During the half year to 31 March 2019, the Fund (VT Cape Wrath Focus Fund A-shares, GBP) delivered a 14.0% loss, while our Benchmark (MSCI UK IMI net dividends reinvested, GBP) delivered a 1.8% loss. Amongst the principal sources of underperformance during the period were our investments in Flybe (FLYB) and Gulf Marine Service (GMS), which are reviewed later in this report.

With an 8.0% weighting, the largest position at the start of the period was EI Group (EIGE, formerly 'Enterprise Inns'). EIGE owns a portfolio of commercial properties (primarily pubs on tied leases), and has been held in the portfolio since launch. We finally exited the position in March 2019 for a 123.3% return over the 26-month holding period (including a 24.3% return over the half-year). EIGE's performance over this time has been down to the strength of the pub segment within the casual dining sector and management's focus on capital allocation. It is rare to find a team who will shrink their business in order to create shareholder value. At EIGE a steady stream of disposals, including the sale of a portfolio of 340 commercial properties for £348m earlier this year at a valuation which was in-line with net book value, has provided cash to buy back shares and pay down debt. At the time of writing the shares are trading near our Approximate Value (AV) for the business, which is around one third below NAV.

Another position that we exited during the period was the uPVC double-glazing business, Safestyle (SFES), which delivered a 16.4% return during the period, on top of a 60.1% return last year. While our position in EIGE represented a relatively long holding period for us, our two-month investment in SFES, split over the end of last year and the start of this one, was at the shorter end. We analyse the returns on our investments using a 'Share of Potential Returns' (SoPR) model. Contrary to the popular investing truism that 'the best holding period is forever' (Warren Buffett), we'd rather achieve our AV over a shorter holding period than a longer one. If you would like to see the summary output from our SoPR model, or are interested in more detail on our investment in SFES and why it is a good example of the behavioural opportunities that we try to focus on, please see the Broadside 'Snog Marry Avoid?' which is available on our website.

The Fund's best performer was CVS Group (CVSG), the veterinary service provider, which delivered a 32.4% return on our average purchase price during the period. CVSG's main business is operating a network of 491 veterinary surgeries, including small animal, farm and equine, across the UK, Ireland the Netherlands. We opened our position in CVSG on 15 February based on an AV of 609p for the business and 39% upside. We view CVSG as a good quality business (62% BAIT score) going through a transition from an acquisitive to an organic growth model, while also facing some margin pressure. We subsequently increased our AV to 677p after the company reported accelerating like-for-like sales at the interims.

We typically add to positions on weakness, increasing our position size as the potential return increases, or the risk attached to that return decreases. We look to build to a full weighting over three tranches based on valuation triggers, although in many cases the thesis or price action play out such that we only buy one or two tranches. Last year provides a good illustration of this. Keen observers may note that in 2018 we reported 15.1% underperformance in the first-half, followed by 22.7% outperformance in the second-half, with the second half performance driven in part by 'doubling-down' on AA Group (AAAA, 53% loss during first-half 2018) and Capita (CPI, 74% loss during first-half 2018), both of which recovered strongly in the second-half. However, there are also cases where we exit into a falling share price, after seeing that our initial assessment of the potential return, or associated risks, was wrong, as with GMS and FLYB.

As with EIGE, we owned GMS at the Fund's inception in October 2016. The company owns and operates a fleet of self-propelled Self-Erecting Support Vessels (SESVs). These vessels look like jack-up rigs, minus the derrick, and are used for the repair and maintenance of offshore oil platforms and wind farms. GMS is a financially geared oil service stock with good asset backing. Our initial purchase price was 50.3p, for which we bought around 95p of vessel (in 2014 the company traded at up to 2x NAV). GMS build their own vessels at a yard in Abu Dhabi and has a relatively young fleet, with an average age of 8-years (versus a 25-year useful life). The shares fell by 63.0% between the start of the period and our final sale in January 2019 as a result of the company's announcement that they would need a more 'appropriate long-term sustainable capital structure' (i.e. rights issue). While this had always been the principal risk to the investment case, the company had a good record of renegotiating their banking covenants, and as ultilisation and day rates normalised, we expected the company would be able to reduce leverage organically. Our weighted average purchase was 30.3p, and our weighted average sale was at 23.7p (our final tranche was sold at 17.13p), which translates into a 21.7% loss over the 28-month holding period. At the time of writing GMS has not yet announced the expected rights issue and the shares trade at around 12p. While this reflects an 87% discount to the net value of the vessels, it is hard to see that much of this value will be captured by equity shareholders in the event of a rights issue.

FLYB declined by 65.5% over the 3-weeks from the start of the period to our final sale in October 2018, and our loss over the 15-month holding period was an equally bruising 63.9%. If there is any consolation it is that we avoided the further 92.3% share price decline over the 4-months between our exit at 13.1p, and the ultimate sale of the business to the 'Connect Airways' consortium for 1p in March 2019. As with GMS, the catalyst for the share price decline was the balance sheet. In the case of FLYB, creditors were less patient than they have been with GMS, and the situation unravelled very quickly once credit card providers deemed that FLYB presented too great a credit risk to pay the airline in advance for ticket sales. Our exit from the position was based on a review of the investment which indicated that FLYB could be structurally loss-making, as airlines have historically had a habit of being. The eventual sale price seems to support this view. For a more detailed look at this investment, please see the Broadside 'Snog Marry Avoid?' which is available on our website.

In terms of process development this year, we have made progress on two related fronts. Firstly, we have a number of projects completed, in progress, and planned which are improving the new ideas net to make sure we get eyes on everything that is potentially interesting. The most straight-forward of these projects has been to update our 'traditional' screening tool, which makes use of conventional financial data sources and simple and / or decision rules to produce a long-list of around ten new ideas per month. We also have a project underway called the 'God Portfolio' which will ultimately help to inform our 'next generation' screening tool ('Walter'). Walter's advantage versus a traditional screener is the ability to pull together diverse and unconventional data sources, and also to use complex decision rules. Do get in touch if you'd like to know more about Walter or the God Portfolio.

Secondly, having worked on the process for arriving at the new ideas long-list, we have recently finalised an improved process for narrowing this down to a short-list, which we call the 'Red Flag Evaluation' (RFE). Anders Jegers (Head of Research) has been instrumental in creating the RFE, which is designed to ensure we invest in fewer GMS and FLYB's ('hand grenades' in Cape Wrath vernacular). Looking at the largest negative contributors to performance, common themes are balance sheet issues and broken business models. Our strategy has always involved walking fairly close to the edge. With the implementation of the RFE, we are saying that if the issue concerns the balance sheet or the businesses fundamental ability to create value, we will stick behind the cordon.

I am mindful that many investors (Buffett included) have a Damascene moment, that takes them from picking cigar butts to looking for quality buy-and-hold opportunities. This is not that moment. We believe that the quality growth / GARP space is crowded and that we will beat such strategies by a significant margin over the long-term by rejecting the received wisdom. At the same time, the 'cigar butt' epithet implies investing in businesses with structural issues, weak or negative value creation and declining fair value. That's not what we are trying to do either. Perhaps a 'sick dog' analogy is more appropriate. We're looking for things with chewed ears, docked tails, odd coloured eyes, uneven coats or perhaps a limp. Creatures ugly enough to be left unwanted at the back of the pet shop, but where we see underlying potential.

Adam Rackley

Investment Director

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