



Setanta Fixed Interest Fund – Q4 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 CFA & Gary Edge CFA



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.

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Fund Performance to 31.12.11



Yearly Performance

Year	2007	2008	2009	2010	2011
Fund	0.0	9.1	5.5	-3.3	-1.2
Benchmark	0.4	10.4	4.0	0.9	3.9

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	27.9%	10.7%
5-10	54.2%	59.0%
10-15	13.4%	21.1%
15-30	4.5%	9.2%
	100%	100%

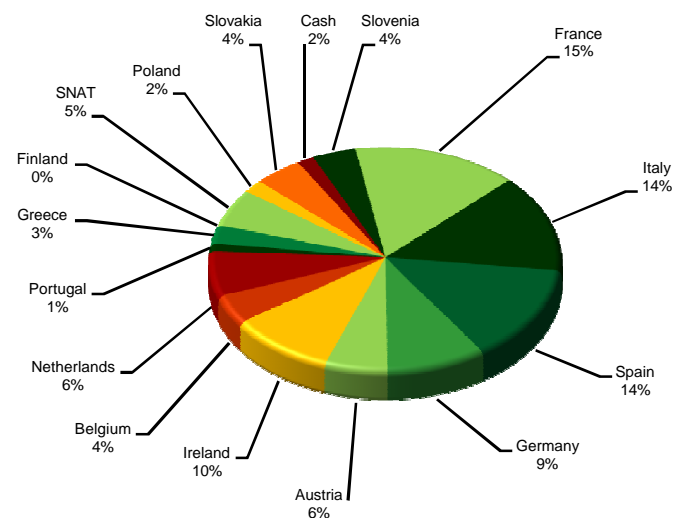
CREDIT RATING WEIGHTING

CREDIT RATING TYPE	ASSET TYPE WEIGHT	BENCHMARK WEIGHT
AAA	40.8%	58.6%
AA	23.1%	17.1%
A	22.6%	22.4%
BBB	10.9%	1.8%
BB	0.0%	0.0%
CC	2.6%	0.0%
C	0.1%	0.0%
	100%	100%

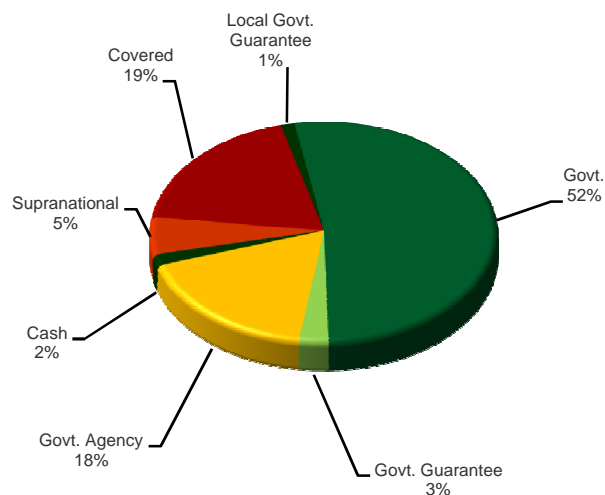
Top 10 Holdings

ISSUER	COUNTRY	COUPON %	MATURITY	% OF FUND
BUONI POLIENNALI DEL TES	ITALY	3.1	15/09/2026	5.4
REPUBLIC OF AUSTRIA	AUSTRIA	3.5	15/09/2021	3.2
DEPFA ACS BANK	GERMANY	4.875	21/05/2019	3.2
SLOVAKIA GOVT BOND	SLOVAKIA	4.35	14/10/2025	2.9
BUONI POLIENNALI DEL TES	ITALY	2.1	15/09/2016	2.9
NEDER WATERSCHAPBANK	NETHERLANDS	3.5	14/01/2021	2.8
REPUBLIKA SLOVENIJA	SLOVENIA	5.125	30/03/2026	2.7
INSTITUT CREDITO OFICIAL	SPAIN	6.0	08/03/2021	2.7
FMS WERTMANGEMENT	GERMANY	3.0	08/09/2021	2.5
IRISH LIFE & PERMANENT	IRELAND	4.0	10/03/2015	2.5

Country Weighting



Asset Distribution



The Setanta Fixed interest fund returned **-1.81%** versus a benchmark return of **-1.34%** in Q4. The Fund had a full year return of **-1.17%** versus the ML 5Yr+ return of **3.90%** for 2011. Suffice to say, looking at those returns, that it was an *annus horribilis* (*horrible year*) for the fund. The poor performance was driven by positioning for three key themes. Insurance was put in place against these expected negative outcomes costing performance.

The Fund was positioned for higher yields in core countries (Germany/France/Netherlands), tighter yield spreads versus the core in peripherals, and a resolution to the Greek debacle. None of these expected outcomes occurred.

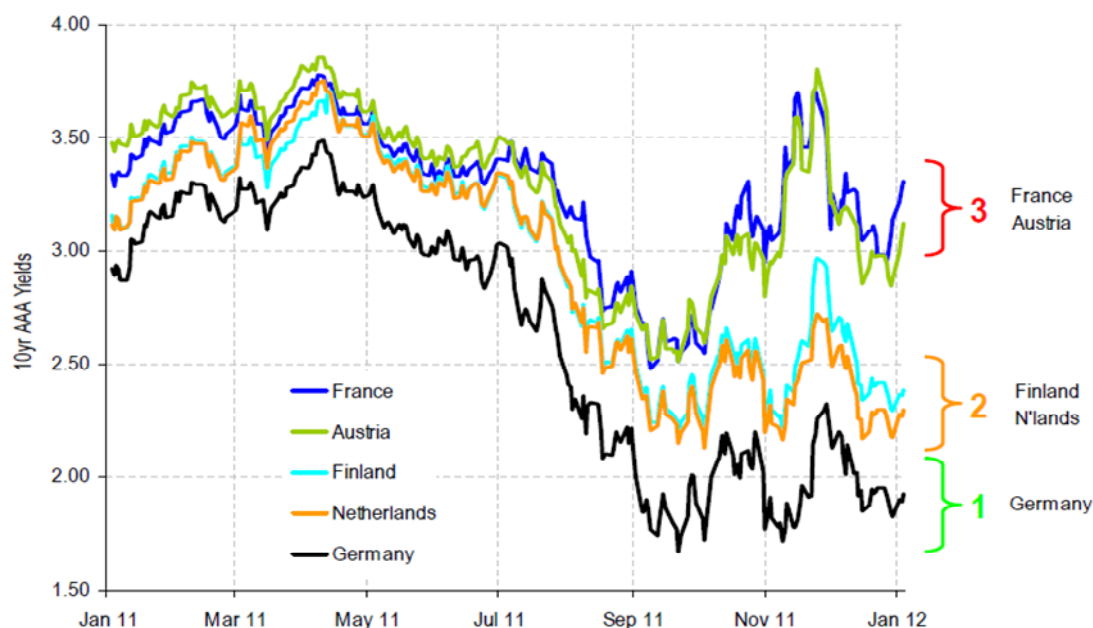
Over the period, higher rated bond yields dropped (10Yr Germany sub 2%), as the market began to price in slower GDP growth, political gridlock in Europe on a “grand solution” and the increased probability of a far more accommodative ECB, through lower interest rates and an expansion of its balance sheet by pumping the banking system full of liquidity.

These factors drove the strong performance in the long end of the core country curve, with 20Yr+ bonds returning on average 15% over the year. The fund had maintained an underweight position to this part of the curve which cost us dearly. So by overweighting the short end of the curve (sub 5YR) and limiting interest rate risk, we missed out on a rally in the long end.

This marked underweight in duration will be closed over time. While we do not expect nominal yields to move significantly lower from here, the steepness of the yield curve and the risk of further unconventional central bank measures would seem to point towards further financial repression. With so much market manipulation it seems prudent to reduce the risk to such a key driver of returns.

This manipulation involves pegging yields below where fundamentals would argue they should be, allowing for a reduction in the real cost of debt over time with steady inflation. Think of it as governments ensuring cheap financing for themselves through various forms of regulation.

While we felt that nominal yields offering a small premium over inflation did not offer great value, the collapse in sentiment towards the European project led to an increase in the flight to the higher quality bonds. It is interesting to see currently that even within the shrinking AAA sphere, divergences are starting to occur.



Source: Citibank / Bloomberg

A part of this active risk was closed somewhat in mid November. Long dated French sovereign bonds were bought, yielding around 4.35%, as pessimism grew of a French downgrade from AAA and the knock on downgrading effect to the new European agencies.

The Fund will look to reduce the underweight to the core AAA (mainly Germany) where value presents itself. The Fund will seek to reduce the underweight position in Germany through allocating to agency and sub sovereign paper. Also, through allocating to AAA rated supranational paper that has suffered due to both increased funding requirements and the spill over effects of the crisis.

Within Peripheral bond markets, Irish bonds outperformed versus the other bailout countries. This was in line with Ireland continuing to meet the requirements under the Troika led bailout package, and with some hope of us achieving an ongoing expansionary fiscal contraction. There is ongoing fear of fiscal austerity fatigue setting in and I have some sympathy for Keynes view that *“The boom, not the slump, is the right time for austerity at the Treasury.”* (1937 collective writings)

While the Fund maintained an overweight to Ireland through all the noise and volatility, we are very conscious of the more pessimistic views on growth projections, with a bias to reduce our large overweight versus the benchmark (10% vs. 2%) over time. This will be achieved by reducing the sovereign paper holdings while holding on to the Government guaranteed paper that is offering a significant yield pickup (15% vs. 8%), but which lagged the move higher in Irish bond prices due to a myriad of liquidity, classification and seniority concerns.

Greece has remained front and centre within the debt crisis. There have been numerous high promising/low delivering European summits to try and ring fence the risk of a disorderly default, with the fear that contagion would spread, to albeit fiscally weak, but most likely, solvent countries.

Greek bonds have continued to trade lower. At first a 21% face value haircut was announced, followed shortly after by a 50%, all under the banner of a “voluntary” exchange. The thinking being that a triggering of credit default swaps under an involuntary exchange could pose a greater risk. Of course, under the Law of unintended consequences, once investors reasoned that CDS may not pay out they just chose to sell the cash bonds of peripherals, exacerbating the problem.

This was evident with Italian and Spanish bond yields starting to widen on the fear that there is not a sufficient entity in place to bailout these countries if needs be. This uncertainty has not been helped by the ECB reluctance to become the lender of last resort. With Germany and France pushing ahead with the idea of the private sector involvement (PSI) causing a large part of the contagion, as private investors realised there would more likely be a “bail-in” rather than a “bail-out”.

Time will tell whether anything resembling voluntary is the outcome, with some talk of retrofitting collective action clauses to force “holdouts” to take part in the exchange whether they want to or not. Either way this ongoing drama for Greece will come to a head in Q1 2012 as there is a large redemption that they will hope to swap into the new terms.

The error in questioning the sovereign signature of sovereign debt has led further to a blurring of whether government debt are risk free assets or just high quality corporate proxies! Never has there been such interest in the legal jurisdiction of the bond issues, with international law now being chosen over local law, where there is an ability to change terms through legislature.

The lack of a backstop of a friendly central bank and printing abilities have essentially turned developed European bond markets into a quasi developing world bond market, making funding all the more difficult. The ECB will argue it is not within their mandate, somewhat justifiably. However, the change of the guard from Trichet to Draghi has seen a more aggressive response by the ECB.

The ECB cut rates to 1% in Q4 and provided 3 year loans to banks at very low rates, to try and help liquidity and kick start lending. To date the bulk of this money has ended up back at the ECB as excess reserves, as banks fear lending to one another in the unsecured interbank market.

Globally there has been coordinated efforts by the US, Canada, Britain, Japan, Switzerland and Europe to ease global liquidity by lowering the cost of dollar funding though lowering swap lines by 50bps, with China looking to help out with lower bank reserve requirements. Further cuts were seen in Australia, Sweden and Brazil.

Political risk, once the mainstay of far flung emerging markets, is a big risk for European markets at the moment. Capital flight continues from the Southern economies, with even their northern brethren looking unlikely to invest. Germany, undoubtedly the strongest economy at the moment, some would say are not letting a good crisis go to waste. There is a push at political level for towards constitutional debt brakes and a tighter fiscal compact (not unlike the Instability & no growth pact).

The German & French axis needs to be maintained to push things through, with the technocratic governments of Italy and Greece currently playing ball with the endgame of stronger government balance sheets. While all of this will be for nothing if growth collapses, there has been an increased effort in trying to target structural issues to enhance competitiveness and future growth.

Ultimately our base case scenario is that the Euro will survive and all will be done to keep the structure intact. There will be ongoing volatility but hopefully this should reduce somewhat over 2012. The ECB could continue a recent trend of being a little ahead of the market. It's interesting to consider a former French prime minister comments on the central bank in 2007. While Germany seems to be leading the way in fiscal austerity, maybe France has a better handle on how this will all end.

“Independence of the Central Bank is a means to an end, to win Germany's approval for monetary union, but it is not the end of the story. We will not be able to escape a situation taking place where the government will have to give orders to the central bank. This could take place in a war, or as a result of an American collapse. If the American financial tsunami explodes - \$12,000 billion external debt and \$2 billion in new borrowing every day – then European governments and the European central bank will have to act in concert.” Michele Rocard 2007

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.
