Quarterly investor letter December 2017

Castlebay Investment Partners

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**

Taking Stock and defining success

Dear fellow shareholders,

Another year has passed in the blink of an eye. Three years have almost passed since the launch of our fund, as we celebrate that milestone at the end of January 2018. It feels like a good time to take stock and look at our progress as well as the lessons learned along the way.

How do we define success in fund management?

Is it merely strong investment performance; assets accumulated; time investing; or having the freedom to structure and manage a business and fund? For us, success is being able to manage the Castlebay UK Equity fund for many years, whilst staying true to our investment philosophy and always seeking to improve what we do. As we continue to apply consistently our investment approach, the results will follow. Investment performance should never be forced. It is why we invest in businesses not stock prices and look to be judged over a meaningful business cycle – three years being the very minimum period. Over shorter periods, one is more likely to be hostage to fortune amidst prevailing fads and fashions. Such trends tend to dissipate over the longer term, giving way to sound, business perspective investment. We remain focused on investing in good businesses, whilst minimising mistakes, which can detract from our performance. Our partnership structure allows us the freedom to write our own investment philosophy, test it and improve it. We believe such an approach provides us with the best chance of ongoing success.

Company	Sector	Position
Victrex	Basic Materials	6.0%
Intercont Hotels	Leisure	5.9%
Domino's Pizza Grp	Consumer	5.7%
Admiral Group	Financials	5.3%
Aveva Group	Technology	4.8%
Serco Group	Supp Services	4.2%
Tesco	Consumer	3.7%
Capita	Supp Services	3.5%
Dunelm Group	Consumer	3.4%
Imperial Brands	Consumer	3.4%
Kone Oyj	Industrials	3.4%
Compass Group	Supp Service	3.3%
Rotork	Industrials	3.2%
Craneware	Technology	3.2%
Avon Rubber	Industrials	3.0%
Burberry Group	Consumer	2.9%
BATs	Consumer	2.8%
Rolls-Royce	Industrials	2.5%
Colgate Palmolive	Consumer	2.3%
Reckitt Benckiser	Consumer	2.2%
AstraZeneca	Healthcare	2.2%
Unilever	Consumer	2.1%
Croda Intl	Basic Materials	1.9%
Page Group	Industrials	1.9%
Novo Nordisk	Healthcare	1.8%
BHP Billiton	Basic Materials	1.8%
Rio Tinto	Basic Materials	1.7%
Cash	Cash	12.1%
Total		**100.0%**

Source: Valu Trac

Investment Performance

Ultimately, we are in business to provide our fellow investors with two things. Firstly, a return on the cash which they entrust to us. Investment after all is about deferring the utility of cash today, in the hope and expectation more money is made in the future. However, this greater amount of cash only pays for more if it has risen faster than inflation. So secondly, we need to protect and enhance the spending power of the cash invested. It is for this reason that we compare our performance against the Consumer Price Index (CPI) +4% each year, on a rolling three year basis. The "+4%" element of the annual return reflects the fact that the fund's cash is being invested in equities. As equity owners of businesses, we benefit from the residual value that is created after all other obligations are fulfilled. That benefit carries risks and the "4%" premium, above CPI inflation, is designed to reflect those risks. The performance of our fund is detailed in the table below. As we near our third anniversary at the end of January, the fund to the end December 2017 has returned 28.0% since inception, with CPI+4% returning 17.7%.

Performance table

We realise that we will also be judged by some against the UK equity market. Our return of 28% since launch compares with the MSCI UK All cap market return of 28.2%. The Home construction and the Construction materials sectors illustrate well how lower returning companies can perform strongly over shorter time periods. Since our fund launched, these sectors have risen over 40% and 50% respectively. However, Return on Equity for both sectors is low—14% for Home Construction (excl. Reckitt Benckiser which sits oddly in that sector) and 10% for Construction Materials. In time, share prices tend to reflect the underlying returns of the stocks and so Reckitt Benckiser is the only company in the two sectors present in our Investment Universe. Since launch, we have carried an average cash position in excess of 10%. As we don't believe in market timing, this position has been because we have stayed true to our investment philosophy of not overpaying for high returning companies. This cash position has created a material drag on performance in a rising market. However, we are happy to remain patient. In time, further opportunities will arise.

VT Castlebay UK Equity Fund total return investment performance (A Accumulation) to end December 2017

	2017^	2016	2015	Inception
VT Castlebay UK Equity Fund[1]	**10.1**	**17.7**	**-1.3**	**28.0**
CPI +4%*	**6.4**	**5.6**	**4.7**	**17.7**
UK Equities[2]	**13.1**	**17.3**	**-3.3**	**28.2**

[1]Net of Fees, priced at Noon UK time (Source: FE 2016). Castlebay UK Equity Inception 28/1/2015 [2]MSCI UK All Cap (GBP) Source FE 2016
[3]Bloomberg/EFFAS Bond Indices UK Govt 5-10yr (Source Bloomberg). *CPI+4% to 15/11/17 (source: FE 2016) ^2017 YTD perf 31/12/16-31/12/17

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.

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Where have we gone wrong and what is an investment mistake?
In investment, as well as in life, we tend to learn the most from our mistakes. To that end, in the fourth quarter last year we spent a day analysing all our investment decisions since we launched the fund to identify when we had made investment mistakes which we define as:

- Deviation from our investment process
- Investing in a company which passes our quality test but shouldn't have
- Doing nothing if the share price of a company in which we invest declines since purchase
- Inaction once the investment thesis changes or red flags are raised

Our findings highlighted:

- All decisions have been consistent with our investment process.
- We have acted when share prices of companies in which we have invested have fallen, by allocating more capital, thus reducing the book cost price of the position. Examples include Rio Tinto, Serco, Rolls Royce, Tesco, Capita, Rotork and Aveva.
- When the investment case has changed we have taken action with sales of Mitie, Shire, Wood Group and BG.
- My mistakes generally have been in companies which had passed our quality test but shouldn't have, or where the quality aspect was misunderstood. In this category we include Mitie Group, Tesco, Capita, Serco and Petrofac.
- It was encouraging to see strong performances from: Intercontinental Hotels, Kone, Rotork, Rio Tinto, Admiral, Pagegroup, BG & Unilever.

Capital was permanently impaired following the sale of Petrofac, where non-operational issues meant it failed our acid test and had to be sold, thus crystallising a loss. In the case of Mitie we were able to identify my error and dispose of the position before the significant share price decline. All the 'problem companies' mentioned above have demonstrated the ability to generate high returns and growth in the past. Issues have been caused by changes to the competitive landscape or markets in which they operate. These issues have often been compounded by poor capital allocation decisions made by the management teams. In the cases of Tesco and Serco – we have drawn up turnaround checklists and averaged down our book costs. We believe both companies have largely been the architects of their own downfalls and can therefore recover their positions. Tesco is now making a positive return for the fund and Serco is not that far behind.

How do we guard against making the same mistakes in the future?
In analysing what has gone wrong, it is important to look at what we have done to guard against making these misjudgements again in the future. Our investment universe was incorporated into our investment process in the early part of last year to filter out lower quality companies which do not generate the returns for which we are looking.

We then spend time analysing the companies and the industries in which they operate to gauge more effectively where lie the wider investment risks. When these companies become attractively valued, we are able to act quickly and allocate capital as we have done with a number of our positions. Greater emphasis is also placed on analysing the incremental returns on capital that businesses are making. Experience has shown how a deterioration of these returns is often an early warning sign of trouble to come. Capital is ultimately attracted towards value creation and away from value destruction.

A mind map is completed for each of the companies in our universe which complements the financial models we construct. This allows us to think about both the qualitative and quantitative investment cases and risks. Our investment checklists reflect the quality characteristics that form our quality test. These developments to our approach help guard us against being tempted into lower quality companies, which whilst being attractively valued could become value traps - as returns fall below the cost of capital and value is destroyed by the businesses.

Key Metrics Table
We assess continually the key performance indicators and publish them in our Key Metrics table. It continues to highlight the higher quality of the companies in which we are invested, at similar valuations to the market. In the final month of 2017 we introduced our 27th position to the fund in Compass Group, which we will highlight in our next investor letter. When we first launched the fund we set out how we were going to invest. As actions speak louder than words, as we approach the fund's third anniversary, the Key Metrics table shows we have kept to our investment principles: Investing in high returning businesses whilst not overpaying for the privilege.

Key Metrics Table	VT Castlebay UK Equity Fund	Market
Return on Equity	37%	26%
Operating Profit Margin	21%	13%
Net debt to equity	38%	79%
Cash conversion (free cash/net profit)	119%	94%
Free Cash Flow Yield	3.6%	3.7%

Source: Bloomberg 31DEC17

We thank you for your continued support throughout 2017 and in the years since we launched our fund.
Best wishes for 2018

David F Ridland

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Tesco update:
The Competition and Markets Authority (CMA) concluded in December that Tesco's purchase of Booker did not raise competition concerns. Tesco doesn't supply the catering sector which makes up 1/3rd of Booker's sales. Whilst Tesco and Booker supply shops in competition with each other: 12,000 shops in common areas, the CMA deemed the level of competition sufficient to defeat a strategy of raising prices or reducing service levels, either in the retail or wholesale businesses. Thus, the £3.7bn takeover deal can proceed with no concessions.

The acquisition of Booker strengthens further Tesco's position in the UK retail market. It appears to be a value creating deal with post tax cash returns on invested capital set to exceed a conservative 10% cost of capital. That said, Tesco remains a business making returns at the lower end of the companies in our investment universe. Over time it has to be appraised as a turnaround situation where value can be realised, as opposed to a consistently high compounder of shareholder returns. This deal represents the latest step in the turnaround of Tesco, effected by the Chief Executive, Dave Lewis.

What has been interesting about the issues surrounding Tesco, is the fact that it was largely the architect of its own downfall. Before Dave Lewis arrived, previous management teams had over-expanded thus increasing the number of items for sale, wastage, prices and debt on the balance sheet. Return on capital subsequently declined and management were having to drive the business harder than before, culminating in the accounting scandal of 2014.

Turnaround checklist
Our Tesco turnaround checklist was created in 2015 in order to plot changes we thought the management needed to effect for progress to be made. As can be seen, the checklist has subsequently been completed. From a trading perspective this action has been reflected in stronger sales figures over recent quarters. Tesco is beginning to win back the trust of its customers by investing in price, lowering its margins and strengthening its balance sheets, whilst selling off non-core assets.

Tesco turnaround checklist:	
1. Non-core assets to be sold in order to reduce debt and focus on investing in UK business: Evidenced by sale of South Korean operations, Homeplus for £4.5bn. Tesco also looking at potential sale of other overseas and non-core operations.	✓
2. Increase investment in service	✓
• Mainly through employing more staff. There is no point in investing in price if the level of service is sub-standard.	✓
2. Invest in price to reduce premium pricing v. discounters – halve difference of £100 Aldi shop v Tesco.	✓
• Operating Profit Margin (OPM) to decline virtually to zero over 'investment period' Recent trading update reflects this ongoing investment in price	✓
• Do this consistently so that consumers can see this is not just a short term 'sale' Not enough time yet to assess this factor.	✓
4. Reduce floor space which reversing decline in sales density	✓
• Allowing for a reduction in Stock Keeping Units (SKUs) Evidenced in recent	✓
• Return to historic waste of 0.8% of sales from 1.2% will save £400m p.a.	✓

Fund Turnover & Total Costs of Investment in 2017

You will see at the top of the first page that two of our guiding principles are **Transparency** and a **Focus on Costs**. Unlike most of our peers we pay the ongoing costs associated with the fund from our Annual Management Charge. This means that the Annual Management Charge is capped and is the same as the Ongoing Charges Figure. As we have done since we launched the fund, we publish the transactional costs which reflect the number and cost of transactions carried out in the fund.

Whilst higher compared to historical standards, the number of transactions in the fund remained low, as did our turnover. To make a meaningful comparison, given asset flows into the fund, turnover has been calculated as purchases or sales (whichever is lower) divided by the average NAV of the fund, annualised. Since the fund launched, annualised turnover has been 10%. In other words, our average holding period is 10 years.

Voluntary commission occurred when we made an investment decision to buy or sell a position in the fund. The fund flow commission has been generated when we have increased existing positions in the fund as a result of new flows of capital into the fund.

VT Castlebay UK Equity Fund	01 Jan17 -31 Dec17
Portfolio Turnover Rate*	16%
Voluntary Commission	£8,614
Fund Flow Commission	£4,883
Total Commission Paid	**£13,497**
Percentage of Fund NAV	0.07%
Transaction Taxes	**£39,771**
Percentage of Fund NAV	0.22%
Additional Cost of Investment	0.29%

Source: Valu Trac

Our low turnover approach to investment means that we will invest and hold companies generally for the long term, thereby reducing the ongoing costs of the fund. The transactional costs are divided by our average NAV of £18.2m to calculate our Additional Cost of Investment. This is then added to our Annual Management Charge, in our three share classes, to calculate our Total Cost of Investment for 2017.