Castlebay Investment Partners

Quarterly investor letter March 2017

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**

To sell or not to sell….

Dear fellow shareholders,

Since we first started investing in the VT Castlebay UK Equity fund, we have regularly produced the Quality table below. It is central to our investment approach as it highlights how we seek to invest in good quality companies whilst endeavouring not to overpay for the privilege. The table highlights an interesting dynamic. Higher quality companies have generally performed well over the last few years, in a low growth environment, where any growth delivered has been rewarded by the market. However, since the middle of 2016 there has been a move towards 'Value' as an investment style. The table below shows that given this rotation there are an increasing number of high quality companies now trading more cheaply than the market, based on the cash flows they generate. Fortunately, we have been able to take advantage of this with our recent purchases of both Domino's Pizza Group and Dunelm Group.

Observing how the metrics of the quality table have changed over time can also be informative. In this regard it is worth noting:

1) The Return on Equity (ROE) of the fund (35%) is the highest it has been since launch.
2) The premium of the Fund's ROE versus the Market's (24%) is at its greatest since launch.
3) Following recent investment activity, the free cash flow yield for the fund is 3.7%. This means that the fund is invested in higher quality assets compared to the market for a cheaper free cash flow valuation.

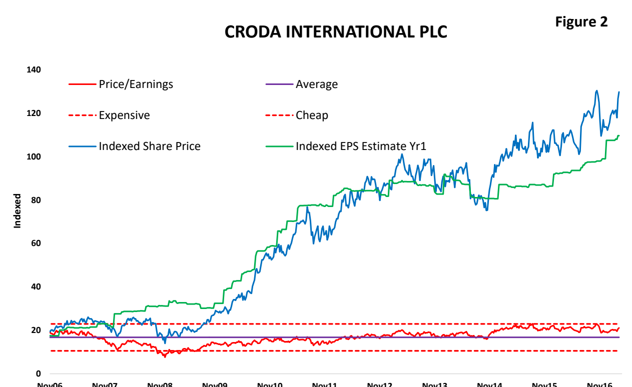
Quality Table	VT Castlebay UK Equity Fund	Market
Return on Equity	35%	24%
Operating Profit Margin	21%	13%
Net debt to equity	48%	77%
Cash conversion	122%	92%
Free cash flow yield	3.7%	3.4%

The 'Market' excludes financials in order to make a meaningful comparison of debt levels. A high Return on Equity would be of little use to us, if the companies were overburdened by debt, thereby introducing too much financial risk. When companies get into difficulty it is often because they have too much debt on their balance sheets. Free cash flow is effectively the cash a business generates after the cost of doing business. Investing in higher quality assets for less than the market on average seems like a good deal to us!

When to sell or not to sell:

Our investment process balances quality with valuation. Finding the right balance is important. Overpay for even the highest quality company and the subsequent valuation de-rating can materially detract from the growth in shareholder value, over the medium term. Conversely, buying low quality assets at a 'bargain' price/valuation can also impact returns; turning into the so called 'value trap', as the performance of the lower quality business continues to deteriorate. Our investment universe helps to prevent us from falling foul of the second scenario. However, focusing on the higher quality companies in our investment universe doesn't address the issue of owning good companies, the valuations of which are then re-rated. When these shares become expensive, what should we do then? The following example shows how we determine our allocation of capital in the fund, highlighting how the quality of a business will help determine when valuations become too expensive and exposure is reduced.

The Croda graph (figure 2) highlights how the Price/Earnings line moves above and below the average purple valuation line. An important aspect when assessing the efficacy of a valuation metric is that the valuation measure is mean reverting. It illustrates how the market falls both in and out of love with Croda—re-rating and then de-rating the shares.



Over recent years the valuation measure has become more expensive, trading above the average (purple) line. We term this a valuation 'Margin of Peril', where the risk of a de-rating of the valuation increases the more the red line rises above the average (purple) line. Importantly though, we don't view the valuation graph as a black box and sell merely because the valuation is above the average (purple) line. Rather it is one way we can appreciate how the market is valuing Croda, through both business and economic cycles. So when should we reduce exposure to this stock, trading with a valuation Margin of Peril?

The 'Compounding table' (adjacent) focuses on the high returns Croda makes to create shareholder value. The 'return on retained equity' reflects the rate at which shareholder equity is compounded as profits have been generated and retained in the business. Over the long term, the share price of a stock tends to follow this rate of return. The valuation of Croda displayed in the chart above is currently circa 20% above its long run average.

Compounding Table	
Croda International	**Percentage return**
Return on Equity	39%
Retention Ratio	52%
Return on Retained Equity	20%

Croda is currently around 1 year expensive i.e. 20% valuation premium divided into 20% return on retained equity. In allocating capital we have to ask the key question—do we want to lose access to a company like Croda, generating consistent high rates of return, for the sake of the valuation being 1 year expensive? Our average turnover since the fund launched in January 2015 is 7% indicating an average holding period of 14 years. Given our long term approach to investment the answer is we are happy to hold Croda at these levels, however we are not allocating additional capital to increase this position.

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

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Conversely, we recently sold out of BAE Systems on valuation grounds. Whilst the valuation margin of peril for BAE Systems, was only slightly higher than Croda's, at 23%, the return characteristics were much less supportive. For example over the last few years, BAE Systems has made on average a Return on Equity of 21%. As it has retained just under half of these profits, its retained return on equity has been around circa 10%. As with our Croda example, BAE System's valuation can be expressed compared to its return on retained equity. For BAE Systems it was trading over 2 years expensive! Following its very strong share price performance and its declining free cash flow yield, which had fallen below 3%, we deemed the valuation as being too stretched and sold the entire position.

Company	Sector	Position
Intercontinental Hotels	Leisure	5.7%
Rio Tinto PLC	Basic Materials	5.3%
Admiral Group PLC	Financials	5.3%
Victrex PLC	Basic Materials	5.1%
Rotork	Industrials	5.0%
Petrofac Ltd	Energy	4.8%
Serco Group PLC	Support Services	4.8%
Aveva Group	Technology	4.7%
Rolls-Royce	Industrials	4.7%
Capita PLC	Support Services	4.1%
Page Group	Industrials	4.0%
Kone Oyj	Industrials	4.1%
AstraZeneca PLC	Healthcare	2.9%
Tesco PLC	Consumer	2.9%
Domino's Pizza Group	Consumer	2.8%
BATs	Consumer	2.5%
BHP Billiton PLC	Basic Materials	2.5%
Burberry Group	Consumer	2.4%
Colgate Palmolive Co	Consumer	2.4%
Unilever PLC	Consumer	2.1%
Craneware PLC	Technology	2.0%
Dunelm Group PLC	General Retailer	1.9%
Reckitt Benckiser	Consumer	1.7%
Imperial Brands PLC	Consumer	1.6%
Croda International	Basic Materials	1.6%
Cash	Cash	13.1%
Total		100.0%

The shares in Wood Group were also sold following the announcement of the takeover of Amec Foster Wheeler. The management of Amec were going to raise £500m in a rights issue, due to recent weaker trading activity, to support their balance sheet. The suspension of this rights issue, following the news of the Wood Group deal means one thing. The balance sheet risk that was going to be dealt with by Amec's shareholders, is now being transferred to the owners of Wood Group. Despite the promises of great synergies from the deal we are not happy with this transfer of financial risk and therefore sold the shares.

During the first quarter of the year we introduced a position in Dunelm which has been weaker with the valuation now at a margin of safety (discount to its own long term average valuation) with an initial 2% position at purchase.

Domino's Pizza Group. We have recently purchased Domino's Pizza Group for the fund. Whilst the brand is well known to many, the business model may not be. Domino's Pizza Group operates a franchise model in the UK with outlets in Europe also supporting revenues. This business model by its nature requires less capital to generate returns. One of the great benefits of investing in companies with high rates of return is that for a given level of sales, less capital is put at risk.

Take the two Scenarios highlighted in the tables below. In Scenario 1 both companies are funded with £100 of shareholder equity. This is the capital that the owners of the business are effectively putting at risk. Company B is twice as profitable as Company A with profits of £20 compared to the £10 that Company A makes. The same Equity is invested, however Company B generates twice the profits. Another way of looking at this is represented in Scenario 2. In order for both companies to make £10 in profit, Company B only has to put £50 of shareholder equity at risk, compared with Company A's £100.

Scenario 1	Company A	Company B
Shareholder Equity	£100	£100
Return on Equity	10%	20%
Net Profit	£10	£20

Scenario 2	Company A	Company B
Shareholder Equity	£100	£50
Return on Equity	10%	20%
Net Profit	£10	£10

Domino's is an excellent example of how this dynamic benefits its shareholders. Rather than earning a 10%, or even 20% Return on its Equity, Domino's makes 47%! The franchisees, to whom Domino's grants a licence, invest the capital when establishing the growing number of outlets. Not only does this allow Domino's to maintain a lean, efficient balance sheet, no debt is required in order to expand operations. Thus, this 47% Return On Equity is generated with Domino's holding more cash on its balance sheet than debt. This seems like a pretty good combination to us. It proves that with the right business model and structure, shareholders can earn strong rates of return on their equity, without taking on perilous levels of financial risk.

Last year illustrated beautifully the vicissitude of markets and the folly of trying to predict the impact of macro events. In 2017, domestically in the UK and internationally, political and economic uncertainty persists. In trying to separate ourselves from this maelstrom, we continue to invest in the companies within our investment universe, using our valuation framework to add to these stocks when they have fallen out of favour with the market, reducing our exposure when the opposite is the case.

We are very grateful for your continued support. Thank you.

Best regards

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