Quarterly investor letter September 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

'Compound interest is the eighth wonder of the world. He who understands it…earns it. He who doesn't… pays it!'
Albert Einstein

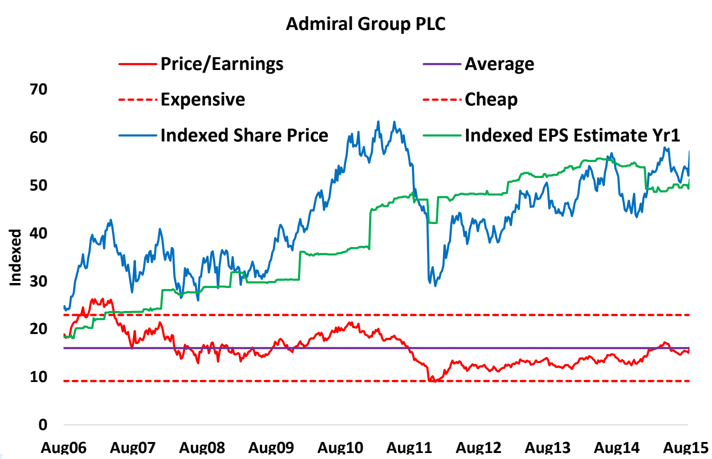
Dear fellow shareholders,

In our latest quarterly letter we look at 'time machines, investment returns and the power of compounding.' As the new series of Dr Who gets underway we jump into our own time machine and fast forward ten years to 2025. Flinging the doors open we observe, hopefully, strong investment returns that have been made by the VT Castlebay UK Equity fund. We then ask how those investment returns would be constructed. If past performance is a guide to the future, we believe that there would be two main components: 1) a return derived from cheaply valued shares re-rating to their long run average valuations 2) the 'compounding effect', as high marginal rates of return are earned on retained shareholder earnings, by the companies we own.

The Portfolio in the third quarter 2015

We wrote in our previous quarterly about 'selling the market in May and going away, only coming back in St Leger's day' at the beginning of September. The first part of this advice was correct, although due to continued economic uncertainty in Asia, September saw prices fall further. Our 20% cash position at the beginning of the period reflected the lack of good quality companies trading with supportive valuations. However, our patience was rewarded following the summer weakness and we invested in three new stocks—InterContinental Hotels Group, Colgate Palmolive and Unilever.

Given that we try and buy good quality companies and not pay too much for them, we are trying to capture an effect called mean-reversion. Valuation measures for companies often move above and below their long run averages. We are trying to buy companies whose valuations are trading below their averages and benefit, over time, from the shares' valuations moving back to their respective averages (the purple line in the Admiral graph). In the example of Admiral, which was purchased back in December 2013, Admiral had fallen out of favour with the market. Its valuation rating was depressed and there was c20% upside to its average historic valuation. If, for example, we continue to hold this company for another ten years until 2023 (which is quite possible given our low turnover of stocks) then that 20% upside return has to be spread over that ten year period. So each year it would contribute roughly a 2% return, assuming that by 2023 it was trading back at its average rating. Given that developed markets return c.8% each year over the long run and as unconstrained managers we are trying to outperform the market, we would hope 2% is not the largest part of our yearly investment return!



So what is expected to deliver the greatest part of returns? We believe it is through the power of compounding 'returns on shareholder equity' that would most likely constitute the greatest part of our returns. In other words, if the stocks in our fund can continue each year to make high returns on shareholders equity (ROE) and capital employed (ROCE), the value of these companies (and subsequently their share prices) should rise over the long term. Furthermore, if the premium of these measures relative to the market is maintained, then over time with all else equal, the fund should be in a strong position. Thank you for your continued support as shareholders. We hope you enjoy the read.

Company	Sector	Position
Tesco	Consumer	5.3%
Aveva Group	Technology	5.2%
Capita	Industrial	5.1%
Wood Group	Basic Materials	5.0%
Rolls-Royce	Industrials	4.9%
Petrofac	Basic Materials	4.7%
Victrex	Basic Materials	4.7%
Kone Corp	Industrials	4.6%
Admiral Group	Financials	4.6%
Shire	Healthcare	4.3%
Rotork	Industrials	4.1%
Michael Page	Industrials	4.0%
Rio Tinto	Basic Materials	3.6%
InterContinental	Consumer	3.4%
BATS	Consumer	3.2%
BAE Systems	Industrial	3.1%
Colgate Palmolive	Consumer	3.1%
BHP Billiton	Basic Materials	2.7%
Reckitt Benckiser	Consumer	2.7%
Imperial Tobacco	Consumer	2.7%
Serco Group	Industrial	2.5%
Croda	Industrial	2.3%
AstraZeneca	Healthcare	2.1%
Unilever	Consumer	2.1%
Cash		10.3%
Total		100.0%

David F Holland

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

It is no coincidence that throughout our communication to our fellow investors, we consistently present our key metrics table. It emphasises the importance of investing in high quality companies as a key part of our investment approach. We have updated the table below to reflect the impact of recent purchases. Fortunately, the recent weakness in share prices generally, has allowed some of the key metrics to increase as we have invested in some new high quality companies which the market is now offering at more attractive valuations.

Key Metrics Table	VT Castlebay UK Equity	Market
Return on Equity	34%	25%
Operating Profit Margin	20%	15%
Net debt to equity	39%	83%
Cash conversion (free cash/net profit)	109%	85%
Free Cash Flow Yield	4.5%	4.2%

Premier Farnell: Satisfied our valuation screen but failed our Quality Test

Premier Farnell distributes electronic components and equipment internationally. After initially identifying it as an attractively valued company in our weekly valuation screening, we then carried out the due diligence by constructing a historic ten year investment model and framed our analysis through the use of our Investment Checklist. This list is designed to help us avoid repeating our past mistakes as well as to provide an efficient structure through which to carry out our analysis.

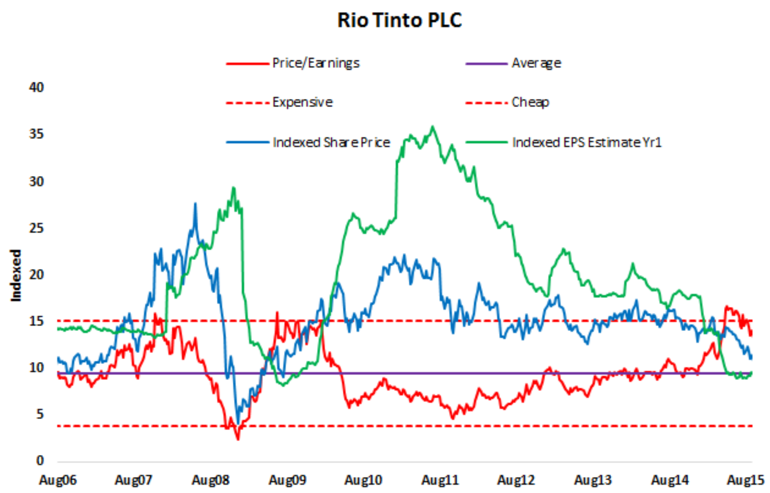
Castlebay Investment Partners

Investment Checklist

Model: Insolvency Risk, Returns decomposition -	
21. Is the Balance Sheet strong enough to withstand bumps in the road?	?
22. Does leverage drive returns? – ie Banks	X
23. Is the company both operationally and financially leveraged? – If yes, it's a NO!!	X
24. Has leverage increased over recent years at the expense of returns?	X

Operational and financial leverage has been steadily rising over recent years, with net debt rising to £260m. Operating margin has also been declining from 13% to 9% in recent years. Asset turnover has been constant at 1.7x, however, increasing debt implies that returns are driven more by leverage than operations. As highlighted by question 23 on our checklist, we avoid companies that have both high operational and financial leverage. In our experience, companies that exhibit both forms of gearing are most often the ones that get into financial trouble. Thus, for the reasons noted we decided not to continue our due diligence process with Premier Farnell. Time would be better spent looking for other opportunities.

Rio Tinto: Our valuation methodology highlights an interesting aspect with Rio Tinto, as well as with some other economically cyclical companies. As commodity prices have been weak, having declined in recent years, Rio Tinto's short-term Price/Earnings valuation appears expensive as earnings have declined. Yet an investing axiom comes to mind – 'never buy a cheap cyclical (on peak earnings); buy instead when cyclical earnings are at their 'nadir' and valuations appear expensive. Thus, a key question is the extent to which we are confident that earnings are reaching the bottom of the cycle. Copper, a bell-weather commodity of the mining sector, is currently trading at a large discount to its ten year historic average. This is important, as the long run average copper price should largely reflect the marginal cost of production and the point at which declining supply can help bring prices back toward their equilibrium level. If copper is symptomatic of the other hard commodities, in general, then it suggests that commodity prices and by extension earnings, may be near their nadir. Once earnings start recovering they often increase faster than share prices. This leads to a valuation de-rating, but a rising share price.



At Castlebay we believe that cash is king. Subsequently, through the construction of our ten year model for Rio Tinto, we can observe how well the company has generated cash flows, through economic cycles and after the cost of doing business. The answer is rather well. Dividing the current market capitalisation of the company into its free cash flow (cash generated after the cost of doing business), results in a free cash flow yield of 7.5%. This is compared to a dividend yield of 7.2%. This means that after paying out dividends to its shareholders, Rio Tinto is still able to strengthen its balance sheet through retained earnings, even amidst a backdrop of weak commodity prices. The economic backdrop may remain fragile, but Rio Tinto appears well placed to weather the difficult trading environment.

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