Setanta
ASSET MANAGEMENT

Global Perspective – April 2012

Global Equity and Bond Indices	2012 YTD %	3 Yrs p.a. %	5 Yrs p.a. %	10 Yrs p.a. %
MSCI World	8.8	20.1	-0.7	0.4
S&P 500 (US)	9.4	23.1	2.1	-0.2
Hang Seng Index	9.3	17.3	-0.8	2.4
FTSE 100 (UK)	5.0	22.6	-1.7	1.8
S&P Euro Stoxx 600 (Europe)	8.5	18.6	-3.3	2.0
MSCI High Dividend Yield	2.5	22.7	-1.9	1.1
Euro Govt. Bonds (5yr+)	4.9	4.6	4.9	5.8
EMU Corporate Bonds (Credit)	5.3	9.1	4.5	5.0

Source: Bloomberg. Returns are in Euro to 31.03.12

Learning from a Superinvestor

In Setanta we greatly admire Walter Schloss. He sadly passed away at the age of 95 on February 19th. Walter was identified as a 'Superinvestor' by Warren Buffett in his famous article, The Superinvestors of Graham-and-Doddsville, published in the Fall 1984 issue of Hermes, Columbia Business School magazine.

Warren spoke with reverence of 'Big Walt' and pointed to his phenomenal track record as part of the evidence that those investment managers who practice value investment using the tenets of Graham and Dodd have outperformed in the past and will continue to prosper. According to various reports, during the period including 16 years post the article, 1956-2000, the fund earned a compounded annual rate of return of 15.3% (20.9% pre-fees) versus 10% for the S&P.

Highlighting his independence and a contrarian streak probably essential in a value investor, Buffett said of Schloss:

'I don't seem to have much influence on Walter. That's one of his strengths; no one has much influence on him'.

Having worked prior to WWII with Loeb Rhodes he was pointed in the direction of Ben Graham's then new book, Security Analysis by a director of the firm Armand Erpf. Walter subsequently took two classes with Graham at the New York Stock Exchange. Graham, who many regard as the father of Value Investing, contacted Schloss while he was serving in the war to ask him to work for the Graham Newman Partnership. His 10 year stint as a security analyst with Graham commenced in 1946.

Graham's performance suffered greatly during the great depression and was therefore intensely focused on downside risk. He targeted stocks at 2/3 of net working capital. When these so-called 'net nets' traded back to the value of their working capital Graham Newman had made 50%. Schloss stated many times that you should invest in a way that suits your personality. For him this was the value approach, first exemplified by a simple net net formula which encompassed a low level of debt. He often quipped about how bad he was at judging management unlike Buffett, but he liked to see management owning stock.

When Ben Graham retired in 1955 Schloss started his own partnership with $100,000 from 20 partners. Gradually valuations increased as stocks managed to shake off their unpopularity, most likely garnered from investors being burned in the bear market of the great depression. Schloss joked;

'Well we look at book value, which is a little lowering of our standards, because book values have good and bad features.'

It is important to point out that Schloss and Graham did not just take naive accounting figures such as net working capital or book value as the basis for their valuation. In one example in the mid 1980s Schloss spoke of then current holding Crown Zellerback (now a part of Georgia Pacific).

'Then trading at $34 and with a similar book value, but I've got it worth $100 per share with all the timber reserves and everything.'

Schloss was the grandfather of statistical investing, but he recognised that we have to make significant adjustments to published financials to get a view of what a stock is really worth.

One question posed to us by both consultants and potential clients is 'how do you come up with investment ideas?' I often sense disappointment when I answer that we do not have a robust all-encompassing screen which churns through thousands of metrics on listed companies to identify the most attractive candidates from which we merely cherry pick the most attractive stocks. Unfortunately I don't believe this is credible.

In truth we do use screening as part of our search. We recognise, like Schloss, that often accounting numbers don't actually capture the economic value. Maybe an asset which constitutes a major element of book value is on the book at cost when with rigorous analysis we discover it is worth much more. A price to book multiple element in the screen will not capture this. A price to earnings multiple may appear low based on vastly inflated earnings, but does this really help us find undervalued stocks? We can correct for this for example by taking 10 year average earnings, but again this solution has many flaws.

The search involves many sources and these evolve and will hopefully continue to improve over time. Increasingly ideas come from our own network of like-minded investors. All our fund managers make very deliberate efforts to build and nurture a global network of value investors with whom we discuss and analyse opportunities. (We believe these are immeasurably better than sell-side analysts and brokers although we are wary that there are many articulate and intelligent investment managers and most can cite persuasive reasons for buying a stock. Our analysis must be logical and independent).

Naturally as we continue to build our experience the team mines the database of stocks we already have knowledge of for potentially attractive valuations. Often looking at the peers of these companies leads to an attractive investment. It can be beneficial to read professional publications targeted at value investors. Finally, new lows lists sometimes provide rich hunting ground. We like it when other investors feel very disappointed and have overreacted.

My sector specialty within the Setanta Global Equity Fund is Consumer Staples. This sector encompasses food and beverage, household and personal care companies, food retail and tobacco companies. Opportunities in the sector include many of the companies laden with brand names we encounter in our every day interactions with media. In the five years to the end of February the staples sector has been the best performer in the market, gaining a little over 7% per annum versus the market essentially flat. (Remember this includes the dark days of 2008 and early 2009). If we look back ten years and beyond staples companies have been stellar performers.

Given the importance of brands and other intellectual capital in this sector it is unlikely Walter Schloss would have found too many potential opportunities. That is not to say opportunities don't exist. Schloss in his normal self-depreciating manner often commented that unlike Buffett he wasn't capable of judging the future. This might seem like an unusual admission from one of the all time great investors but I believe it is much closer to the truth than many in our industry would admit! By all accounts Edwin Schloss, Walter's son who joined his father in the partnership in 1973, was prepared to purchase stocks on a normalised earnings multiple basis so long as the price to book was below 3[1] (They purchased McDonalds at one stage and in 2000 they purchased JM Smucker).

Buffett, through Berkshire Hathaway has owned almost 9% of Coca Cola since 1988. His son Howard replaced him on the Coca Cola Board in 2010. Buffett clearly understood the power of Coca Cola's brand and distribution network. At no time could he have justified buying the company without factoring in an ability to grow, and more importantly while generating an excess return on the deployment of additional capital. Incidentally according to the latest Berkshire Hathaway Annual report Buffett's $1.3 billion investment is today valued at close to $14 billion.

Is Tesco On Sale?

A recent idea I have been working on is UK based food retailer Tesco. Identified in a simple screen focused on stocks within the consumer staples space which have underperformed over the recent period (5 years) and which generate strong returns and exhibit balance sheet strength.

Having had a strong start to this century Tesco has underperformed Staples companies and the equity market since February 2005 by 77% and 27% respectively. It is quite often the case that stocks we focus on have been disappointing for a period of time. We like to focus on reviled companies. A key element of our intensive research is to ascertain whether we believe the disappointment is temporary.

Tesco is a much more complicated animal than one would expect. Sure it is a retailer, and a grocery retailer at the core (UK Market share of over 30% and just for local interest their Irish market share is 28%) but over the past five years it has moved into non-food retail in a major way. They also expanded into banking, insurance, and the telecom business. When judging their core operational performance I think it is fair to say Tesco have a very strong reputation. Margins have been impressive and they were leaders in the move to a private label and loyalty card focus.

Sticking with food retail but outside the UK, Tesco has very successful operations in the Czech Republic, South Korea, Thailand and Ireland. On the less successful front, Tesco have recently put their small portfolio of shops in Japan up for sale writing off all goodwill and have also lost over £1 billion in the US since first opening Fresh and Easy in 2007. The hope is that the US will become profitable soon, but whether they will ever make a decent return in this notoriously tough market is debatable. Tesco management recognise they cannot continue to grow much more than GDP in the UK and have been deploying capital elsewhere. This of course, provides risk.

CEO for the past year, Phil Clarke shocked the market on February 12th with an admission that Tesco has underinvested in their UK stores. This may well be as a result of the constant focus on cost take-

[1] Value Investing: From Graham to Buffett and Beyond, Greenwald et al

out and increasing margins. Maybe they went too far. A quick look at EBIT margins versus peers shows they have a 1% advantage. At best we should assume this is now gone. (Despite the scale advantages of being significant market leader).

Tesco have invested significant amounts of capital over the past few years between buying out the JV from RBS in Tesco bank, putting in financial systems and also building out new stores. It is possible that the negative impact of this on margins (from extra depreciation and under-utilisation due to immature stores) is temporary. But there are no guarantees. Overcapacity is also possible and the internet is a challenge.

There is also a cyclical element to the pressure Tesco are feeling. The magnitude of this is difficult to ascertain. On the other hand we know for sure that Tesco recently has been underperforming peers.

I believe that there is a strong possibility this latest hiccup is temporary. Tesco is far from the perfect company but their franchise in the UK has a very strong foundation which I believe can flourish again. Management also seems to be focused on returns outside the UK. This is essential.

On a conservative basis I don't ascribe any value to their property portfolio as I believe this is already captured in current profitability. Assuming a 25% tax rate and an operating margin of 5% on current sales levels and growing them at a nominal rate of 2% (again all conservative numbers) I believe net of all liabilities the stock represents good value at the £3 level. Will it get there? I hope so.

Let's finish with another quote from one of the greatest; and remember his track record!

'People come to me and ask me well what do you think the market is going to do? And I always say 'I've no idea your guess is as good as mine.[2]'

Paul McNulty, CFA
Portfolio Manager

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[2] Who is Walter Schloss and Why is He Such a Great Investor? Barrons February 25, 1985.