Quarterly investor letter September 2016

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**

Balancing quality and value investing in a world of growth

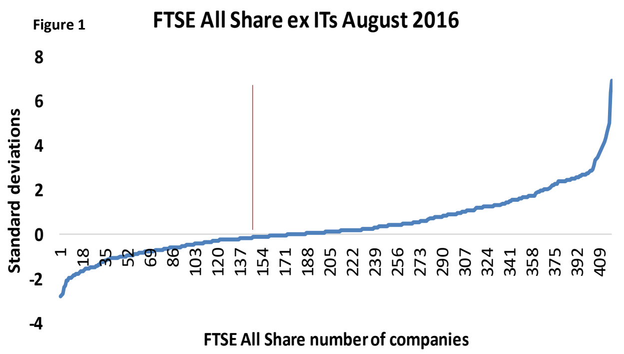
Dear fellow shareholders,

As we have stated before, we believe investment is a balance between Quality and Value. Our approach is to identify a universe of high quality companies and through our valuation framework invest in these assets, whilst not paying too much for the privilege. As we detailed in our last quarterly, we share in Charlie Munger's belief that share price returns eventually reflect the underlying returns that businesses make.

Company	Sector	Position
Aveva Group	Technology	5.6%
Intercontinental Hotels	Leisure	5.5%
Petrofac Ltd	Energy	5.5%
Rio Tinto PLC	Basic Materials	5.1%
Rotork	Industrials	5.1%
Wood Group PLC	Energy	5.1%
Victrex PLC	Basic Materials	4.9%
Capita PLC	Support Services	4.7%
Serco Group PLC	Support Services	4.6%
Kone Oyj	Industrials	4.5%
Admiral Group PLC	Financials	4.1%
Page Group	Industrials	3.7%
AstraZeneca PLC	Healthcare	3.5%
Rolls-Royce	Industrials	3.4%
Tesco PLC	Consumer	3.3%
BATs	Consumer	2.8%
BHP Billiton PLC	Basic Materials	2.8%
BAE Systems PLC	Industrials	2.7%
Colgate	Consumer	2.7%
Burberry Group	Consumer	2.3%
Unilever PLC	Consumer	2.3%
Imperial Brands PLC	Consumer	2.0%
Reckitt Benckiser	Consumer	2.0%
Croda	Basic Materials	1.8%
Cash	Cash	10.2%
Total		**100.0%**

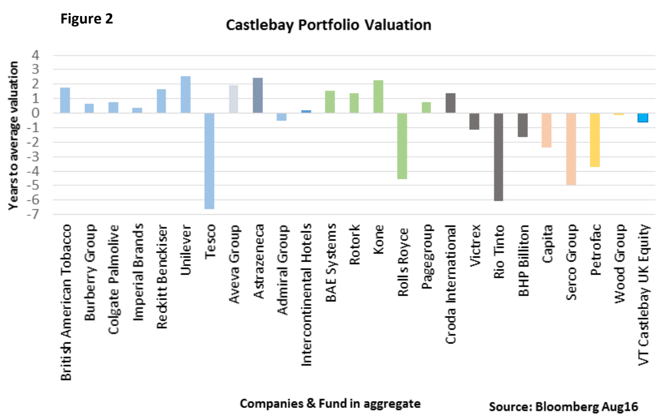
Let's first look at the opportunities that the UK market is currently offering. Our valuation analysis is centred on how a company is valued versus its own long term average valuation. If a company's valuation is lower than its long term average, it has a valuation margin of safety and is cheap. Conversely, if the company's valuation is above its long term average, it has a margin of peril and is expensive. Applying the caveat that this framework focuses on current, spot valuations, we can identify where each individual company is valued relative to its own respective history. The chart (figure 1) below illustrates that nearly two thirds of the UK market is trading expensively. The red vertical line signifies the point at which companies are trading at their average (mean) valuations.

- Only 163 companies (39%) are trading below historic average valuations. Only 4 companies are more than two standard deviations cheap. i.e. very cheap.
- Over 60% of companies are at or above average valuations. 54 companies are more than two standard deviations expensive. i.e. very expensive.
- On an even weighted basis, the market as a whole is currently expensive, particularly many of those companies which are deemed to be of high quality.



Our valuation framework allows us to define how many years it takes for a company to compound its shareholder equity, thereby bringing any valuation divergence back to average (mean) valuations. We do this by dividing the company's valuation rating by the average retained Return on Equity – the average rate at which retained earnings has grown shareholder equity. The bar chart below, shows each of the companies in which we are invested and whether they have a valuation margin of safety or a margin of peril, based on the number of years to average valuation ratings— driven by these shareholder equity compounding rates.

The fund, denoted on the bar chart (figure 2), has in aggregate a margin of safety of 0.6 years. In essence this means that there is a re-rating potential for the fund in aggregate relative to historic valuations, even though there is a focus on quality. It highlights that we are maintaining a balance between investing in high quality companies, whilst not paying too much for them. The analysis overleaf highlights why this is a particularly important consideration at this stage of the investing cycle.



Quality Table		
Key metrics	**VT Castlebay UK Equity**	**Market**
Return on Equity	33%	23%
Operating Profit Margin	20%	14%
Net debt to equity	48%	77%
Cash conversion	119%	86%
Free cash flow yield	3.1%	3.2%

Our Quality Table continues to highlight our focus on long term investment in high quality businesses.

Once again we would like to thank our investors for their ongoing support and hope you find this letter of interest.

Best regards

David F Ridland

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

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Castlebay Investment Partners

Why have growth companies been so well rewarded over the last seven years at the expense of value companies?

Investment Universe:

We explain the outperformance of growth against value over recent years by using the simple demand / supply curve illustrated in the graph (figure 3) below. Simply stated, a consumer, who may demand a given product, wants to buy more of that product the cheaper it is priced. So 'quantity demanded' increases along the horizontal axis as 'price' falls on the vertical axis. From a supplier's perspective of course, the opposite dynamic normally holds true. The supplier will happily supply more quantity when the price rises, but as prices drop they will likely become less willing to supply their product or service. Where the two curves meet is called the equilibrium. It is effectively where demand matches supply and the market is in balance.

We can also think of the Demand curve from a slightly different perspective. The very top left of the demand curve shows that if a product is very scarce, i.e. in very low quantity, then people are often prepared to pay a very high price for it.

Now we can apply this simple economic model to our question above regarding 'growth' and 'value' companies. Since the financial crisis and the economic recession that followed, banks in particular have had to repair their fragile balance sheets due to regulatory changes and the need to hold more capital to support their businesses. This 'deleveraging' of their balance sheets has meant that bank lending—a key component to support growth in the economy, has been weak.

Also the dramatic decline in interest rates has created a disincentive for companies to invest—a so-called 'liquidity trap'. Many have taken out cheap debt and rather than investing for the future growth of their businesses and the economy, they have bought back their own shares. These factors have resulted in growth becoming a scarce resource. As we mentioned above, when this happens people can be prepared to pay a lot more for companies showing any growth dynamics, than would otherwise be the case.

Figure 3

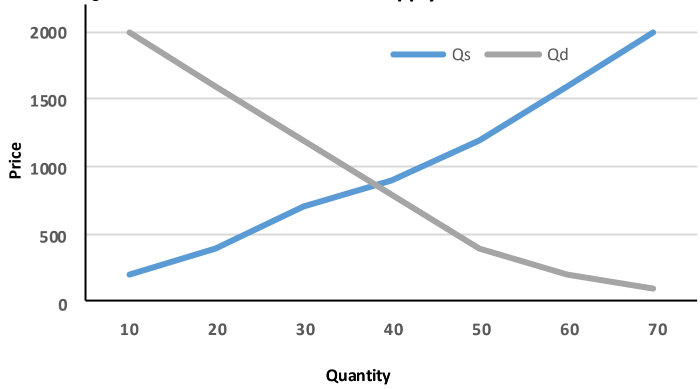
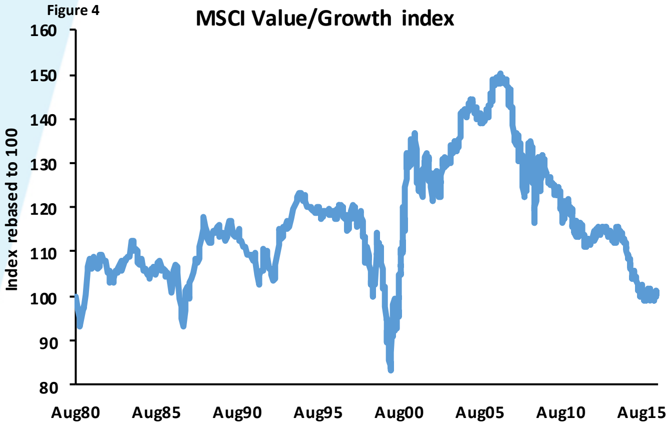


Figure 4



Many of the companies that have such growth characteristics have been consumer type companies with strong brands and high rates of investment return. Due to their consistency of growth and high compounding rates of return, these stocks have been well supported by the market. Therefore some of these companies have become expensive. Whilst their underlying fundamentals may well be intact, there is a materially greater risk that valuations will be de-rated over time. This in turn can impact the returns we make as investors.

Whilst following Britain's vote to leave the European Union, interest rates have been reduced, in the US the opposite is true. In the latter's circumstance, rising interest rates are normally a portent of higher expected inflation brought on by greater economic growth. Another way of saying this would be a greater supply of growth. Suddenly growth is not so scarce. As the supply increases, the price of 'growth' falls. It is for this reason that value investing often starts to perform better than growth investing when the US starts an interest rate rising cycle, during an economic recovery.

The Value Growth index shown in figure 4, highlights the extent to which growth has outperformed value over the last eight years. Interestingly, since 1980 this index shows returns between growth and value to have been of a similar order. However, the magnitude and time period over which value has been in the doldrums, suggests that value could soon have its day in the sun!

As mentioned, there is currently an unusual dichotomy at play—where monetary policy either side of the pond is heading in opposite directions. However, global equity markets often take their lead from the United States. As such, we believe it is particularly important at this stage to have a keen focus not just on the quality of the companies in which we are investing, but also their valuations.

Having analysed our UK equity fund through both a quality and value prism, we are reassured on two main counts. Firstly, our Quality Table reproduced overleaf highlights the quality premium the aggregate companies in our fund hold over the market. Secondly, the fund in aggregate displays a valuation margin of safety. As political uncertainty through Brexit and the US presidential campaign persists; and rising US interest rates signal a more plentiful supply of growth, we continue to focus on balancing quality and value investments, in a world of growth!

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