Quarterly investor letter March 2022

Our guiding principles:

- **Transparency & alignment of best interests with our fellow investors**
- **Independence of thought to avoid the market herd**
- **Adherence to our investment philosophy and process**
- **Focus on costs: management fees capped, low stock turnover**

Investing through uncertainty: Part 2 - The perils of forecasting the Future!

Dear fellow shareholders,

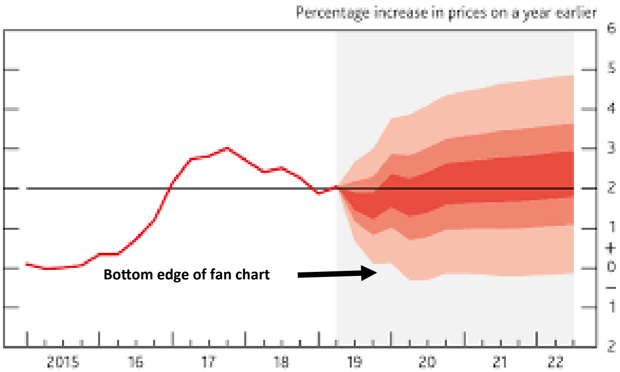
In our last quarterly investment letter we embarked on a new series, the aim of which was to set out how we '**Invest through uncertainty'.** We looked at how our companies try and deal with **price instability—** which is currently manifesting itself through inflation rates at 30 year highs in many countries. In the second part of our series we are going to look at **the future.** This may seem an absurdly obvious factor to acknowledge when talking about the field of uncertainty. As we have often mentioned, we live in a complex, dynamic and uncertain world, as the tragic conflict in Ukraine bears testimony. This makes determining what may happen in the future both at an economic level, but also at a company specific level, somewhere on the spectrum between 'very hard to impossible!'

So the obvious question that follows is—what should we do? Should we for instance, base our investment philosophy and process on trying to forecast the future? What if we're wrong? Or perhaps more injuriously to our long term wealth, what if we are right in the short term and gain a false sense of security? Investors are often petitioned against 'driving using the rear view mirror'. Even the regulator requires the oft quoted mantra published at the bottom of this very page, that 'past performance cannot be relied upon as a guide to future returns.'

Somewhere in all of this confusion, we need to plot a path that helps us learn from our past investment mistakes; creating a process that is robust during the good times and more importantly endures through the tough times. Quality companies that have established their business models over many decades have no given right to an undisturbed future. However, their very survival points to resilient business characteristics. If one were to estimate the probability that they would be around in ten years' time, it would likely be higher in relation to that of an untested start-up. So we believe that the past should inform us as we look to the future, but that this view should be constrained within certain parameters.

It would be churlish to suggest that we are not looking towards a prosperous future for our companies. Importantly though, this is framed by the acknowledgement that our businesses—due to their quality and resilient business models, have a greater chance of dealing with whatever 'the future' throws at them.

In some regards we think like the Bank of England when it publishes its fan graphs, showing the range of its expected outcomes for inflation over coming years. Investing in these higher quality businesses gives a better probability of prosperity, across a range of potential future outcomes.



Source: Bank of England

We look for management teams which combine a positive view of their potential, whilst managing the business to navigate the worst outcome—akin to the bottom edge of the BoE's fan chart opposite. Who could have predicted the impact of Covid? Yet the way our companies have come through this great period of upheaval is testimony to the success of this approach. 'Resilience' must always be the master over 'the creation of an optimal business'. The former ensuring survival during the storm and the latter foundering on the rocks of hubris.

There are other aspects of our investment approach that can also limit the risks of peering into the future. As 'Quality value' investors one of the ways in which we value our businesses is by using a **reverse discounted cashflow model**. This is an inversion of the traditional discounted cash flow (DCF) system, where future business cashflows are forecast and then discounted back to the present day using a created discount rate. This approach is fraught with peril, not least as it requires the ability of forecasting accurately the cashflows of a business to the end of time or its life, whichever is sooner! Earlier in my career, as a consumer of sell-side analyst research, it was always amusing to see the precision to which these DCF models were produced. Analyst valuations and price targets were generated to the penny, betraying the inexact nature of these models. All the while, such prognoses being declared with a confidence that would put Nostradmus to shame!

The reverse discounted cashflow process that we use, simply takes your required return as an investor, assesses any dividend yield and computes the required growth in earnings, needed to meet this total return figure.

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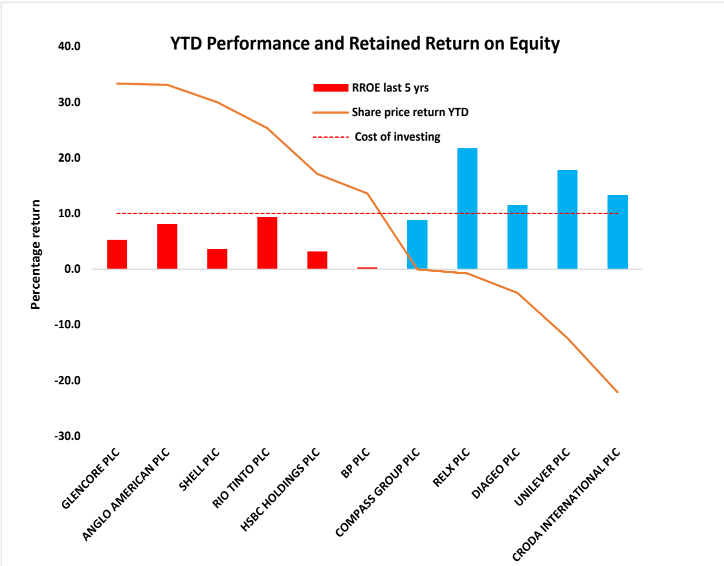
We should also adjust for a reversion to the valuation mean over the holding period. An example will hopefully clarify this process. Assume a required annual return for Company A of 12%. The company has a dividend yield of 3%, which contributes to your return. If the company were also trading on its average price/earnings valuation both now and at the point of sale, then earnings growth of 9% would be required to deliver the 12% total return. We can then compare this to the historic growth in earnings, to determine how likely it is that this 9% growth can be achieved. All this has been done without fallacious foretelling and the risks associated with such an approach. We feel much more comfortable rooting our analysis in observable factors, than pinning our colours to a mast decorated with such forecasting follies.

As we have mentioned in many of our letters over recent years, we seek to invest in a collection of good businesses and then own them for the long term, in order to benefit from the power of compounding. As such we tend to avoid commenting on shorter term periods which normally contain much 'market noise'. So just to prove the exception to this rule - in light of recent turbulent events, here is an observation on performance year to date, made through our lens of quality and compounding. Our focus on **retained return on equity (RROE)** is highlighted in the graph below. The principle we often cite in relation to Charlie Munger, is that share prices tend to reflect the underlying returns a business makes—our companies' RROEs being a reflection of this.

This retention and reinvestment of retained earnings, is the main way in which shareholder equity can compound to create value for the owners of the business. Return on equity multiplied by the retention ratio is how we calculate the RROE. Ideally we like to see this return exceed 10% (the dotted red line in the graph opposite).

It is essentially what we look at as our 'cost of investing.' As unconstrained investors we can choose what return we require in order to invest. This cost of investing hurdle gives a margin of safety above 'Siegel's constant' - the very long-run annual returns made by developed market equities, which when adjusted for inflation sits around 8-9%.

Yet in the graph opposite, the share price return line shows how recent events have distorted this relationship - due to the war in Ukraine and the associated impact on the oil price and other commodities.



Source: Bloomberg as at 31/03/22

The graph shows some of our companies, represented by the blue bars, with strong retained returns on equity. Compass sits slightly below the 10% level, which has been due to the margin and asset turnover impact from reduced 'end demand' caused by Covid. We anticipate that their profitability will recover over time. In contrast the red bars show some companies with much lower returns on equity capital and therefore lower retained returns on equity.

Given the conflict in Ukraine and the associated impact on oil and other commodities, it is not surprising that Shell PLC has seen its share price rise by around 30% in the first quarter. However, were this level of performance to continue for the rest of the year, this would produce more than a doubling of the share price! Yet Shell has only averaged a 5% return on equity over the last five years which produces a retained return on equity of only 3%!

A share price compounding at this 3% rate would take 24 years to double, not the one year that the recent performance implies! So we would argue that its share price has risen far out of line, from the value the underlying business is earning. This is unsustainable in our view. Capital has been taken away from our companies over this short period and allocated into these lower quality businesses. We believe that this provides an interesting investment opportunity as the share price performance has become divorced from the business fundamentals.

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This dynamic is further highlighted in our 'Quality Table'. The Return on Equity (ROE) of the businesses in our fund is around the highest level it has been, over the life of the fund. Therefore, that large spread in relation to the market has widened. The operating profit margin (OPM) of the fund has been maintained at 20%.

Quality Table	Castlebay Fund	Market
Return on Equity	44%	18%
Operating profit margin	20%	11%
Net debt to equity	54%	89%
Cash conversion	86%	86%
Free Cashflow yield	4.2%	3.9%

Source: Bloomberg as at 31/03/2022

Interestingly, the market's OPM which was at 12% pre Covid, fell to 7% and has now recovered back to 11%. This positive change explains some of the recent market performance. Yet as mentioned in this letter, we believe our companies' greater resilience is in part reflected in the lower levels of debt in relation to the market: 54% v 89%. Following the impact of Covid on the economy, the cash conversion levels for both the fund and the market are returning to more normalised levels.

Finally, as noted above, recent performance divergence means that our fund is attractively valued on a free cashflow yield basis, both in nominal terms and in relation to the market. Whilst in the short term some of our quality companies are out of favour with investors, they continue to create value as illustrated in our table.

Activity during the first quarter was focused on maintaining our desired exposure to our companies as subscriptions came into the fund, as we remain fully invested.

Thank you once again for your continued support and we hope that you find this series of letters of interest.

Yours,

David F Ridland