Setanta
ASSET MANAGEMENT

FACTSHEET

Setanta Fixed Interest Fund – Q3 2011

Fund Description

The **Fixed Interest Fund** ('the Fund') is managed by Setanta Asset Management Limited ("Setanta") and is a representative account of the Fixed Interest strategy.

The Fund is an actively managed portfolio invested mainly in government, government agency and covered bonds. The bulk of exposure is in Euro, although the Fund can take advantage of non Euro fixed income investments, up to a maximum exposure of 40% of fund assets. The Fund invests in the highest quality investments with a minimum credit rating of "A" at time of purchase. Maximum exposure to a single Government with a credit rating below "AA" is 15% of fund assets. Duration of the fund is kept within +/- 2 years of this benchmark.

All investments are taken after careful analysis of all relevant metrics and on a long term view. Bond investments offer investors the potential for regular income, capital preservation and diversification from other types of investments. Returns are likely to be less volatile than equity returns and offer investors the potential for good risk-adjusted returns over time.

Investment Philosophy

We in Setanta do not believe the market is efficient. Our aim is to purchase and own assets at a price below a reasonable assessment of their worth. This is where we focus our resources. Our process is akin to assessing a part ownership of a business rather than trading a security. This assessment of value must always encompass a thorough understanding of where this value is derived. We have a long term investment horizon and risk management is always central. We regard risk as the potential for permanent impairment of value. Integrity is a key tenet of our professional DNA and we embrace a culture of continued learning.

Portfolio Managers

David Ryan & Gary Edge

Investment Principles

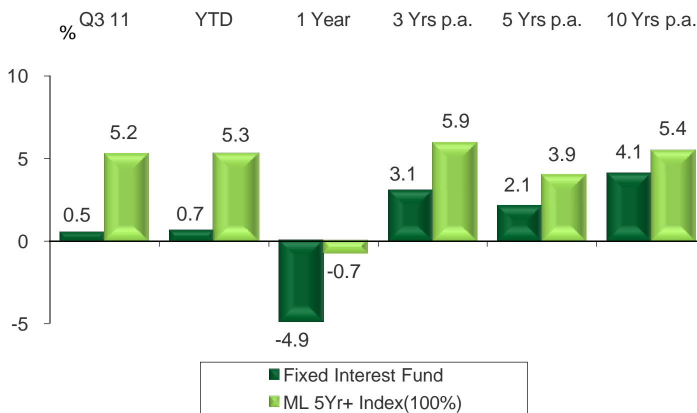
- We do not believe the market is efficient.
- We aim to make investments at a price below our assessment of intrinsic value.
- We make an investment in a business rather than trade securities.
- We believe risk is the possibility of permanent impairment of value.
- We make investments for the long term.
- We invest where we see value and are not afraid to be contrarian and swim against the tide.
- We don't make forecasts, we consider scenarios.
- We demand financial strength from the companies we invest in.
- We will act with integrity and communicate with our clients in a manner representative of our investment style.
- We have the humility to know we make mistakes and embrace the need to continue learning through both experience and study.

Contact Details:

Setanta Asset Management Limited,
College Park House, 20 Nassau Street,
Dublin 2, Ireland.

Alan Hickey, Tel: + 353 1 612 4903
Email: alan.hickey@setanta-asset.com
www.setanta-asset.com

Fund Performance to 30.09.11



Yearly Performance

Year	2006	2007	2008	2009	2010
Fund	-1.5	0.0	9.1	5.5	-3.3
Benchmark	-1.8	0.4	10.4	4.0	0.9

The investment objective of the Fund is to outperform the Merrill Lynch EMU Government 5yr+ index and the peer group.

Performance Source: Setanta Asset Management Limited. Benchmark: Bank of America Merrill Lynch EMU Government 5 yr+ index. The Fund returns stated are based on the movements in the unit prices of a representative account, based on mid to mid prices, and are gross of management fees. The performance will be reduced by the impact of management fees paid, the amount of which varies. **Credit Rating Source:** S&P.

Fund Duration & Credit Metrics

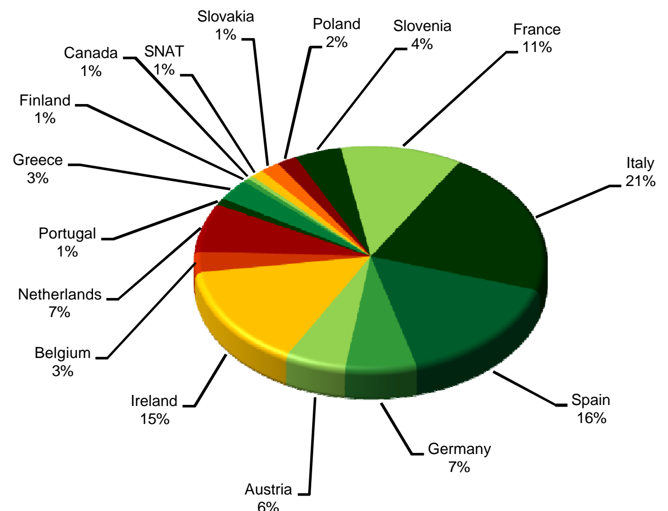
YIELD CURVE POSITIONING		
DURATION (Yrs to Maturity)	FUND WEIGHTING	BENCHMARK WEIGHTING
0-5	25.3%	8.6%
5-10	52.0%	60.6%
10-15	19.5%	20.8%
15-30	2.8%	9.9%
	100%	100%

CREDIT RATING WEIGHTING		
CREDIT RATING TYPE	ASSET TYPE WEIGHT	BENCHMARK WEIGHT
AAA	35.0%	58.8%
AA	24.8%	16.1%
A	25.6%	23.2%
BBB	11.1%	1.9%
BB	0.0%	0.0%
CCC	3.1%	0.0%
C	0.1%	0.0%
	100%	100%

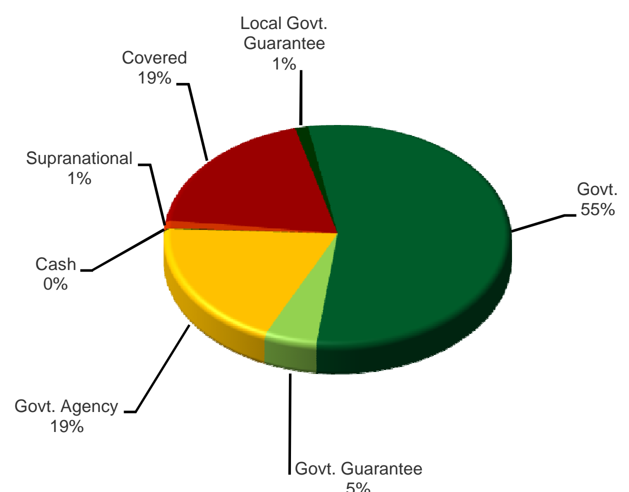
Top 10 Holdings

ISSUER	COUNTRY	COUPON %	MATURITY	% OF FUND
BUONI POLIENNALI DEL TES	ITALY	3.1	15/09/2026	5.3
FMS WERTMANAGEMENT	GERMANY	3.0	08/09/2021	3.5
REPUBLIC OF AUSTRIA	AUSTRIA	3.5	15/09/2021	3.1
INSTITUT CREDITO OFICIAL	SPAIN	5.125	25/01/2016	3.1
DEPFA ACS BANK	IRELAND	4.875	21/05/2019	3.0
BUONI POLIENNALI DEL TES	ITALY	6.0	01/05/2031	3.0
BUONI POLIENNALI DEL TES	ITALY	2.1	15/09/2016	2.9
REPUBLIKA SLOVENIJA	SLOVENIA	5.125	30/03/2026	2.8
NEDER WATERSCHAPSBANK	NETHERLANDS	3.5	14/01/2021	2.7
INSTITUT CREDITO OFICIAL	SPAIN	6.0	08/03/2021	2.5

Country Weighting



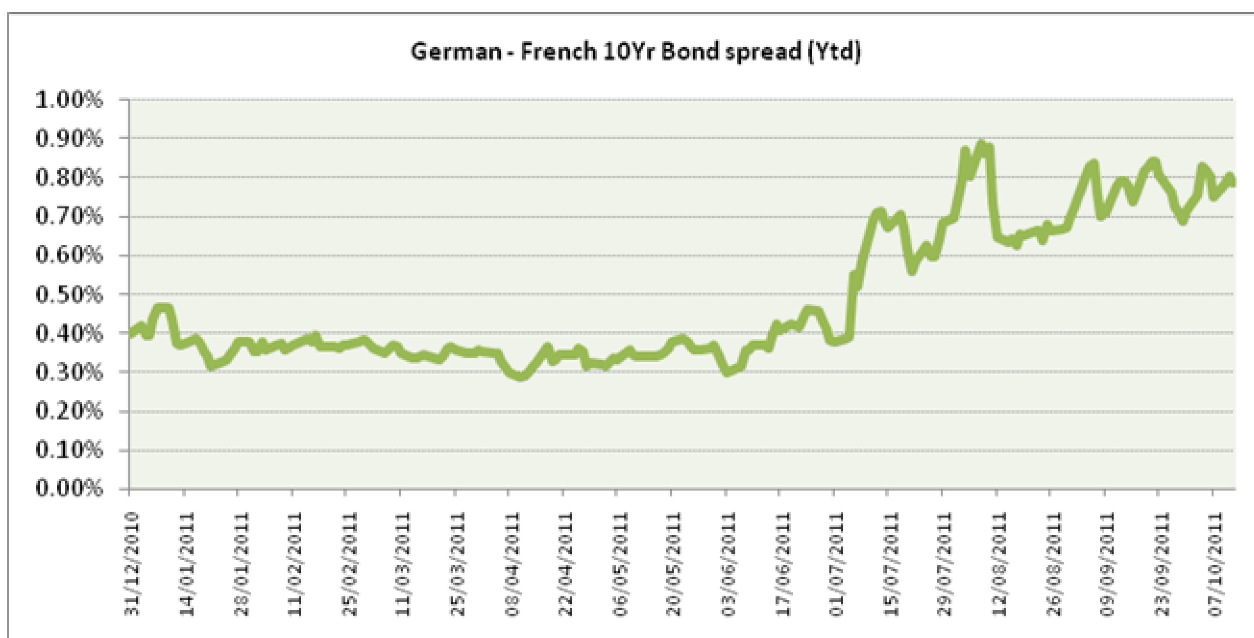
Asset Distribution



In Q3 the 5Yr+ Merrill Lynch benchmark delivered 5.21%, bringing performance year to date to 5.31%. This performance was primarily driven by long dated (20Yr+) core government (Germany/France/Holland) bonds. The bond fund delivered 0.77%, bringing returns to 0.71% year to date. The current underperformance is driven by three key positions.

1. A short of duration stance, as we don't deem absolute bond yields offering an adequate return for the given duration risk.
2. An underweight position to core Europe, namely Germany, which we think has been driven up in price by the ongoing flight to liquidity and safety, to unsustainable levels of sub 2% in 10yr bonds.
3. Greek holdings which are outside of benchmark but have been marked down to near 50% of par. These positions are expected to mature or be involved in a debt exchange within the next two quarters.

This positioning is under constant review, though no change in strategy is expected in the near term.
Over the third quarter, the sovereign debt crisis in Europe continued unabated, with growing concern that both Italy and Spain will prove the next targets. It was particularly hard going for bonds other than AAA government debt, even within AAA assets in Europe, Germany stood out as the main outperformer. French yields rose to over 80bps over the German equivalent. Contagion fears ushered in ECB buying of both Spain & Italian debt, bringing the total sovereign debt bought by the ECB to about €163bn.



This uncertainty was not helped with the US political deadlock relating to increasing the US debt ceiling, which ultimately culminated in the first downgrade of US government debt from its benchmark AAA status to AA+ by the S&P rating agency. The political wrangling was viewed badly by both S&P and bond investors. Economic data has broadly shown a stronger than expected first half to the year with an expectation of a possible slowdown in the second half. This could have a marked effect on already finely balanced debt sustainability metrics, as GDP growth is needed to pull weaker countries out of the mire.

The European EFSF project took on the EFSF 2.0 mantle, with various suggestions as to how to leverage up its capabilities and size. Suggestions varied from views that it be given a banking license to allowing it to insure the first 10/20% of sovereign loss. Either way, it needs to get fully ratified first before changing its structure.

The Greek default/non default question continues. It is expected that they will miss nearly all targets within their bailout criteria as both a wider recession and implementation fatigue set in. The ongoing Grecian debacle is causing the bulk of the negative sentiment towards European sovereign debt, and hence wider spreads in the non-core countries.

Bond markets have priced in some form of default in Greece (50% haircut approximately), the question now is how orderly this can be achieved. The uncertainty around this base case scenario is the reason there is such a hurry to recapitalise European banks. Some form of complete solution is due in the next few weeks (prior to G20 meeting), how final this will be remains to be seen.

Other doubts have also manifested themselves since the "Deauville" stroll by Merkel & Sarkozy, instilling the idea of greater private sector involvement (read haircut) into advanced economies "risk-free" debt. The importance of this event should not be underestimated, as the current Greek debt private sector owner haircut is 21% and a further haircut to as low as 60% is being considered.

The ECBs reluctance so far to engage in quantitative easing (outside of some unsterilized covered bond buying) in any real size is felt to be one reason that the crisis has not yet been contained. I am sympathetic to the ECB view that governments need to adhere to some fiscal rectitude to strengthen sovereign balance sheets. While Trichet steps down in Q4, it does not look likely that the ECB will change its mantra any time soon.

Most financial asset classes point to a slower growth profile over the second half. This can be seen in bond markets through a bull flattening of various yield curves (aided by the US "Operation twist"), wider credit spreads, and reflected in currencies through a marked US Dollar rally. Commodities have not been left unscathed, with Oil and Copper down over the quarter, with a slowdown in China an ongoing concern.

Closer to home, Ireland has stood out as one of the best performing bond markets over the period. Stronger than expected growth, strict adherence to the bailout criteria and new improved bailout terms have all helped reduce bond yields. While, we are not out of the woods in any way, there has been a definite separation in sentiment towards ourselves, versus both Greece and Portugal.

Looking at investing in sovereign debt, I would like to give a Setanta view on credit ratings versus investor risk. Sovereign credit ratings have hit global headlines recently with the Standard & Poor's downgrade of the USA from AAA to AA+, a move that put the global benchmark on a lower rating than Liechtenstein! Markets in general have protested this move with bond yields moving lower towards all time lows, the deterioration in economic surveys have probably softened the blow of the lower rating. Such has been the vitriol, that even Warren Buffet felt it necessary to class the good old US of A as quadruple A!

Why the fuss? What is a Sovereign debt credit rating anyway? It is essentially a forward looking opinion of an issuer's ability to pay back principal and interest due on the bond. The three largest agencies S&P/Moody's/Fitch use a similar ranking system with "AAA" the highest/safest rating with a 9 notch drop to sub investment grade debt. The creditworthiness of the issuer falls the lower the rating, with the likelihood of default increasing the lower the creditworthiness.

The salient point for investors is that the rating is an assessment of the relative likelihood of default, ***not a reflection on whether the relevant "bond" as priced is good or bad value***. This view can only be taken when looking at an investors purchase price versus the expected loss given a default.

Why do countries even acquire a rating? Technically the USA rating is unsolicited, though most other countries do pay. An investment grade credit rating is a de facto requirement for most large buyers (institutional) of sovereign debt (some would say an outsourcing of due diligence) while they are a de jure factor for gaining market access for most sovereigns.

The reasoning sovereigns want a rating is that over time lending to sovereigns has been risky, they are not the risk free asset often touted. As an example the large issuance of sovereign debt in the 1920's ended with a raft of defaults during the Great Depression. Twenty one out of fifty eight countries defaulted on their international bonds between the period 1930 and 1935. Though, it is important to qualify risk between local and foreign currency issues. Ultimately, a rating allows countries to differentiate themselves from more profligate issuers.

By forcing asset managers to only hold high quality debt, the hope is that this will mitigate the risk of permanent loss of capital through outright default. The credit rating agencies have shown that most sovereign defaults occur in the lower ordinal rank ratings (sub investment grade). This fact is indisputable, that however is not really the point for investors.

The issue is more about what level of stress is put on bond prices post downgrade versus the likely recovery value in case of default. **Simply, what's your upside and what's your downside.**

Is there much reaction to credit rating changes? Various studies have shown that there is a significant reaction by sovereign yields and particularly credit default swaps (CDS) to negative events (downgrading outlook/rating change), while the reaction to positive events tends to be more muted and more evident in CDS levels.

Post Lehman's, it can be shown that the bond market has become even more sensitive to negative events, particularly CDS. Given investors have only received "bad" ratings news in developed sovereign bond markets since then this may be the reason for the general nervousness in the market.

A few anomalies are worth noting post credit rating moves. Countries recently downgraded (within the last 6 months) tend to have higher yields than those countries of the same ratings (technically same risk), exhibiting what is called a "persistence effect". This may be linked to another anomaly of serial correlation of rating direction. If a sovereign is downgraded, the next move will more likely be in the same direction. This becomes very important when a country is close to the dividing line between investment and non investment grade as the largest price and volatility effect occurs when moving through this sub division.

This "threshold effect" (dropping to sub investment grade) and subsequent price volatility can be as a result of a number of factors. Credit ratings have become so embedded in the global financial architecture through legislation, regulation and private sector mandates, that many investors are forced to sell irrespective of investment merits.

There are also price effects driven by the CDS market. Once a country drops below investment grade it is likely that clearing houses will increase the margin required to trade these bonds. This can make certain trades, such as negative basis trades unattractive from a cost perspective which leads to an unwinding of positions, notably selling of the cash asset. Also, Repo counterparties will likely demand a higher haircut on the bond asset for funding purposes, also leading to unwinding of various positions into illiquidity.

Studying the scenarios post a credit downgrade is instructive. Sovereign bonds can only return Par (100% of face value) along with any coupons due. You do not receive more than par, so, in theory, your upside is capped at 100 (ignoring Inflation linked bonds). On the downside your loss is theoretically capped at zero, though unless a government completely repudiates its sovereign debt (usually post wars/civil uprising) you tend to receive some form of a recovery value (% of Par).

In sovereign debt, the issuer weighted recovery value has tended to be approx 53% (Moody's 1983-2010) of face value over the recent past. So, it is prudent to estimate a downside of around 50% for sovereign debt – from Par. Further analysis is warranted to estimate what is the optimal debt level, or more specifically, sustainable levels are to calculate a likely recovery value. From a risk perspective it makes more sense to see at what level you can buy the asset, the ultimate upside (limited in plain vanilla fixed coupon bonds) and the likely downside.

Opportunities would seem to occur when you move across the threshold from investment grade to non investment grade. The increased forced selling due to rating change brings about a large increase in supply of the bond just at a time when the pool of available buyers diminishes. It can become priced as a value investment at a time when few can take advantage of it.

Suddenly more risk capital has to be placed against the asset from a regulatory perspective, benchmark indices drop the bonds come month end and fund managers look to reduce such toxic assets/names from their portfolios.
In recent times Ireland is a prime example of the upside down thinking of market actions. At a time when the benchmark Irish 5.4% of 25's reached a level of around 50% of par, many investors were afraid to buy given the "Junk" status or more pertinent, not allowed to buy given various regulatory/mandated restrictions. The market became only one sided as investment managers tried to sell their Irish exposure into a market where there were limited buyers.

Investors, be they disparagingly viewed as "vulture funds" or more accurately as "distressed debt" investors will wait post downgrade below investment grade for the market to become self clearing. There is no rush in buying the asset as they will let it fall towards levels where close to recovery or expected recovery value lies.

On this basis, any coupon paid becomes a larger part of the return and acts as a buffer against a lower recovery value in the period up to default or ultimate recovery at par.

As per the Irish example, a 14yr bond had a cash price of € 53, with a 5.4% coupon. Even assuming a recovery value of 50 at maturity would leave you with a yield of 9.98% to maturity. Compare this to the European benchmark AAA, the German Bund maturity equivalent, offering a 2.80% yield to maturity. Assuming the ECB attain their goal over the next 11 years that they have achieved in the previous 11 years, inflation in and around of 2%, you could achieve a real return of close to 7% in Irish bonds (even with a restructuring) versus 0.8% in the Bund.

Investors are currently allocating to the perceived "low risk" of the AAA bund trading at a cash price of €110 versus selling out of Irish bonds at €50. Surely for a risk-averse investor the goal should be to achieve the highest real return as opposed to the more psychologically comfortable return?

Ultimately it is the price you buy the bond at that defines the risk you are taking, not the subjective credit rating that (serial correlation notwithstanding) can move up as well as down. Investors are blindly buying high credit rated sovereign debt at price/yield levels near historic highs & lows. With future expected returns a function of the level you purchase the asset at, the only aspect that a high sovereign credit rating is locking in at current prices/yields is the guarantee of low nominal returns and possibly negative real returns. High credit quality does not mean low investor risk!

IMPORTANT INFORMATION

The Fund is currently available in Ireland via a unit-linked offering of Canada Life Assurance (Ireland) Limited. For this life assurance product, investors should refer to the relevant policy conditions. The strategy is also available on a segregated basis. Investors should consider the investment objectives, risks, charges and expenses carefully before investing. See 'WARNING' and IMPORTANT INFORMATION' sections below.

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WARNING: Past performance is not a reliable indicator of future results. The price of units and the income from them may go down as well as up and investors may not get back the amount invested. The return may increase or decrease as a result of currency fluctuations. Forecasts are not a reliable indicator of future performance.