Setanta
ASSET MANAGEMENT

Setanta Asset Management

INVESTMENT CHARTER

Value is more than a number

What is Value Investing?

The origins of Value Investing date back to the 1920s at a time most investors were guided by speculation and insider information. Using techniques pioneered by Ben Graham, a Value Investor seeks to purchase securities where the true worth is not reflected in the market price. To measure value an assessment of the strategic position of a company is central.

The practice of Value Investing seeks to achieve superior long-term performance by acquiring stocks of financially strong (quality) companies run by capable management at a market price significantly below, a reasonable assessment of, intrinsic value. As Value Investors it is our belief that buying stocks at sufficiently low prices increases the probability of long term successful performance. Techniques of Value Investment are just as pertinent to marquee stocks such as Nestle as to underfollowed, under researched stocks. The key is price relative to value.

Investors often suffer from the human weakness of fear of being left behind; they like to own the hot and popular stocks. There is a comfort in being part of a crowd. There is no place for this herd mentality for a Value Investor.

From an intuitive and practical perspective Value Investing appeals greatly. While clarity of thought, a reasonable level of intelligence and a willingness to swim against the tide are necessary to ensure success, good Value Investors follow a simple and understandable process.

To give a better understanding of what Value Investing is, it might be useful to emphasise what it is not. Value Investing is not buying stocks where the price charts "look good". It is not about buying popular stocks and popular themes. Value investing is not *'pass the parcel investing'*[1] as the legendary Fidelity Investor, Anthony Bolton calls it, where investors buy stocks solely in the hope that continued increases in price allow their sale to another investor. It is not buying stocks on rumours, recommendations by others, or buying without intimate knowledge of the business. Value Investing is not closet indexing.

Value investing is buying stocks with a sufficient "margin of safety". Seth Klarman, president of Boston based Baupost Group explained this as *'A margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck or extreme volatility.*[2]*'*

Does Value Investing Work?

We recognise that the superior investment returns generated by value stocks over time constitute an anomaly. Surely once investors know that cheap stocks outperform expensive stocks, they should bid up the cheap stocks and eliminate the superior performance? Yet the differential has persisted.

Having surveyed academic evidence on the subject of the relationship between investment approach and returns there is a compelling amount of evidence that value investing delivers superior returns. Below we refer to 3 studies out of over 50 we have accessed.

Roger Ibottson, Professor of Finance at Yale School of Management and president of Ibottson Associates showed in a 1986 study of the relationship between the market price as a percent of book value and investment returns that 'stocks with a low price to book value had significantly better investment returns over a 18 year period than stocks priced as a high percentage of book value'[3]

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[1] Anthony Bolton Investing against the tide. Lessons from a life running money 2009
[2] Seth Klarman Margin of Safety Risk Averse Strategies for the Thoughtful Investor
[3] Decile Portfolios of the New York Stock Exchange, 1967 – 1984, Working paper Yale School of Management

The 1997 study by Fluck, Malkiel and Quandt examined the performance by 1000 large company stocks ranked by price-to-earnings and price-to-book value ratios from 1979 through 1995 and found low price-to-earnings and low price-to-book value strategies yield sizeable excess returns[4]

A particularly well-known 1993 study by Lakonishok, Vishny and Schleifer, looking at over 20 years of US stock returns showed that "value" stocks outperformed their "non-value" counterparts over a 22 year period and also outperformed in the worst 25 months and the other 88 months the market declined showing very positive conclusions for a Value Investment Strategy in both absolute and risk adjusted terms.[5]

We cannot be sure of the reason, but human biases (behavioural finance) might explain why this value anomaly persists. That is, investors are in the grip of systemic biases that induce them to pay too much for perceived winners and too little for apparent losers. So while the glamorous company's profitability might do well, the price of their shares already anticipates this. The ugly companies might plod along, but the price of their shares anticipates that they will perpetually stumble and foul up. All they need to do is get back to normal to surprise investors.

Another possible explanation is that holding ugly companies is risky from the viewpoint of a fund manager's career. An underperforming manager that holds large and well-known companies is less likely to be fired than one who owns obscure issues that few others are following. If in the business world, "no one ever got fired for buying IBM equipment"; in the investment world the same is true of General Electric. At Setanta we are never shy to step out from the pack when an investment is compelling, without regard for how well known the company is.

Rejecting Market Efficiency

Eugene Fama's 1970 review of financial market efficiency introduced the strong form of the Efficient Market Hypothesis (EMH). This effectively stated that asset prices are correct and so reflect all available information, rendering excess returns unattainable[6].

Our value-based active stock picking approach explicitly rejects market efficiency: we do not believe that price and value are equal. Warren Buffett put this is in a very concise way, *'Price is what you pay, value is what you get'*[7] The belief that value resides in the business rather than the stock price gives Value Investors like Setanta the opportunity to take advantage of investment opportunities. We like a key teaching of Ben Graham, the father of Value Investing, that in the short term the stock market is a voting machine, with the stock's price reflecting the stock's popularity with investors on any given day. In the long term the market is more of a weighing machine, aligning the stock's price to reflect the value of the underlying business.

The strongest argument levied by EMH fans to confirm their beliefs is that *active managers don't outperform.* However, a 2009 paper[8] by Jonathan Lewellen of Darthmouth College shows something we know from experience: in aggregate institutions ***don't try*** to outperform. This may sound like an

[4] 'The Predictability of Stock Returns : A Cross-Sectional Simulation' Fluck, Malkiel and Quandt Journal of Economics and Statistics May 1997
[5] Contrarian Investment, Extrapolation and Risk, Lakonishok Vishny and Shleifer, Working Paper No 4360, National Bureau of Economic Research May 1993.
[6] Efficient Capital Markets: A Review of Theory and Empirical Work.
[7] 2008 Berkshire Hathaway letter to shareholders
[8] Institutional investors and the limits of arbitrage - working paper

outlandish statement but when you examine the construction of most actively managed portfolios a very significant proportion merely replicate the index. While potentially logical from a career longevity and business risk perspective, this of course is not in the interest of the investor and is a sure fire way to underperform (especially when transaction costs and fees are taken into account). Setanta Asset Management follows an active management approach.

Warren Buffett, widely regarded as the greatest investor of us all, speaking on the issue of market efficiency put it succinctly; *'Most institutional investors in the early 1970s regarded business value as of minor relevance when they were deciding the prices they would buy or sell. This now seems hard to believe. However these institutions were under the spell of academics at prestigious business schools who were preaching a newly fashioned theory: the stock market was totally efficient, and therefore calculations of business value – and even thought itself – were of no importance in investment activities'*[9].

Some Important Elements of our Process

It is worth highlighting a few of the important elements of our philosophy. First and foremost, ***Integrity*** is a central value of our company. Our actions, recommendations and decisions are carried out for the long-term benefit of our clients.

"Somebody once said that in looking for people to hire, you look for three qualities: integrity, intelligence, and energy. And if they don't have the first, the other two will kill you. You think about it; it's true. If you hire somebody without the first, you really want them to be dumb and lazy.[10]*"*

To be considered a Value Investment the stock under scrutiny must exhibit ***Quality*** characteristics. Among desirable criteria are attributes such as generation of strong free cashflows, the ability to sustain and improve a high return on capital employed and of course a solid balance sheet. (See below)

In Setanta our analysis is detailed and thorough. Our appraisal attempts to get at the ***Economic Meaning of Statements*** rather than relying on accounting data, which often leaves out as much information as it includes.

We buy stocks when they display ***Value Characteristics***. We don't care if no one else has even heard of the companies we buy, in fact in most cases this is a positive (this is not a popularity contest). We don't care if the chart looks terrible.

Setanta's investment process is based on ***Common Sense*** values. We do not believe that added complexity translates into better returns.

We are very careful regarding ***Leverage****.* Buffett agrees: '*Leverage doesn't make an investment better; it merely magnifies the gains and losses. And any combination of fundamental difficulty, falling asset prices, reduced market liquidity, collateral value tests and margin calls can be the ruination of investors employing too much leverage'*.

It is very important when making investments to leave a ***Margin for Error****.* We are not arrogant enough to think that we are always right; in fact we at Setanta expect to be wrong quite often. So it is of paramount importance that leverage, whether it be in the fund, or indeed within the companies we own, is at a reasonable level.

We have instilled throughout our team an ethos of ***Independent Thinking****.* We do not buy a stock because a broker calls us with a fantastic idea. We do not read an analyst report and decide to sell a long

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[9] 1985 Berkshire Hathaway letter to Shareholders
[10] Thoughts of Chairman Buffett: Thirty Years of Unconventional Wisdom from the Sage of Omaha

term holding because the analyst believes the company will miss the next quarter. We don't, for instance, buy mining or emerging markets stocks, because 'that's what is hot right now.'

Independent Research is at the heart of each investment, forming a well-grounded thesis that looks out over the long term. Through our own investigation, we can more completely understand the forces that will determine an investment's success. Because we independently build the case for our ideas, we have the confidence to invest in out-of-favour areas and the fortitude to hold our ground should short-term sentiment turn against us.

In Setanta we believe a healthy degree of ***Investment Scepticism*** is beneficial. We take nothing at face value and no Wall Street 'fact' on faith. Our value process means we are ***Contrarian*** more often than not. This is a place we are happy to be because we believe that to outperform the market an investor must be prepared to think and act independently. In our experience, we have found that compelling opportunities are often created by an overly pessimistic consensus among other investors.

In Setanta we are not traders, but ***Investors.*** Our long term focus may not suit stockbrokers (who want to see many transactions) but is essential for a value manager. It also has the added benefit of minimising transaction based fees within our client portfolios.

Each Setanta fund manager is focused on a particular ***Sector*** and develops a circle of competence around this sector. We believe that the best way to assess the relative attractiveness of an investment proposition in an increasingly globalised economy is to compare it to others within a similar industry. Surely a French bank should be appraised against a US bank and other banking peers rather than a German household products company?

In Setanta, ***Autonomy*** resides with the manager of the relevant sector or fund. We believe this ***Accountability*** sharpens the decision making process. In a ***Collegiate Environment***, each manager presents investment ideas to the team. Because of our varying experience and outlooks we find the regular team meetings an extremely useful method of augmenting our investment ideas and disseminating thinking throughout our portfolio managers. Debate over each proposed purchase or sale is a respectful if sometimes vigorous exchange among colleagues. When all voices have been heard the manager takes action, or reconvenes if further research is warranted. The team environment helps us all ensure that we remain true to our investment principles by searching for investment ideas through the same value prism.

We like to see a company with strong economic resources paying out a ***Dividend***. This is both because of the discipline imposed on management from this implicit shareholder demand and the flow of cash into our portfolio which can be a significant proportion of the total return over time.

It goes without saying that we want to own companies managed by good and honest people who are focused on our interests as shareholders. But actions speak louder than words. What company ***Management*** say to the market is rehearsed down to the adverbs. As a partner from Tweedy Browne, a value manager we admire said on a recent conference call, *'it's about the horse rather than the jockey.'* Fairholme Capital's Bruce Berkowitz comments *'It is always nice to own a company that your idiot relative could run[11].'*

In contrast to many fund managers we believe in the benefits of taking a ***Significant Position*** in a stock. This is in stark contrast to many tracking error focused investors. We invest only in stocks we have conviction in. Each good idea will have an effect on performance.

We will ***Communicate*** about our investments and funds in a manner which is representative of our investment style. Too often fund managers concoct the same old blurb to fill out an investment update or to explain the relative performance of a fund over a month. (This of course to a large extent is random). We must admit to having been guilty of this in the past!

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[11] Graham & Doddsville The Investment Newsletter of Columbia Business School Winter 2009 Page 2.

Determining Intrinsic Value

We believe many investors go wrong in a very fundamental sense. They spend far too much time focusing on the ***Income Statement*** first and the ***Balance Sheet*** second. No question, profits are important, but without a solid foundation, those profits are only as good as the business environment. And no business environment stays rosy forever.

We believe the balance sheet must always be the most relied upon piece of information. In basic value terminology, the ***Balance Sheet*** is the ***First Moat.*** Of course, the balance sheet alone is not enough. A debt free, cash rich company is great, but not so great if that business can't produce profits. The ***Income Statement*** is the ***Second Moat***. A profitless company with a sound balance sheet still has value creating catalysts - buyout, liquidation, etc. - that serve to protect the investor. The same is not true for a profitless company loaded with debt or poor assets. The result here can often be massive shareholder dilution in order to keep the company afloat or, worse still, bankruptcy.

By definition, Value Investors put a lot of emphasis on valuation. We at Setanta use various tools in our attempt to ascertain a reasonable estimate of a company's intrinsic value. Due regard is placed on traditional metrics but here an attempt is made to account for their flaws.

The reproduction cost of the company's assets provides a strong basis for this valuation when it can be measured with some precision. This may be as simple as a price to book value or more often will involve an informed assessment of current asset values. Importance is placed on adjusting earnings for a 'normal' environment. Whether earnings are depressed, or potentially inflated, Setanta's approach attempts to get at the real earnings power of a business and base our valuation on this adjusted number rather than face value. Due recognition must be placed on the need for judgement in this process, but we attempt to be conservative throughout. Our experience is that the market tends to extrapolate near term trends when in fact mean reversion is a crucial driver. In situations where establishing these "normalised" earnings is particularly challenging, we may attempt to establish a downside valuation scenario where the stock is valued using a lowered earnings base.

When we believe a company has a sustainable competitive advantage that will allow growth in line with, or indeed ahead, of the economy, our value approach factors this in. In Setanta we are very aware that in many circumstances growth in sales and profits add nothing to a firm's intrinsic value. Remember growth normally has to be accompanied by additional assets: more receivables, more inventories, and more plant and equipment.

Buffett hit the nail on the head when he stated:

'Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive'[12]

In Setanta we manage many funds for our clients using this Value Investment process. It is of course important we adhere to the mandate requirements our clients have agreed to. In those funds where we must be fully invested stocks are chosen on a relative value basis.

[12] Berkshire Hathaway 1977 Annual Report.

We are Long Term Investors

It is true – valuation really doesn't matter over short periods (the "voting machine"). However valuation is the primary determinant of long term returns (the "weighing machine") and this is where our circle of competence is. In Setanta we try to keep clients and consultants aware of our long term focus and do all we can to incentivise our managers to take long term decisions. At purchase we expect to hold a position for up to 5 years (though of course if we are lucky enough for the intrinsic value gap to close quickly we will sell sooner). Many of our positions have remained for longer. We stay the course and attempt to stay away from fleeting fads.

Keynes noted, in the 1930s, that long term investment *'is so difficult today as to be scarcely practicable[13].'* We believe it is more difficult today! There will be periods when our value style is out of favour. Indeed if you look at the long term performance of some of the great investors (by long term we mean 30 years plus) there are periods of up to 5 years when they underperformed, yet over the total period they significantly outperformed the index.

Paul Samuelson, recently deceased Nobel Prize winning economist, once opined, *'Investing should be dull. It shouldn't be exciting. Investing should be like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas, although it is not easy to get rich in Las Vegas.[14]'*

Market Timing & Forecasting

Economist John Kenneth Galbraith once observed: *'We have two classes of forecasters: Those who don't know – and those who don't know they don't know[15].'* We agree. We do not believe it is possible to time the market. Our fund managers spend time on things important and at least somewhat knowable (Company fundamentals).

From a lecture by Ben Graham:

'Market forecasting, of course, is essentially the same as market "timing." On that subject let me say that the only principle of timing that has ever worked well consistently is to buy common stocks at such times as they are cheap by analysis, and to sell them at such times as they are dear, or at least no longer cheap, by analysis.

That sounds like timing; but when you consider it you will see that it is not really timing at all but rather the purchase and sale of securities by the method of valuation. Essentially, it requires no opinion as to the future of the market; because if you buy securities cheap enough, your position is sound, even if the market should continue to go down. And if you sell the securities at a fairly high price you have done the smart thing, even if the market should continue to go up[16]'.

[13] John Maynard Keynes - get reference
[14] Paul Samuelson The Ultimate Guide to Indexing Bloomberg September 1999
[15] Oaktree Capital Memo to clients 'Touchstones', Page 6
[16] The Rediscovered Ben Graham Lectures -Number 10

Well known T2 Partners Value manager Whitney Tilson showed that between 1984 through 1995, the average stock mutual fund posted a yearly return of 12.3%, yet the average investor in a stock mutual fund earned only 6.3%. That means over these 12 years, the average mutual fund investor would have made nearly twice as much money by simply buying and holding the average mutual fund.[17]

The 2010 CSFB Global Investment Returns Yearbook details that, over the last 110 years, the real value of equities, with income reinvested, grew by a factor of 331 as compared to 6.4 for bonds and 2.8 for bills. Global equities real return was an annualized 5.4% as compared to bonds and bills, which gave a real return of 1.7% and 0.9% respectively.[18]

Risk Management - A Common Sense Approach

Worryingly, in our opinion, the vast majority of the fund management world measure risk through the use of quantitative metrics such as Value at Risk, Tracking Error and Beta. These are simplified but highly flawed, single number measures of complex outcomes.

'Not everything that can be counted counts, and not everything that counts can be counted' [19]

Risk has been at the centre of Value Investment thinking from the beginning. Ben Graham argued, *'Beta is a more or less useful measure of past price fluctuations of common stocks. What bothers me is that authorities now equate the beta idea to the concept of risk. Price variability, yes; risk no. Real investment risk is measured not by the percent that a stock may decline in price in relation to the general market in a given period, but by the danger of a loss of quality and earning power through economic changes or deterioration in management'*[20]. *Or as Buffett said 'The risk that matters is not beta or volatility, but the possibility of loss or injury from an investment.*[21]'

Bruce Berkowitz argues that *'much of investing is about not losing, just as much of life is about not dying*[22]'. Charles Brandes, a closely-followed Value Investor and Ben Graham disciple, firmly rejects the Modern Portfolio Management view of risk. *'Volatility is measurable, uncertainty is not… defining volatility as risk (as modern portfolio theory does) obscures the true definition of investment risk as the possibility of losing money…Beta is used primarily by those who are looking at the whole market (or large numbers of stocks in it) and who don't look in detail at the fundamentals of specific companies. As I have shown for value investors, this concept is irrelevant and downright dangerous at worst.'*[23]

The thesis that value stocks are riskier than the market is simply wrong. Ironically even those academics that developed this Modern Portfolio Theory recognise that value stocks were found to have lower betas and higher historical returns than growth stocks. Given our disregard for this metric as a measure of risk we obviously find this irrelevant. Warren Buffett often speaks of how crazy the accepted market thinking regarding risk and reward is. Using the Washington Post example he shows how in 1973 it was selling for $80 million in the market, yet at the same time you could have sold the assets for not less than $400 million. If the price had declined more and the value fell to $40 million instead of $80 million its beta would

[17] Applying Behavioural Finance to Value Investing – Presentation T2 Partners November 1995
[18] CSFB Global Investment Returns Yearbook Elroy Dimson, Paul Marsh and Mike Staunton, London Business School 2010
[19] Attributed to Albert Einstein
[20] Benjamin Graham and Risk by Bruce Grantier – The Brandes Institute.
[21] Warren Buffett cited in L Cunningham. The Essays of Warren Buffett.
[22] Graham & Doddsville The Investment Newsletter of Columbia Business School Winter 2009, Page 6
[23] Charles Brandes Value Investing Today 2004

have been greater. On that basis the cheaper price would have made it look more risky! *'If you can buy a dollar for 60 cents, it's riskier than if you buy a dollar bill for 40 cents.*[24]

Howard Marks, Chairman of Oaktree Capital, at all times an eloquent and illuminating writer, noted *'The "I know" school of investing has received frequent mention in my memos. Its members – money managers, Wall Street strategists and media pundits – believe that there's a single future, it is knowable in advance, and they're among the people who know it. They're eager to tell you what the future holds, and equally willing to overlook the inaccuracy of their past predictions. What they repeatedly ignore is the fact that (a) the future possibilities cover a broad range, (b) some of them – the "black swans" – can't even be imagined in advance, and (c) even if it's possible to know which one outcome is the most likely, the others have a substantial combined probability of occurring instead.*[25]*'*

Risk management is at the forefront of the ***Setanta Investment Process***. Most importantly, at the stock level the economic resources of each investment are assessed and valued. Buying stocks at below our assessment of their true worth lowers the chance of a "permanent loss of capital" (though cheap stocks can become even more unpopular in the short term).

A strong balance sheet with a low level of debt gives a business breathing space to deal with unforeseen mishaps, be they company specific, industry problems or general economic weaknesses. We recognise the danger of "unknown unknowns", the limitations to our knowledge. Position sizes are taken to reflect this assessed risk and the reward potential of the investment. Careful consideration is also given within a portfolio to industry concentration risk. Our "common sense" risk management is an essential element of our investment process.

Continuously Building Experience

Economist and historian JK Galbraith once stated, *'markets are characterized by extreme brevity of financial memory. There are few fields of human endeavour in which history counts for as little as in the world of finance.*[26]*'* In Setanta we value experience and attempt to learn from history. Experience helps an investor attain the ability to deal with the many difficult decisions which invariably must be made. In Setanta we have 13 investment professionals with an average of 11 years experience. But we are careful not to make judgements solely on our own narrow experience.   As another Value investor we respect, Donald Yacktman put it*:*

''Good judgment comes from experience, and a lot of that comes from bad judgment. I add to my base of experience every day.[27]''

In Setanta we realise that as investors we are always learning. We embrace the need to continue our education both through experience and study. We also openly read and discuss letters memos and ideas written by fellow Value Investors we admire, many of whom you see quoted in this Charter.

Paul McNulty

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[24] Ben Graham The Intelligent Investor Revised Edition 2006
[25] Oaktree Capital May 2004 investment memo
[26] John Kenneth Galbraith 'A short history of Financial Euphoria' 1990
[27] Value Investor Insight 'Lying in Wait.' November 2009

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