



Setanta Managed Fund – Q4 2011

Fund Description

The **Managed Fund** (“the Fund”), managed by Setanta Asset Management Limited (“Setanta”), is a unit-linked offering of Canada Life Assurance (Ireland) Limited.

The Fund is an actively managed multi-asset portfolio, which holds a combination of equities, fixed income, property, commodities and cash. The Fund holds between 50-80% of its assets in equities. The asset exposures of the Fund are achieved primarily via:

- Equities: The Setanta Global Equity, Irish Equity
- Fixed Income: The Setanta Fixed Income Fund
- Property: The Canada Life Property Fund
- Commodities: The ETFS All-Commodities DJ-AIGCI ETC
- Cash: The Setanta Cash Fund

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

John Looby & David Ryan, CFA



Investment Principles

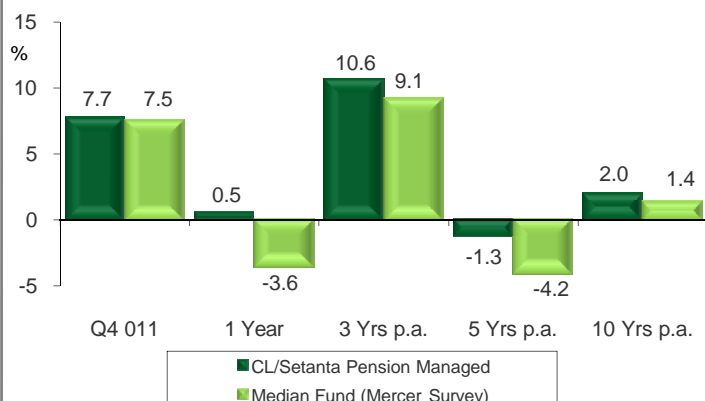
- We do not believe the market is efficient.
- We aim to make investments at a price below our assessment of intrinsic value.
- We make an investment in a business rather than trade securities.
- We believe risk is the possibility of permanent impairment of value.
- We make investments for the long term.
- 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

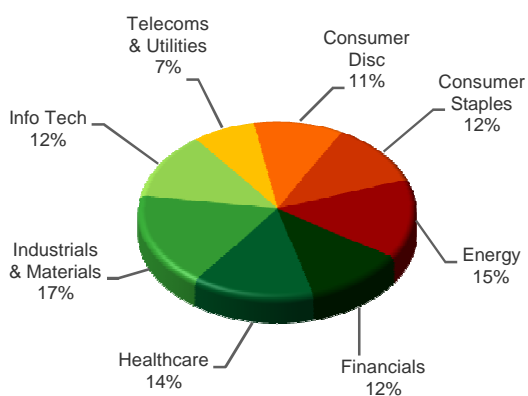


The investment objective of the Fund is to outperform the median of the domestic Managed Fund peer group.

Fixed Interest Portfolio

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%
CC	2.6%	0.0%
C	0.1%	0.0%
	100%	100%

Sector Distribution



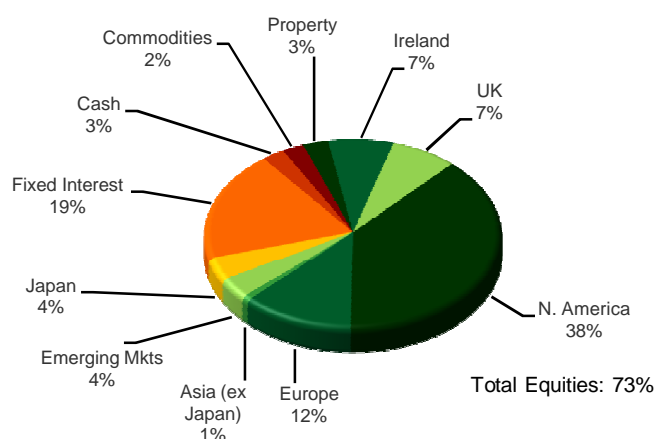
Fund Statistics (Equities)

PRICE/BOOK	1.9
PRICE/EARNINGS RATIO (FY 1)	11.7
FREE CASH FLOW/EV %	6.5
DIVIDEND YIELD %	2.5
AVERAGE MARKET CAP €BN	49
NO. OF HOLDINGS	135

Top 10 Holdings

COMPANY	SECTOR	% OF FUND
Johnson & Johnson	Healthcare	1.7
Pfizer	Healthcare	1.6
DCC	Industrials & Materials	1.6
Microsoft	Information Technology	1.6
CRH	Industrials & Materials	1.5
Medtronic	Healthcare	1.4
Exxon Mobil	Energy	1.4
Total	Energy	1.4
BP	Energy	1.3
ENI	Energy	1.3

Geographic Distribution



Yearly Performance

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Fund	-8.4	-20.4	12.2	9.8	21.7	9.1	-1.8	-29.6	22.9	9.5	0.5
Benchmark	-5.6	-19.0	12.2	10.2	21.7	13.3	-3.9	-35.6	22.0	11.3	-3.6

Performance Source: Setanta Asset Management Limited. Benchmark: Mercer Pooled Group Pension Managed Fund Survey. The actual Fund returns stated are based on the movements in the unit prices of an institutional series of the Fund and are net of management fees.
Fund Statistics source: Bloomberg (Median ex Financials); **Credit Rating Source:** S&P

The CL/Setanta Managed Fund returned 7.7% for Q4 2011 against a benchmark of 7.5%, a strong absolute return. For the year 2011, the Fund returned +0.5%, out-performing the benchmark return of -3.6% by 4%, and being the only Managed Fund in the peer group to post a positive return for the year.

In terms of performance drivers for the year, asset allocation was positive overall and stock selection and sector allocation within equities was very strong. The Fund has had a lower equity weighting and a higher bond weighting than the peer average throughout the year, having gone as low as 8% underweight in equities by end June, and used the fall in equity markets in Q3 as a buying opportunity. At the end of the Quarter the Fund held 73% in equities. Within the equity holdings the Fund continued to underweight financial stocks on the basis that banks are highly leveraged and opaque businesses which we do not wish to own currently. We also maintained the overweight position in the energy and healthcare sectors. Both stock selection and sector allocation were positive for the quarter and for the year. Bond performance was also positive relative to the BofA ML5yr+ Government index over the year, aided by a large overweight to long dated Irish sovereign debt.

With 2011 behind us, where to from here? As value investors, Setanta are keen readers of Benjamin Graham, the father of value investing. Two of Graham's central tenets are the price/value equation and the concept of margin of safety. As a 'compass' to guide us through the noise of the markets and market forecasters, it is worth focusing on the price/value equation and how it applies to equity markets today. Let's consider the following extract from a writing by Ben Graham in 1974,

"I think the future of equities will be roughly the same as their past; in particular, common stock purchases will prove satisfactory when made at appropriate price levels. It may be objected that that is far too cursory and superficial a conclusion; that it fails to take into account the new factors and problems that have entered the economic picture in recent years – especially those of inflation, unprecedentedly high interest rates, the energy crisis, the ecology-pollution mess, and even the movement towards less consumption and zero growth. Perhaps I should add to my list the widespread public mistrust of Wall Street as a whole, engendered by it's well-nigh scandalous behaviour during recent years in the areas of ethics, financial practices of all sorts, and plain business sense."¹

He goes on to say that "the real question is the same as it has always been in the past, namely; Is this a desirable time or price level to make equity purchases?". We can add to this question by asking if it is desirable to buy equities as a whole (i.e. at the general price level of the market) or even if the overall price level is not satisfactory, is it desirable to buy individual issues at good prices?

As in 1974, the 2012 economic picture is equally murky. Debt levels in developed nations are very high relative to output, money printing has gone into overdrive, interest rates are at historic lows (and even negative in some places), and public mistrust of the financial industry is as great as it has been for generations. But even this non exhaustive list of economic problems should not preclude us from considering the all important question posed above; Is this a desirable time or price level to make equity purchases? Below is a list of major indexes around the world with their corresponding Price/Earnings ratios (trailing, based on 2011 earnings) and dividend yields.

Index	2011 P/E	Earnings Yield	Dividend Yield
Dow Jones	12.7	7.9%	2.5%
S&P 500	13.3	7.5%	2.1%
FTSE 100	10.1	9.9%	3.8%
Euro Stoxx 50	10.4	9.6%	5.0%
Dax	10.3	9.7%	4.0%

Source: Bloomberg (04/01/2012)

From observing the table above we can make the following statement; If 2012 revenues stay the same and profit margins decline by 20% the S&P 500 still offers us an earnings yield of 6% (assuming price level of S&P500 stays the same also). Compared with AA corporate issues or government issues that would be expected to make good their interest and principal payments, the earnings yield on the S&P500 looks sufficient. Some may argue that profit margins are at too high a level relative to history (eg John Hussman², Jeremy Grantham³) and that a reversion to mean would mean that prospective 10 year annual returns are around the 5% level. This is indeed a valid point and

¹ The future of Common Stocks, Financial Analysts Journal, September/October 1974

² <http://www.hussman.net/wmc/wmc120103.htm>

³ <http://www.gmo.com/>

something that concerns us at Setanta. However, if the overall price level is not satisfactory we can still consider the second part of the value question; is it desirable to buy individual issues at good prices? We think there are individual issues available at good prices. Our most recent purchase in the consumer discretionary portfolio, Mohawk Industries, should help demonstrate this.

Mohawk Industries

Mohawk is a leading manufacturer of flooring products primarily sold in the United States. They sell anything you can walk on in the home and a bit more. To understand the dynamics of the flooring business in the United States, it is necessary to consider how an end user makes a purchase. The typical customer is somebody who is remodeling their home. This person will go to a carpet/flooring outlet and choose a carpet/floor from a book of samples. They will then select a local tradesman to fit and install the floor. Often the store, which is typically a local mom & pop type outlet, will do the installation for them. This makes it possible for the mom & pop to make a decent return. As a result the market is quite fragmented as the home-centres (i.e. Home Depot and Lowe's) do not have significant service elements in their operations. They are a much more dominant force in other product categories, such as appliances. To think about this further if one is buying a washing machine one will probably drive to the home-centre, make the purchase, have a sales assistant load up the car and then drive home. Usually when making a carpet/flooring purchase the retailer only holds samples of the floor and orders the stock from a manufacturer/distributor after you make the purchase. A tradesman then delivers and installs the floor at a later date.

Mohawk's largest customer is Home Depot who account for around 5% of sales, Lowe's is next with a slightly smaller share. The upshot of this dynamic is that Mohawk enjoys a fragmented customer base that shows little sign of consolidating soon. Mohawk have taken advantage of this position and have built up an efficient production and distribution process enabling them to extract value. Furthermore, the carpet and floors are expensive to keep on site for the retailers so they keep samples and send the orders through to manufactures as they are received.

The US flooring market has 2 main producers (Mohawk and Shaw's) that share approximately 40% of the total market (20% each). Shaws are a subsidiary of Berkshire Hathaway. Berkshire CEO, Warren Buffett, bought Shaws in 2001. He paid approximately \$3Bn (around 0.7x Sales and 13x earnings). Shaws was formed back in the 1960's and was built up over the decades with a series of bolt on acquisitions. Buffett tends to like businesses built up by managers that have a passion for business and skin in the game. One positive for Mohawk is that Shaws will probably behave rationally in regard to pricing.

Mohawk's success and profitability is linked to the health of the US housing market, but more specifically private fixed residential investment. Also household formations in the United States are at 40 year lows. Household formations can't be put off forever and should revert to more normalized levels soon. This dynamic should help Mohawk's profitability in the near future.

Mohawk has a good financial position, the majority of the debt is issued in bonds due 2016 (\$900m), there is \$400m in notes due 2012 and also \$253m in a secured credit facility due 2013. Total operating cash flow for the last 3 years has been around \$1.5bn or so. Mohawk should be well able to meet obligations coming due. We purchased Mohawk in the low \$50s which was approximately 14 times our estimate of normalized earnings. This equates to an earnings yield of just over 7%. Getting back to the question posed by Graham, "is this a desirable time or price level to make equity purchases?" we think Mohawk is a business with excellent industry dynamics and good cash generating ability that offered good value at our purchase price.

IMPORTANT INFORMATION

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