Setanta Global Focus Fund

Q4 2018

Fund Description

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

The Fund is an actively managed equity portfolio which holds c.20 global stocks. The portfolio is managed in accordance with the Setanta investment philosophy. That is, the managers seek to own good businesses for the long-term at prices below what they think they're worth, carefully considering each investment's risk profile. Stocks are chosen through bottom-up analysis, based on investment merit. Due to the Fund's concentrated nature, investments require an even greater than normal margin of safety. The Fund can hold up to 30% cash where investments of sufficient quality cannot be found. Rather than focusing on the historic level of volatility of an asset, the portfolio managers regard the probability of permanent impairment of capital as the most relevant measure of risk. In doing so, they seek to maximise downside protection by understanding the risks posed by the valuation, financial, and operational characteristics of the asset.

Fund Commentary

The year began calmly but finished dramatically. To illustrate, in February the S&P500 set the dubious record for the longest period (over 400 trading days) without a 5% pullback, while in August it set another record for the longest period (over 9-and-a-half years) without a 20% correction. The 5% and 20% falls duly arrived in the fourth quarter of the year. It was a timely reminder to everyone that investing isn't a one-way street.

(Fund Commentary continued on Page 3)

Portfolio Managers

David Coyne & Rowan Smith

Our Investment Principles

We do not believe markets are efficient

We invest below our estimate of intrinsic value

We invest in businesses rather than buying stocks

Preservation of our clients' capital is key

Investing is a marathon, not a sprint

We are not afraid to swim against the tide

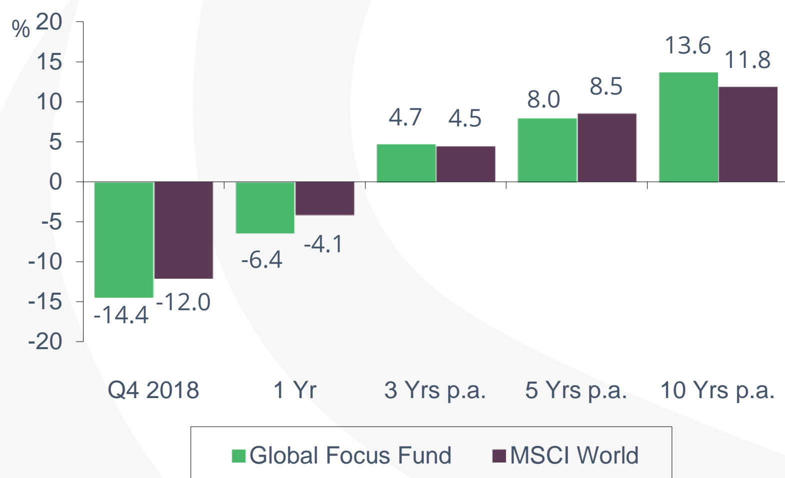
We consider scenarios rather than making forecasts

Businesses we own must have strong balance sheets

We make mistakes and always endeavour to learn from them

We will act with integrity in everything we do

Fund Performance – 31.12.18



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

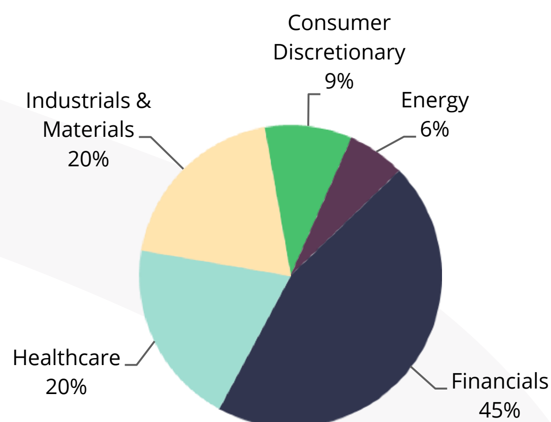
Top 10 Holdings

COMPANY	SECTOR	% OF FUND
BERKSHIRE HATHAWAY	FINANCIALS	8.5%
MINCON GROUP	INDUSTRIALS & MATERIALS	7.7%
STERIS PLC	HEALTHCARE	7.6%
LANCASHIRE HOLDINGS	FINANCIALS	7.3%
FAIRFAX FINANCIAL	FINANCIALS	6.5%
DCC	INDUSTRIALS & MATERIALS	6.5%
LSL PROPERTY SERVICES	FINANCIALS	6.5%
JOHNSON & JOHNSON	HEALTHCARE	6.0%
JEFFERIES FINANCIAL	FINANCIALS	5.4%
RICHEMONT	CONSUMER DISCRETIONARY	4.4%

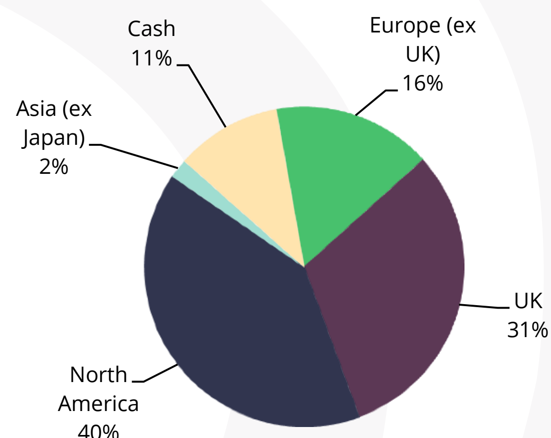
Fund Statistics

PRICE/BOOK	1.4
PRICE/EARNINGS RATIO (FY 1)	15.6
DIVIDEND YIELD %	2.1
AVERAGE MARKET CAP € BN	48.8
NO. OF HOLDINGS	18
DEBT /EQUITY %	39.0
ACTIVE SHARE %	92.9

Sector Distribution



Geographic Distribution



Yearly Performance

Year %	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Fund	17.0	-2.7	-35.2	44.0	28.2	1.5	9.0	20.0	19.1	7.3	11.7	9.7	-6.4
Benchmark	7.4	-1.7	-37.6	25.9	19.5	-2.4	14.1	21.2	19.5	10.4	10.7	7.5	-4.1

SETANTA Asset Management

Commentary

In the 2017 year-end fund report I mentioned how tough we were finding it:

"We think this is an exceptionally difficult market to navigate. We regularly observe ordinary companies trading at gold-plated valuations. There are very few beaten up stocks to be found – typically a good place to look for cheap companies – and when we find them there's often just too much hair on them for us to consider as an investment."

As we sit here in early 2019, has our opinion changed? Not really. Overall the MSCI World (Total Return, Euro) fell by less than 5% in 2018, although some pockets of the market have been hit hard and as we sift through the wreckage over the coming weeks and months we might find some good quality bargains.

Our difficulty in finding good investment opportunities is at odds with the attractive headline market valuations you may read about. According to my Bloomberg screen, the consensus sell-side one-year forward price-earnings ratio is 13x for Europe and 15x for the US, undemanding in a historic context. In short, we are sceptical of the earnings numbers used in those P/Es. Most obviously, they are based on peak sales and peak margins, as most of the world's big economies are at full employment, interest rates are very low and consumer confidence is generally strong. On top of this, sell-side analyst forecasts are always biased upwards, typically omitting a host of legitimate business expenses, giving the appearance of higher than actual profits. We would also throw in the potential for systemic corner-cutting that can accompany times of exuberance. For example, in late-December US-listed healthcare company Perrigo (not a fund holding) fell 30% on the news that it has been ordered by the Irish Revenue Commissioners to pay a massive $1.9bn in back taxes relating to Elan, bought by Perrigo in 2013. Elan had previously sold intellectual property rights to Biogen and treated the event as trading income (12.5% tax rate) rather than a capital gain (33% tax rate). This is a specific Perrigo event, but could hint at general corporate behaviour, under pressure by the large body of short-term investors that demand results, now, by whatever means! This risk is most definitely not captured in forward P/Es. Setanta doesn't calculate bottom-up earnings across the market, but we regularly find that decent companies typically trade on scrubbed down, cyclically-adjusted P/Es of 20-30x, on the expensive side versus history.

You may have seen that the share prices of "FANG"-types came under pressure during the second half of the year. FANGs is shorthand for Facebook, Amazon, Netflix and Google, but more broadly is a catch-all for trailblazers of the information age (including Bitcoin, which I sceptically featured in the 2017 year-end fund review). A full discussion of this topic is a thesis in itself but, in brief, we have avoided the FANGs typically because their business models are relatively new and unproven, meaning their warranted valuations are hard to determine (who would have guessed the data privacy issues Facebook and others have faced in the last year?). Some of the FANGs may dominate their fields for years to come, but for a long time it looked to us that investors too easily bought the hype — the mere mention of "network effect" seemed to free companies of the need to turn a profit. We are happy to see investors begin to cast a more critical eye now.

Commentary

Fund Review 2018

The fund fell by 6.4% during the year, behind its benchmark which fell by 4.1%. To state the obvious, your fund managers are very disappointed with this outcome, especially because we have been wary of stock valuations generally and consequently held over 10% in cash on average over the year (10.6% at year-end). At year end the fund was slightly ahead of benchmark over 3 years (+0.2%), behind over 5 years (-0.6%) and ahead over 10 years (+1.8%).

A table showing the top and bottom five performing stocks for the year is shown below, but we caution that stock performance is best seen in a longer term context than 12 months. For example, while luxury goods company Richemont fell by one-quarter in 2018 this was a reversal of its increase in 2017; its share price over the last two years is virtually unchanged. Also, this table does not take into account a stock's position size. So while Ryanair was down by 28% in the year, thankfully it was a smaller than average weight through the year.

2018 Top 5 Performers	Sector	Year-end weight	Total Return, Euro
Mincon Group	Industrial	8.2%	+57%
Steris	Healthcare	7.6%	+43%
Henry Schein	Healthcare	4.1%	+36%
Granite Real Estate	Financial	-	+31%
Berkshire Hathaway	Financial	8.5%	+30%
2018 Bottom 5 Performers	**Sector**	**Year-end weight**	**Total Return, Euro**
Richemont	Consumer Cyclical	4.4%	-24%
National Oilwell Varco	Energy	2.3%	-25%
Ryanair Holdings	Industrial	2.1%	-28%
Jefferies Financial	Financial	5.4%	-30%
Diamond Offshore	Energy	3.2%	-47%

Mincon performed strongly during the year, albeit it fell by more than 25% from its mid-year peak as stocks more generally sold off. As a reminder, Ireland-based Mincon manufacturers a range of rock drilling tools that are sold into a variety end markets around the world. We first bought the stock for the fund in Q1 2015, after what we believed was a cyclical fall in sales and a tightening of margins. Since then the company has made significant investments in growing the scope of its business. Sales are now at a record level and we believe a ramp in profitability will soon follow. We are excited about Mincon's long-term prospects for its ability to grow its market share and profits through innovative products and broader distribution. However, demand for drilling tools is cyclical so you should expect this to be a bumpy ride at times.

US-based **Steris** is also worth a mention, as its 30% share price rise in 2018 should be seen in the context of its purchase in 2010 at around $30 per share versus a year-end 2018 price of over $100 (with dividends on top of this – equating to a total return of close to 20% p.a. since initial investment). A review of Steris highlights the difficulty we currently face in trying to sensibly deploy the fund's capital. Steris' main business involves making sterilisation equipment and consumables for, and providing related services to, hospitals and laboratories worldwide. It has a strong market position with sizeable barriers facing potential new entrants, highlighted by the fact that customers rarely switch suppliers. We believe that the company will continue to grow profitably for many years. At purchase Steris was relatively unknown in the investment community and was valued on a mid-teens P/E (using our own conservative earnings estimate), which we considered highly attractive as we saw considerable potential for after-tax profit margins to increase alongside steady revenue growth. However, while the business has grown nicely since, the share price has increased at a faster rate, and so the valuation is now over twenty times earnings. Furthermore there is far less potential for profit margins to rise given the significant increase in recent years. We still believe the current valuation is justifiable because of the strength of the business, but returns for shareholders over the long term are highly likely to be well short of those achieved in the past eight years. While this might not excite, finding better investment candidates – cheaper and of sufficient quality – is not an easy task in the current market.

Diamond Offshore also fell sharply in 2018. The offshore oil and gas driller typically benefits from a high oil price, but the oil price collapse in Q4 (Brent price per barrel -40%) may have put the skids on a demand-led recovery for the time being. This has been a very challenged investment for us in the 6 years since we first purchased (a function of the exceptionally difficult drilling industry backdrop rather than Diamond-specific issues), but we remember that the environment for drilling rigs can be exceptionally favourable for prolonged periods too. The weak oil price in Q4 also weighed on the share price of drilling parts supplier **National Oilwell Varco**, another fund holding.

Among the weak performers in 2018 were our holdings in the high-quality albeit cyclical luxury goods *maisons* **Richemont / Swatch** (down around a quarter in 2018) due to fears of slowing Chinese demand, a key consumer of luxury products. UK stocks generally fared poor due to a combination of Brexit fears, expected cyclical demand weakness, general competitive struggles and/or valuation; some of these factors weighed on **DCC**, which lost around 20% of its value in the year (Euro-terms). Also, some of our financial stocks were heavily hit during the year, notably **Jefferies Financial Group**, formerly known as Leucadia, which was down 30% due to continued poor performance at its key investment banking subsidiary. Some of the above listed risks and worries will prove to be real and long-lasting, while others will be overblown or fleeting and these latter cases and their share prices will recover. At an individual stock level we cannot tell which will occur, it is just the nature of investing. However at a *portfolio* level, we remain confident that the fund will prove more durable than the market if there is a prolonged spell of economic or stock market weakness.

Fund Transactions in 2018

During the year the fund added 2 and exited 2 positions.

The new stocks were Henry Schein (purchased in Q2 and profiled in the Q2 report) and Melrose Industries (purchased Q4, see below). The sales were Brookfield Asset Management (Q1 report) and Granite Real Estate (Q3 report).

Commentary

	Buys	End of year weight	Sells	Start of year weight
Quarter 1	-	-	Brookfield A.M	2.1%
Quarter 2	Henry Schein	4.1%	-	-
Quarter 3	-	-	Granite Real Estate	3.8%
Quarter 4	Melrose Industries	3.2%	-	-

We are no strangers to **Melrose Industries**, having owned it in Focus in the past and having held the stock in other Setanta funds since 2014. UK-listed Melrose owns a collection of industrial businesses. Its business model is based on identifying and buying quality industrial assets that have been mismanaged, fixing them and selling them on at higher prices. The current management team has a long-history (going back to the early 1990s) of doing just that, producing stunning results along the way. It should be noted that Melrose has not followed a 'slash-and-burn' approach typically followed by corporate raiders; it tends to increase investment in businesses it acquires. In mid-2018 Melrose made its largest acquisition ever by buying GKN, the British manufacturer of engineered components for the aerospace and auto industries. GKN's products are well-regarded, but under previous management it had a history of over-promising and under-delivering on financial targets. Under new management, the company says they have already made improvements. However, for now investors are focused on the big picture: Brexit, slowing auto sales, potential trade wars, as well as increasing interest rates. The fall in industrial asset prices has led Melrose management to postpone the sale of other assets it had previously flagged, which has meant that Melrose's debt levels post the GKN deal remains elevated – a potential fly in the ointment. However we feel that following a 25% fall in the Euro-price of Melrose between May and October we are being compensated for these risks. The fund started with a below-average 3% investment.

David Coyne – Portfolio Manager

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