Setanta
ASSET MANAGEMENT

FACTSHEET

Setanta Focus 15 Fund – Q4 2011

Fund Description

The **Focus 15 Fund** ('the Fund') is managed by Setanta Asset Management Limited ("Setanta") and is a representative account of the Focus 15 strategy.

The Fund is an actively managed, concentrated Global Equity Fund that is invested in circa 15 stocks. As a fundamental value investor our research is designed to properly understand how each business functions and to consider pertinent risks to the business. We attempt to value each business, incorporating relevant upside and downside scenarios.

As such the Fund attempts to invest in the most attractive stocks across all the firm's strategies using a risk-return framework. Investments are made for the long-term and are based on investment merit rather than with reference to benchmark. This Fund is mandated to be fully invested in equities. Due to the concentrated nature of the Fund, performance may be volatile

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

Rowan Smith & David Coyne

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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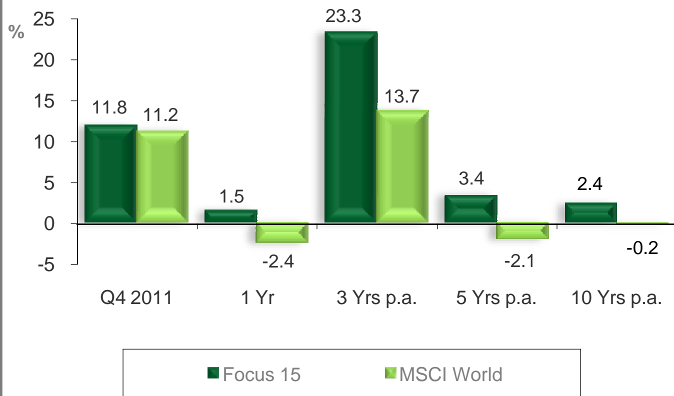
Fund Performance to 31.12.11

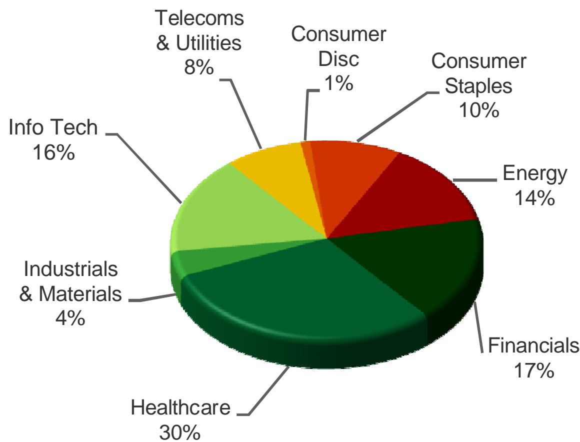


Focus 15 MSCI World

The investment objective of the Fund is to outperform the MSCI World index over periods of three years or more.

Performance Source: Setanta Asset Management Limited. Benchmark: MSCI World. 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. **Fund Statistics Source**: Bloomberg (Valuation) Median ex Financials

Sector Distribution



Fund Statistics

PRICE/BOOK	2.2
PRICE/EARNINGS RATIO (FY 1)	10.6
FREE CASH FLOW/EV %	7.0
DIVIDEND YIELD %	3.6
AVERAGE MARKET CAP (€BN)	55
NO. OF HOLDINGS	16

Holdings

COMPANY	SECTOR	% OF FUND
Sysco	Consumer Staples	9.6
Tidewater	Energy	9.1
Johnson & Johnson	Healthcare	8.8
Steris	Healthcare	8.5
Microsoft	Information Technology	8.3
Wincor Nixdorf	Information Technology	7.5
MI Developments	Financials	6.5
Astellas Pharmaceutical	Healthcare	6.4
Pfizer	Healthcare	5.9
Leucadia National	Financials	5.2
Everest Re Group	Financials	5.2
Total	Energy	4.5
NTT Docomo	Telecoms & Utilities	4.4
Komori	Industrials & Materials	4.0
Belgacom	Telecoms & Utilities	3.8
OPAP	Consumer Discretionary	1.0
Cash		1.2

Yearly Performance

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Fund	-22.1	-31.3	12.5	7.7	23.9	14.7	6.1	-14.7	32.3	23.6	1.5
Benchmark	-14.9	-27.6	20.5	6.6	22.8	5.2	7.2	-17.9	15.7	15.3	-2.4

Fund performance and risk-adjusted returns

Focus 15 was up – barely – in 2011. We might chance a little smile for having outperformed the benchmark, the MSCI World in Euro terms, by nearly 4% over the year. Yet this would be somewhat disingenuous of us. We've been at pains to point out in previous commentaries how short-term performance (less than 3 or even 5 years) is more random than skilful.

So it is the longer term numbers that we are most pleased with, as they are a better reflection of your fund managers' value-add as stewards of your wealth. In the 10 years to end-2011, the Fund has delivered returns around 2.5% per annum better than the benchmark (the performance of which was slightly down over the period). While this outperformance might not sound much on an annual basis, cumulatively investors are almost 30% better off over the entire period. And we believe our investment skills have markedly improved as time has gone on. Thus, over somewhat shorter time frames the performance is even better; for example, over the last 5 years the Fund is cumulatively up 18%, a 5.5% per annum relative performance. All figures mentioned above are before broker and management fees, but nevertheless this track record puts the Fund among a select group.

If some investment consultant takes the time to crunch some numbers on our Fund, as is their tendency, they will be able to produce such wondrous measures of risk-adjusted performance as Sharpe ratios, Information ratios, Treynor ratios or (one they didn't teach me in college) Sortino ratios. All of these maths-y measures use the same essential building block: historic performance volatility. And the Holy Grail is to generate lower historic fund return volatility for a given unit of return. While we haven't done the calculations ourselves, we're pretty sure that such quantitative measures would make the Focus performance numbers look even more impressive than the bare numbers presented above. Now before you reach for your cheque book to entrust the rest of your life's savings with us, we urge caution. We have absolutely no confidence in such risk-adjusted measures; we ask you to be similarly sceptical.

It's not that we don't see what the consultants are trying to understand – of course we do! Performance numbers alone are far too one-dimensional: a 10% return by one fund, generated conservatively, could be far superior to a 20% return by another that takes high-risk gambles or employs leverage. Our contention with quantitative measures is the use of historic volatility as a measure of risk. We don't target volatility – in fact, we do our damnedest to ignore it. We strongly believe that volatility does not capture risk, just as wind does not capture weather. As is more fully explained in the Setanta *Investment Charter*, we define risk as the likelihood of permanently impairing capital invested. In that regard, paying a lower price is less risky than paying a high price for a given asset; a more predictable business with a stronger balance sheet is preferable to a leveraged, speculative one.

Therefore rather than pointing you to quantitative risk-adjusted measures of performance, we will try to illustrate to you qualitatively, and with examples, how the Fund is run. Risk is at the forefront of everything we do. Or put another way, we do not eye future returns without giving serious consideration to the risks involved. This is the case with all the funds managed by Setanta but is especially true with the Focus Fund, given its concentrated nature (just 16 stocks held at year end).

Sink Holes

In the last year we came across a US fund manager called Levy, Harkins. We reluctantly highlight them to you as their stunning historic performance figures make our performance numbers positively dreadful! Nevertheless, there's a lot yours truly can learn from them. And one of their most powerful investing concepts is their estimation – a rough guess for sure – that two-thirds of US companies don't make any unencumbered profits. By that they mean profits that are free to be distributed to shareholders after required capital expenditures to maintain the business. This is very different concept from the earnings reported by companies. Levy, Harkins term these companies 'sink holes' and avoiding them *"acts as an endless 12 knot favouring breeze at my back"* (from speech given by Michael Harkins at the *Grant's Interest Rate Observer* conference in March 2011).

We've been on the sink hole-avoidance tack for a while ourselves. For example, this time last year we outlined for you why we had sold all of the bank holdings in the Fund. Banks are highly leveraged and opaque businesses, their shares are very difficult to value and their fortunes are beholden to the whims of bureaucrats and central bankers. They can make profits for long periods, it's true – but history would suggest that this is an industry that periodically blows those profits (and more) during a financial crisis. Profits indeed.

It's not just the structurally unprofitable companies we try to avoid, but the agency problem that is ubiquitous in the corporate world. By agency problem we are referring to management teams with no skin in the game (i.e. they don't own shares bought with their own 'hard earned' cash), who are incentivised to enrich themselves via ill-devised payoff structures rather than for the long-term enrichment of shareholders. It's a tough thing to get incentives right, no doubt, but most management incentive schemes are so wrong we liken it to white-collar crime! C*ha-ching*, we grew earnings per share in the year – with no reference to the inclusion of a large and expensive acquisition, financed by short-term debt, or indeed the previous three years of losses (not to mention excluding the numerous 'one off' restructuring charges). Funnily enough, when there's no penalty for investing capital it tends to be poorly allocated. And so to cut a long story short, otherwise profitable companies pay lip service to dividends and instead reinvest cash flows badly and steadily over time. And if as a shareholder you don't get dividends, you should be confident in management's capital allocation prowess.

As an example of what we do own, take Sysco Corporation, the US food distributor. Distribution is generally a low margin, capital-intensive business. Yet Sysco has a 17% market share in the US, twice the size of its closest competitor and six times the size of the number 3 competitor in the market. This gives Sysco economies of scale that allows it to consistently post returns on capital invested in excess of the firm's cost of capital. While the company is not doing anything hi-tech, the practical challenge of trying to replicate their network would be very difficult and costly – probably the best definition of a business barrier to entry. Sysco is well-diversified by end-customer (all 400,000 of them!), by region and by food type. And as predictable industries go, food distribution has got to be up there. Importantly for us, the company is – and always has been – conservatively financed. Lastly, this is a company that has for 40 years stuck to being a food distributor, despite living through the conglomerate craze of the 1970s, the leverage buyout craze of the 1980s, the internet craze of the 1990s and so on.

Does this sound like a business that is at risk of being over-run by Amazon? Or one whose future is dependent on the launch of a new 'hot' product? Does it require a strong economy to survive? Or low interest rates? Will its brand suddenly become un-cool? We're pretty confident that the answer to all of these questions is: No.

We think Sysco is far from being a sink hole – and its historic metrics back up our claim. It has grown sales and earnings per share at a rate of 7-8% per annum over the last 10 and 20 years. Here's a company that has reinvested far and above their required maintenance rate of capex and despite this has been able to pay 40-50% of profits out as dividends. Sysco's return on equity has steadily improved over time and over the last 10 years has averaged over 30%. And Sysco's is a history that we believe is relevant, which is more than you can say for most companies. The coming 10 or 20 years will look similar, if not better (notwithstanding the current economic travails). Is the good news already priced in? The stock could hardly be said to be unloved, but it still seems good value to us. Take the average profit per share the company has earned over the last 5 years, which to us is a very conservative estimate of their current and future run-rate of earnings. On that basis the stock currently trades on a 6.3% earnings yield, with ample room for this to grow in time (anyone for fixed-rate US or German government 10-year bonds at below 2%?). And finally, Sysco pays us a healthy 3.7% dividend at the current price – a dividend that has increased in each year since 1977.

Now think about alternative investments. How many companies can grow as Sysco has done, while paying a healthy dividend (and regularly buying back shares), where we don't have to worry about whether they can refinance their borrowings and which are unlikely to get sidetracked by some hair-brained venture into, oh I don't know, the movie business? We've come to the conclusion that there aren't many. The Fund has done pretty well as owners since first buying into Sysco in October 2009, up 42% in Euro terms including dividends. At over 9%, Sysco is currently one of the highest weightings in the Fund. We're very comfortable with this, though of course we won't hesitate to reduce (or sell) the stock if we find a more attractive opportunity.

And Sysco is by no means an isolated example in the Fund. At year-end almost 30% of the Fund was in healthcare stocks Johnson & Johnson, Pfizer, Steris and Astellas – not without their issues for sure, but nevertheless these are great businesses and very much out of favour with investors. In recent commentaries we profiled Wincor Nixdorf, Microsoft and Tidewater, all of which we believe fall into the same category. We will continue to review the Fund's holdings and assess whether there are better alternatives.

New stock: Leucadia

During the last quarter we purchased a new stock for Focus. Leucadia is effectively an investment vehicle, something like Warren Buffett's Berkshire Hathaway (though it doesn't own any insurance businesses). It is certainly no sink hole. Here's a excerpt from Leucadia's 2006 annual report:

"We tend to be buyers of assets and companies that are troubled or out of favour and as a result are selling substantially below the values which we believe are there. From time to time, we sell parts of these operations when prices available in the market reach what we believe to be advantageous levels. While we are not perfect in executing this strategy, we are proud of our long-term track record".

And what a record – they are investors *par excellence*! They have compounded book value per share (BVPS) at almost 20% per annum since 1979, the year they took control of the company. BVPS growth is about the cleanest measure of performance as you'll find and theirs is one of the best track records out there – achieved without leverage and excessive risk taking. In fact, we'd go as far as to say that it's been achieved with risk *far below* what your average corporation assumes. The two principle shareholders (owning close on 20% of the company) are also the firm's Chairman / CEO and President – this is quite different from the agency problem that affects most publically quoted companies. This is a management team that doesn't care for short term profits or pleasing the 'street' by beating earnings by a penny; instead they focus on building long-term shareholder value. Can you guess what motivates them to do this? Yes, us too.

Leucadia's share price almost halved in the stock market gyrations of 2011. As part of their investment portfolio, Leucadia owns some mining stocks as well as an investment bank. These types of companies have been de-rated by the market over the last year, but Leucadia's stock has been hit especially hard in our opinion. At the time of purchase, the market was valuing Leucadia at less than the value of its net assets. Now this might be warranted – only time will tell. But we're willing to bet that this superb investment team, who work hard for us as shareholders rather than for themselves as detached managers, will continue to grow BVPS at well-above market rates. We've started with a 5% position in the stock and are praying the stock falls much lower to allow us build a larger holding at even more attractive prices! We'll let you know how we got on in our 2020 letter!!

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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