

During its first year (ending at 30 September 2017), the Fund (VT Cape Wrath Focus Fund A-shares, GBP) delivered a 10.3% return, which was in-line with the Benchmark (MSCI UK IMI net dividends reinvested, GBP), which also delivered 10.3%. Despite this, the fund exhibited very low correlation with UK equity markets (R-squared of 3.5% and a tracking error of 13.5%). There were half a dozen days during the year when our year-to-date performance matched the Benchmark and, by coincidence, the year-end was one of them.

The year started well, and by 16 January 2017 the Fund was up 15.3%, while the Benchmark was up 4.9%. The rest of the year was challenging, and we gave back some of that performance, while also significantly underperforming the Benchmark, but this was in-line with the range of outcomes that history tells us to expect from the strategy. The rest of this Report will, for the most part, focus on the bottom-up drivers of performance.

The top performer for the year was EI Group, which delivered a 51% return over 12 months. EI Group (formerly Enterprise Inns) owns a portfolio of around 4,600 freehold pub properties across the UK. The core of the portfolio operates under tied leases, whereby tenants are required to purchase their beer through EI Group, and pay below market rent. Recent changes in legislation mean that tenants must now be given the option of a free of tie arrangement, paying full market rent, but free to buy their beer from any supplier. Management is focused on effective allocation of both their real estate portfolio and group cashflow. This has driven a segmentation of the estate into a commercial real estate portfolio consisting of free of tie properties; a managed pub estate under various different brands, many of which have a focus on food; and the core tied lease estate, which will be around 60% of the portfolio in 2020, down from over 90% in 2016. Group cashflow is allocated to making investments in the estate that pass a 20% ROI threshold, paying down debt and buying back shares.

At the year-end, EI Group traded below 0.5x book value (adjusted for intangibles and associated deferred tax), and we see a number of catalysts for a re-rating, including management's plan to spin off the commercial real estate portfolio (which will be around 20% of the estate by 2020), possibly into a REIT structure. Our holding is unchanged since the week of the fund launch, when we positioned the portfolio with a full weighting. At the year-end, EI Group was 8.4% of the portfolio, with over 50% upside remaining to our approximate value.

The IT software and services business, NCC Group, was another strong performer delivering a 41% return over the four-month holding period. NCC Group consists of two independent businesses. The high-growth 'Assurance Services' division is focused on cyber-security, and was built through acquisition over a twelve-year period by a long-standing CEO and Chairman team. The original 'Escrow' business, which provides physical secure storage of source code for business-critical software, has more modest organic growth rates, but generates EBIT margins of around 50%.

When we came to look at NCC Group, it had suffered a number of profit warnings over the previous twelve months primarily due to the performance of the Assurance business. The moment of 'capitulation' came on 21 February 2017 when the company announced a further profit warning, cancelled the Capital Markets Day due to take place the following day, and announced a strategic review. The market reacted with a 50% peak-to-trough decline. The CEO resigned two weeks later.

We believed that the aggressive acquisition strategy in the Assurance business left the Group exposed to write-downs, and our accounting analysis showed that in recent years a wide gap had opened up between management's adjusted reported earnings figure, and our own earnings measure. But we were also confident that the Group's issues were confined to the Assurance Services division, with the Escrow business continuing to deliver robust earnings and cash flow.

Our analysis showed that the current share price was ascribing little or no value to the Assurance Services business, and our sum-of-the-parts and normalised earnings models both implied around 60% upside to approximate value. On the basis of our margin of safety analysis, we opened our position in April with a full weighting of 7.1%, and sold out in August as it reached our approximate value of 201p.

The AIM-listed logistics business DX Group delivered a 48% loss over six months, making it the worst performer in the portfolio and the largest negative contributor to performance, taking around 3% off our performance for the year. We have incorporated the lessons we learned from this mistake into the investment process.

DX Group operates across a range of separate business lines, including B2C delivery and installation of large and awkwardly shaped items like white goods and bikes for customers such as John Lewis, Wiggle and Ikea; B2B internal logistics services for customers like Specsavers and William Hill; secure delivery of new passports in the UK; and a subscription-based next-day delivery service called DX Exchange, which services 18,000 mailboxes through 4,200 exchanges, primarily serving legal and government sectors.

We believed that a share price of around 4x earnings provided a significant margin of safety, while an integration and cost-cutting programme called 'One DX' would offset the earnings impact of the high margin DX Exchange business, which was in structural decline. We did have concerns over management quality, while the accounts were fairly opaque (and management would not, or could not provide the clarity we wanted), however we liked the fact that management had recently made sizeable equity purchases. Consolidation in the industry also offered a potential exit.

A profit warning in February 2017, due to deteriorating business mix, challenges in hiring delivery drivers and delays in One DX, led management to cancel the dividend and report that net debt would be higher than expected, with the house broker pencilling in a £15m increase in net debt versus previous forecasts.

After speaking with the new Finance Director, the house broker, and an activist fund which had become the largest shareholder, we updated our models, took the view that the business was on a glide path to becoming structurally loss-making, and updated our equity fair value to zero. On this basis we decided to exit the position.

Our DX Group losses left us with four key lessons. Firstly, we had given management too much credit for their share purchases, and allowed this to take priority over our other concerns. We are now more aware of the importance of management quality. Secondly, we did not take account of the risks of investing in a relatively recent IPO (DX Group had come to market in February 2014). In most situations we now require a company to have spent at least 3-years under the scrutiny of the public markets before we will consider investing. Thirdly, our thesis for how the business would manage the structural decline in its high-margin legacy business carried very high execution risk, with little margin for error, and no 'plan B'. We still believe it is possible for shareholders to profit from businesses that are in structural decline, but it requires a strong management team, with a clear focus on capital allocation. Finally, in part due to our failure to obtain clarity on the accounts, we failed to accurately model the speed with which deferred income would translate into net debt as the high-margin legacy business declined. As a result, the £15m jump in net debt guidance at the February profit warning caught us by surprise. We now avoid companies with poor disclosure, unless there are very clear reasons for it, and we are comfortable with management quality.

Another poor performer during the year was Premier Foods, which was 9.6% of the portfolio at launch, and delivered a 14% loss over the year. Our investment thesis was based on the company delivering modest like-for-like growth which, combined with operational and financial leverage, would deliver respectable earnings growth, while reduced cash pension contributions and zero cash tax in the medium-term would accelerate debt reduction, delivering a strong equity story. However, we had concerns about quality of management, and after meeting with the CEO and FD, we wrote a letter to the Chairman highlighting what we saw as short-termism (using marketing spend as a 'flex' to meet earnings numbers) and the lack of a consistent strategy. A copy of this letter can be found on our website ('An Open Letter to the Chairman').

As the company was delivering consistent like-for-like sales declines, we spent time re-evaluating our investment thesis, with a view to exiting the position, if necessary. During this process we had a number of conversations with the Chairman and spoke with most of Premier Food's major shareholders, including those with board positions. In conjunction with strong first half results, which led us to increase our approximate value by 13% to 66p, we decided to retain the position. At the year-end, Premier Foods was 9.0% of the portfolio.

With a 9.5% weighting, Premier Oil was the largest position in the portfolio at year-end, having delivered us a 9% loss over the year. Our oil exposure, through holdings in Premier Oil, Enquest and Gulf Marine Services accounted for 26.9% of the portfolio at year-end, and during the year we also sold Tullow Oil at a small profit. On aggregate our oil exposure has hurt performance because, although Brent Crude rose by around 16% during the period, sentiment toward the sector remained weak, while Enquest also suffered operational issues at Kraken. Enquest

shares were unchanged over the year at 27.5p, having been on a round trip to 56p. While Premier Oil, Enquest and Gulf Marine Services all have high levels of debt, both Enquest and Premier Oil will deliver free cash flow to firm (before servicing debt) in 2018 in excess of their current market capitalisation. At current oil prices we expect both to be debt-free within five years, excepting any major new field developments. Gulf Marine Services has a later-cycle exposure to the oil price, but by 2019, when it will be in the early stages of recovery, we expect it to deliver 13p per share of free cash flow to equity (after debt service costs), putting it on a 26% free cash flow yield. We have high conviction in our oil-focused stocks, which have an average upside to approximate value of over 100%, however in order to limit our exposure to macro risk factors, we will not be increasing our weighting in this sector.

We seek to maintain a fully-invested position at all times. Our phased approach to portfolio construction means that 'fully-invested' translates into a cash position of around 15%. Cash and equivalents fell from 43% to 23% over the period, and we expect to reach a fully invested position over the next few months as we push more ideas through the investment process.

In terms of coverage, we extended the portfolio and watchlist by looking at twelve new companies, and now that our processes are 'bedded in', we expect to increase our initiations to around 17 new ideas per year. There is no lack of new ideas out there, and we need only 15-20 of the very best to be fully invested. From a process perspective, we broadened our valuation approach, and now consider up to 33 different metrics, which we capture in a 'matrix', and also graphically through a Gaussian distribution. In doing this we try to remember that precision is not the same thing as accuracy, and that we are dealing with 'approximate' valuations rather than 'target' prices. There is more to do in this area in the year ahead, and we also plan to improve our new ideas screen, and to assess the opportunities created by data science and machine learning to develop our investment process. Finally, we spent time thinking about our mistakes, of which DX Group was the most significant example during the year. To add some data-driven insight to this feedback process we have also started working with Essentia Analytics.

Thank-you for joining us on this first step of the journey. It's been a significant year, often stressful, always interesting. I hope we look back on it fondly in years to come. I can't imagine anything else in life that I would rather be doing.

Adam Rackley

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