Portfolio Manager Commentary

FLIGHTLESSNESS

MOATX
CASTX

July 11, 2016

Second Quarter Letter

MARKET COMMENTS

Before the arrival of humans—and the rats, cats, and other predators that we brought—New Zealand was an idyllic haven for birds. Without ground-dwelling mammalian hunters to bother them, many of the local species lost the ability to fly. There's the kakapo, a giant, booming parrot with an owl-like countenance; the takahe, weka, and other flightless relatives of coots and moorhens; a couple of flightless ducks; and, of course, the iconic kiwi.

These birds are part of a pattern that plays out across the world's islands. Wherever predators are kept away by expanses of water, birds become flightless—quickly and repeatedly. This process has happened on more than a thousand independent occasions, producing the awkward dodo of Mauritius, the club-winged ibis of Jamaica, and the tatty-winged flightless cormorant of the Galapagos.

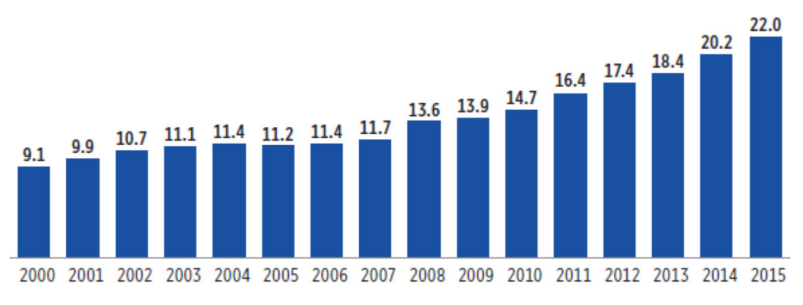
The call of the ground is a strong one, and it exists even when the skies are still an option. Natalie Wright from the University of Montana demonstrated this by collecting data on 868 species. She showed that even when island birds can still fly, they're edging towards flightlessness. Compared to mainland relatives, their flight muscles (the ones we eat when we tuck into chicken breasts) are smaller and their legs are longer.

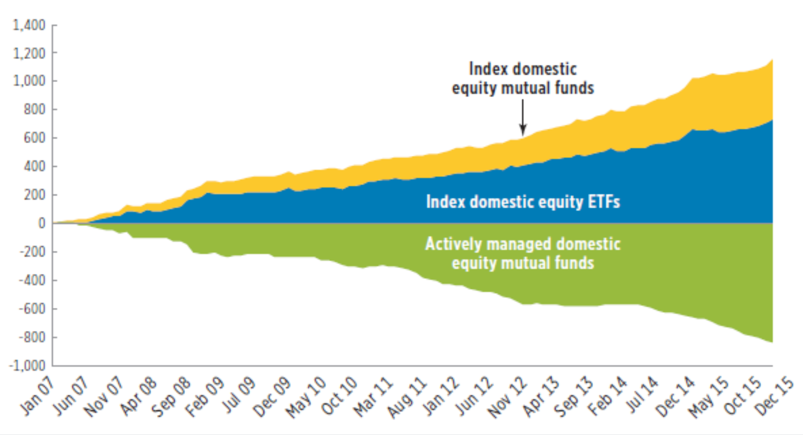
"Pretty much all island birds are experiencing these pressures to reduce flight, even if some can't go to the extreme," Wright says. Her study began about 20 years ago, when her undergraduate advisor David Steadman started weighing the flight muscles of birds at the Florida Museum of Natural History. When Wright got her hands on the data set, she noticed that fruit doves had smaller flight muscles on islands that were further from the mainland. She then travelled to five natural history museums herself to examine more skeletons. For each one, she measured the long bones in the lower legs and the size of the breastbone—the latter revealed how heavy the bird's flight muscles would have been in life.

Across nine major groups of birds, with a wide range of lifestyles, body shapes, and diets, Wright found the same trend. On smaller islands with fewer species, no mammalian predators, and fewer birds of prey, birds have repeatedly reallocated energy from forelimbs to hindlimbs, away from big flight muscles and towards longer legs.

Because flight muscles come with a cost. Even at rest, larger ones require more energy to maintain. So if birds can get away with smaller ones, evolution pushes them in that direction. Large flight muscles are especially useful when birds take off. That's the most energetically demanding part of flying, and the bit that's most important for escaping from ground predators. If such predators are absent, birds can take off at a more leisurely pace, and they can afford to have smaller (and cheaper) flight muscles. (This might also explain why they developed longer legs: they take off more by jumping than by flapping.)
Wright's results suggest that island birds might be more vulnerable to introduced predators than anyone appreciated. Even those that can fly aren't as good at it as their mainland counterparts. They may also help to explain why island birds diversify into such wondrous forms. When they settle in a remote landmass, even the flying ones might quickly lose the power they need to cross oceans and find new homes.

FIGURE 2.13
Index Equity Mutual Funds' Share Continued to Rise
Percentage of equity mutual funds' total net assets, 2000–2015





Islands, it seems, create birds that stay on islands.

—Birds on Islands are Losing the Ability to Fly, Ed Yong. National Geographic, April 11, 2016

The parallels to today's financial landscape are interesting, as central banks have changed markets in the same sense that large bodies of water insulate birds from predators. Investors today now allocate capital with less fear of predators. Just as island birds lose their ability to fly over time, investors now operate today in an artificial environment created by central banks where investors are losing the desire to invest based on fundamentals. Investors continue to increase their allocation to passive index strategies despite deteriorating fundamentals and frighteningly expensive valuations in today's stock market.

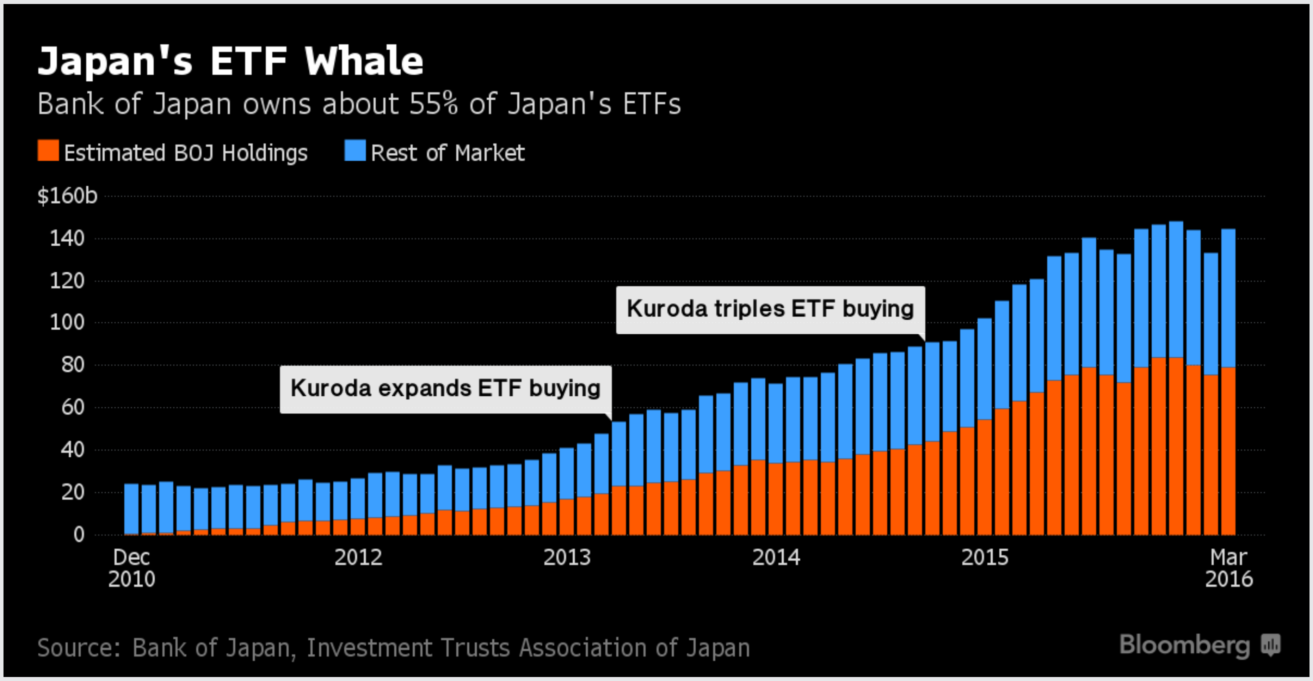
Distortions also exist in sovereign bond markets. Japanese government bonds (JGB) are now the first sovereign debt in history to offer yields of less than 0.1% across every maturity. Even the longest-dated Japanese bond, the 40-year

JGB, is now yielding just 0.065%. Japan's benchmark debt, the 10-year JGB, dropped to a new record of negative 0.23%—hardly a "risk free" rate to use when making rationale investment decisions.

These record-low yields are a result of central bankers influencing markets. Japan's central bank, the Bank of Japan (BOJ), has pushed short-term interest rates down into negative territory. In turn, these actions push money into bonds with longer and longer maturities in search of higher yields. Today, anyone who lends money to the Japanese government for forty years, at just 0.065% per year, can expect a total return of just 2.6%. There is no way to economically rationalize this investment decision—such an investor operates without fear.

Unfortunately, these islands of distortion are not limited to the bond markets. The Bank of Japan already owns over half of all Japanese exchange traded funds (ETFs) and seeks to own more, buying $30 billion of ETF's a year under its current policy. The natural question is why is the BOJ monopolizing the equity market, but the simple reason is that they are running out of bonds to purchase. Japan's ETF market is just 15.8 trillion yen, of which the BOJ already owns 52%. Fortunately for the BOJ, new ETFs can be easily assembled by eager Wall Street banks—there will always be a ready supply to meet this artificial demand. While the Bank of Japan's purchasing of ETF's does temporarily boost demand for Japanese stocks, the question remains just how can they ever exit their position without collapsing prices?

The BOJ will never be able to "retract" from the markets. According to Bloomberg, the Bank of Japan's exchange-traded fund purchases have made it a top 10 shareholder in about 90% of the Nikkei 225 Stock Index. The BOJ's growing presence in the stock market distorts valuations, as the longer the BOJ's buying persists, the bigger the risk that market prices will further detach from fundamentals. While bulls cheer the BOJ's efforts to lift share prices, the central bank must unwind its intervention at some point. When Japan's central bank decides to exit the market, prices will drop and wealth will be destroyed.



Japan's ETF Whale

Bank of Japan owns about 55% of Japan's ETFs

Source: Bank of Japan, Investment Trusts Association of Japan

To be more precise, the Austrian School of economic thought argues that the wealth destroyed is simply wealth which never should have existed. Credit provided by central banks, or “liquidity” or “easy money”, inevitably leads to the misallocation of capital. Easy money distorts relative prices in the economy, which in turn falsifies economic calculation. Meaning, the balance between saving, investment and consumption is no longer optimally aligned. Businessmen underestimate current consumer demand and overestimate both currently available savings and future consumer demand. The inevitable long-term result is that investment capital is directed toward the wrong lines and capital consumption eventually ensues. Money and credit provide the incentive for this process, but what is actually consumed is society’s real capital.

The longer central banks impose their will on markets, the greater potential for capital misallocations. Easy money fueled the expansion into solar and wind power but in reality, easy money led to the consumption of real capital. SunEdison, a renewable-energy startup, was the poster child of a company that took advantage of easy money and low interest rates to transform itself into an icon for clean-energy investors. Mesmerized by the promise of high yields and fast growth, investors repeatedly turned a blind eye to warning signs that ultimately left the company vulnerable to predators, such as a rise in interest rates.

SunEdison traces its roots to MEMC Electronic Materials, a maker of silicon parts that was once part of Monsanto. In 2009, MEMC hired a charismatic chief executive who promised to transform the company into a clean-energy giant. His first big move was buying a solar-project developer called SunEdison. MEMC changed its name to SunEdison, spun off its semiconductor business and began a buying spree to acquire energy projects. The company made nine acquisitions in 2014 and another eighteen acquisitions in 2015. Management bought solar-panel installers and battery startups and pursued projects around the world. In 2015, SunEdison expanded into wind power with the $2.4 billion takeover of First Wind, the company’s largest deal ever.

To finance this robust deal flow, SunEdison turned to an increasingly popular idea known as “captive buyers.” SunEdison created a company called TerraForm Power to handle the less exciting day-to-day business of operating power plants under long-term utility contracts. TerraForm would raise cash from public shareholders and buy completed power plants from SunEdison, which would in turn reinvest the proceeds into new projects. TerraForm offered shares to the public in July 2014 but SunEdison retained a controlling interest, making TerraForm Power the captive buyer to SunEdison’s projects.

TerraForm was one of a handful of such companies making their debut during this time period—these companies were called “yieldcos” (short for yield companies) because they distributed most of their cash to shareholders. As you might guess, in a low yielding environment, investors loved the concept. Demand for TerraForm’s initial public offering (IPO) outpaced supply by more than twentyfold.

With a dedicated buyer for its power projects, SunEdison aggressively expanded and the company’s projects soon generated a gigawatt’s worth of electricity. SunEdison predicted that one day they would manage 100 gigawatts worth of electricity, enough to power twenty million homes. As SunEdison’s acquisition pace increased, standards slipped and deal were sometimes executed with little planning or at unrealistic valuations. In early 2015, SunEdison decided to expand into residential power and focused on acquiring Vivint Solar, which had become a residential leader by hiring former Mormon missionaries to go door-to-door selling solar installations. SunEdison announced the $1.9 billion acquisition in July, 2015, upsetting shareholders. SunEdison had ventured too far from its core operations and investors revolted - shares fell 18% over the next week. Shares of TerraForm, which had offered to buy some of Vivint Solar’s assets, also tumbled. As TerraForm’s stock price fell, the company could no longer afford to buy SunEdison’s power plant projects.

A financing arrangement that had once worked so easily for SunEdison suddenly looked risky to investors. The environment had changed—flightless SunEdison found itself surrounded by new predators. Falling oil prices hurt energy stocks across the board. The Federal Reserve hinted it would soon raise interest rates, which would make high-yielding stocks like TerraForm less attractive. By September, SunEdison shares had fallen by two-thirds. Cash dwindled, and the company delayed payments to suppliers and contractors. In November, a loan against SunEdison's ownership in TerraForm Power came due and the end was near.

SunEdison, once the fastest-growing U.S. renewable energy company, filed for Chapter 11 bankruptcy protection in April 2016 as years of debt-fueled acquisitions proved unsustainable. In less than a year, SunEdison vaporized $10 billion in shareholder value and filed for bankruptcy. Easy money once again led to the misallocation and eventual destruction of real investment capital.

George Goodman wrote Supermoney in 1971 under the pen name of Adam Smith as a follow-up to the best-selling The Money Game (1968). Goodman's book chronicled an investment era that verged on financial insanity: the triumph of perception over reality, the illusion of company reported earnings despite the reality of fundamentals found in the balance sheets and cash flows statements. Goodman described an era where investors considered "concepts" and "trends" as the crux of investing because perception wasn't tethered by the facts. John Bogle, founder of the Vanguard Group, succinctly summarized it best: "The more things change, the more they remain the same." But each era of financial speculation has its own characteristics -- and today's environment is all about the influence of central banks and how their policies impact the capital markets. Goodman's words continue to echo in our heads… *Those who leave early are saved, but the ball is so splendid no one wants to leave while there is still time, so that everyone keeps asking, "What time is it? What time is it?" But none of the clocks have any hands."*

INVESTMENT PHILOSOPHY

We believe that investors should always seek to own successful businesses with competent management, who think like owners because they are in fact significant owners, and who maintain companies that have little or no debt. Lastly, and most crucially, one should never consciously overpay for the shares of any business. Whatever happens to the share price in the short run, which we define as anything less than two to three years, is not really significant. Just like Benjamin Graham advised in The Intelligent Investor – *the disciplined investor can take advantage of other people's impatience and mood swings* – a subtlety that is all too often ignored by the vast majority of market participants.

Growth in intrinsic value is what every investor wants to see in their stock portfolio – but just about everyone gets distracted by what the share *price* happens to be doing from one day to the next. The reality is that as long as management is doing its job to the best of its ability, and the company continues to be run well, investors should have every expectation that the company's growth in intrinsic value and the company's share price will move in lockstep over time. Daily fluctuations in the share price, provided that the business itself is not impaired, should be regarded as potential opportunities to increase, or reduce, one's holding in the stock. Better yet, one should simply leave the investment alone and fundamentally focus on something more constructive with one's time.

Howard Marks, co-chairman of global asset-management firm Oaktree Capital, is the author of a book we consider essential reading, The Most Important Thing: Uncommon Sense for the Thoughtful Investor. He is one of the great investors and investment writers of the past few decades. Marks once published an investor letter based entirely on what he believed were the all-time great quotes on investing by Charlie Munger, Vice Chairman of Berkshire Hathaway, including *"It's not supposed*

to be easy. Anyone who finds it easy is stupid." Marks reflected on the quote and concluded that a good part of the basis for Charlie's comment is that anyone who thinks it's easy to achieve unusual profits is overlooking the way markets operate. Stock picking is difficult to do successfully. Investing is not easy.

Given our high regard for his work and writing, we culled through previous letters and generated a list of great quotes from Howard Marks:

> *"Superior investors know – and buy – when the price of something is lower than it should be. And the price of an investment can be lower than it should be only when most people don't see its merit."*
>
> *"There are two primary elements in superior investing: seeing some quality that others don't see or appreciate (and that isn't reflected in the price), and having it turn out to be true (or at least accepted by the market)."*
>
> *"What has to be remembered is the defining role of price. Regardless of whether the fundamental outlook is positive or negative, the level of investment risk is determined largely by the relationship between the price of an asset and its intrinsic value."*
>
> *"There is no asset so good that it can't become overpriced and thus risky, and few so bad that there's no price at which they're a buy (and safe). This is one of the greatest examples of counter intuitiveness. Only those who are able to see its logic can hope to be superior investors."*
>
> *"Most great investments begin in discomfort. Good investors are subjected to the same misleading influences and emotions as everyone else. They're just more capable of keeping them under control."*
>
> *"Superior investors may not be insulated, but they manage to act as if they are."*
>
> *"Superior investment results can only stem from a better-than-average ability to figure out when risk-taking will lead to gain and when it will end in loss. There is no alternative."*
>
> *"Superior investors and their well-thought-out approaches can produce returns on average in the long run. But even they are far from perfect. The best they can hope for is that they'll be right more often than they're wrong, and that their successful decisions will add more than their mistakes subtract."*

Although not always successful, we try to measure ourselves against the standards laid out by Howard Marks. We do our best to be perceptive, unconventional, and to possess a better-than-average ability to figure out when risk-taking will lead to a gain and when it will end in a loss. We are right more often than we are wrong and our successful decisions have added more than our mistakes have subtracted. We readily acknowledge that we are far from perfect, but fortunately one does not have to be perfect to add value as a stock picker.

With kind regards,

Robert J. Mark
Portfolio Manager

The opinions expressed are those of the Fund's portfolio manager and are not a recommendation for the purchase or sale of any security.

As of June 30, 2016, the Fund does not own any of the following securities mentioned in this letter:
SunEdison; MEMC Electronic Materials; FirstWind; Terraform Power; Vivint Solar; Berkshire Hathaway.

As of June 30, 2016, the Fund does own the following security mentioned in this letter: Monsanto (1.81% of Fund net assets).

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the Fund, and it may be obtained by calling 1-877-743-7820, or visiting www.castleim.com. Read it carefully before investing.

Performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 1-877-743-7820.

The risks associated with the Fund, detailed in the Prospectus, include the risks of investing in small and medium sized companies and foreign securities which may result in additional risks such as the possibility of greater price volatility and reduced liquidity, different financial and accounting standards, fluctuations in currency exchange rates, and political, diplomatic and economic conditions as well as regulatory requirements in foreign countries. There also may be risks associated with the Fund's investments in exchange traded funds, real estate investment trusts ("REITs"), significant investment in a specific sector, and nondiversification. Technology companies held in the Fund are subject to rapid industry changes and the risk of obsolescence. The Fund is non-diversified, meaning it may concentrate its assets in fewer individual holdings than a diversified fund. Therefore, the Fund is more exposed to individual stock volatility than a diversified fund. Distributed by Rafferty Capital Markets, LLC-Garden City, NY 11530.