alongside us, as fellow shareholders in our fund.

Stock in Focus:

Serco: Provider of outsourcing services to governments, international agencies and corporations globally.

Serco's issues are largely because it ignored the maxim of being 'intelligently conservative'. To use the expression of the well known US investor, Peter Lynch, Serco 'diworsified' into unprofitable contracts as they looked to expand the business. They moved away from their core competencies. The combined effect of this strategy put both the business franchise and the balance sheet at risk. However, this story holds in it the seeds of recovery for the company.

The management team brought in to recover the situation is looking to take the business back to its roots. Rupert Soames (CEO) and Angus Cockburn (FD), who led Aggreko so successfully over the previous decade, want to focus on the traditional 'business to government' contracts. When investing we often repeat the mantra that 'a bird in the hand is worth two in the bush.' This applies here to the restructuring of Serco. The operating margin recovery to which Rupert Soames points, of 5-6%, has been delivered historically by the company. Whilst the risk of executing this target remains, it gives us confidence to know that expectations are grounded in a level of profitability achieved historically. Further, management strengthened its negotiating position whilst looking to divest its Business Process Outsourcing (BPO) business by announcing a fully underwritten £550m rights issue. It told potential acquirers that its assets were not going to be sold in a distressed fire sale.

As we look back on some of things we could have done better, it is true that we bought Serco too early; before all of its issues had been fully reflected in its valuation. However, recently we have increased its position in the fund following the sale of its Intelenet business, which further strengthens its balance sheet. Previously the turnaround story had two elements: 1) a weak balance sheet, 2) a loss of goodwill towards the business. Now that the balance sheet has ben materially strengthened we have invested more capital. If the 'black books' of government contacts, developed by Soames and Cockburn over the years, can be put to good use, Serco will be well on its way to improving its fortunes.

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