

# Setanta EAFE Equity Fund (CAD)

Q1 2019

## Fund Description

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

The Fund is an actively managed equity portfolio which holds c.30-35 stocks in the European, Australasian and Far East regions. The portfolio is managed in accordance with the Setanta investment philosophy. The Fund is managed by three portfolio managers, who also look to leverage off the experience and knowledge of their colleagues. The aim is to achieve a sensible level of diversification on a sector and geographic basis. The Fund can hold up to 10% cash where investments of sufficient quality cannot be found.

The investment objective of the Fund is to outperform the MSCI EAFE benchmark over the long term.

## Fund Commentary

For much of the last 5 years the benchmark long dated European interest rate, the German 10 year Bund, has been priced to yield less than 1%. Recently, however, it went negative again having previously spent a short period in 2016 below zero. This set of conditions, we believe, creates serious distortions with capital infusion into real world businesses that make, sell and distribute everything from hairdryers to replacement aircraft parts.

*(Fund Commentary continued on Page 3)*

## Portfolio Managers

Rowan Smith; Fergal Sarsfield, CFA & Conor Walshe



## 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

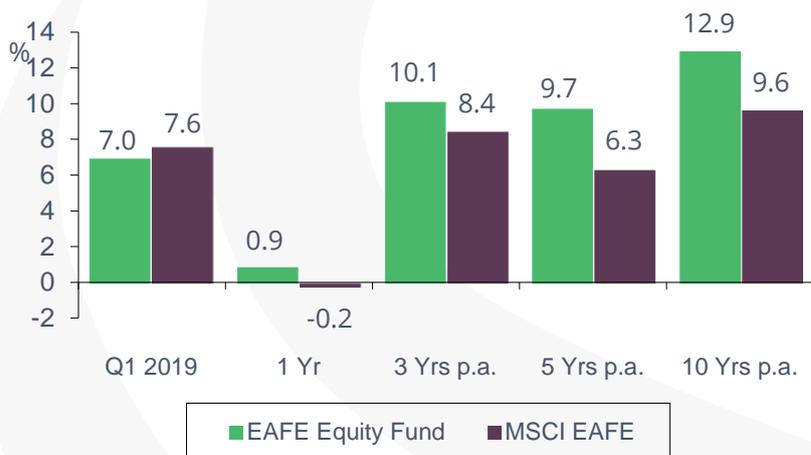
We consider scenarios rather than making forecasts

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 – 31.03.19



## Yearly Performance

| Year %    | 2014 | 2015 | 2016 | 2017 | 2018 |
|-----------|------|------|------|------|------|
| Fund      | 4.5  | 25.2 | 7.0  | 16.7 | -2.7 |
| Benchmark | 3.7  | 19.0 | -2.5 | 16.8 | -6.0 |

**Performance Source:** GWL Unit Prices. Based on CLA EAFE Equity (SF035). Returns are in CAD and are gross of management fees. Benchmark is MSCI EAFE. The performance will be reduced by the impact of management fees paid, the amount of which varies. **Fund Statistics Source:** Bloomberg

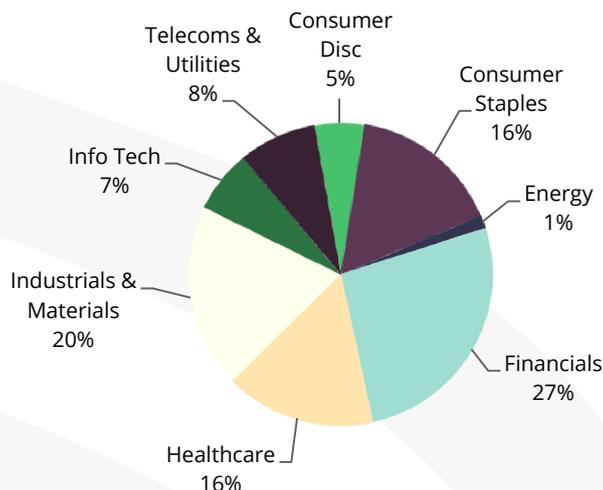
## Top 10 Holdings

| COMPANY               | SECTOR                  | % OF FUND |
|-----------------------|-------------------------|-----------|
| DCC                   | INDUSTRIALS & MATERIALS | 5.5%      |
| GPE BRUXELLES LAMBERT | FINANCIALS              | 5.2%      |
| ALFRESA HOLDINGS      | HEALTH CARE             | 4.6%      |
| UNILEVER              | CONSUMER STAPLES        | 3.8%      |
| MELROSE INDUSTRIES    | INDUSTRIALS & MATERIALS | 3.8%      |
| LANCASHIRE HOLDINGS   | FINANCIALS              | 3.6%      |
| NOVARTIS              | HEALTH CARE             | 3.6%      |
| ERICSSON              | INFORMATION TECHNOLOGY  | 3.5%      |
| SANOFI                | HEALTH CARE             | 3.4%      |
| DIAGEO                | CONSUMER STAPLES        | 3.4%      |

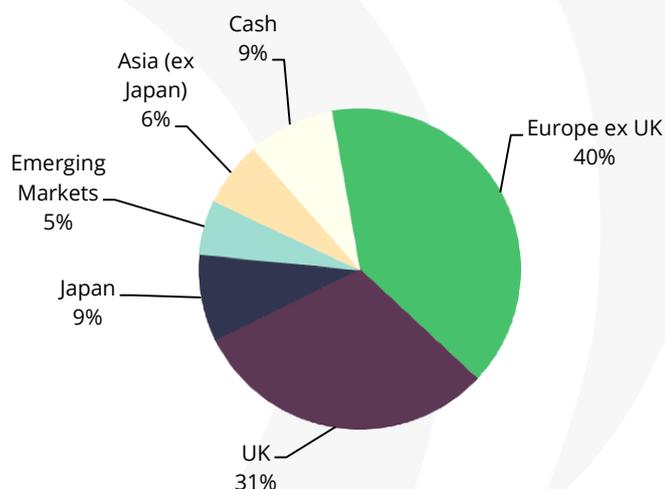
## Fund Statistics

|                             |      |
|-----------------------------|------|
| PRICE/BOOK                  | 1.5  |
| PRICE/EARNINGS RATIO (FY 1) | 13.9 |
| DIVIDEND YIELD %            | 3.4  |
| AVERAGE MARKET CAP C\$BN    | 53.2 |
| NO. OF HOLDINGS             | 34   |
| DEBT/EQUITY %               | 57.0 |
| ACTIVE SHARE %              | 89.4 |

## Sector Distribution



## Geographic Distribution





## Commentary

In the capitalist system, when money is priced to yield zero or even a negative return, capital can get pushed to unproductive resources for longer than initially anticipated. From reading finance textbooks one could assume we know where the excess capital will show up. We can ponder and guess but we can't know for sure. There are too many variables.

Our task then is to observe, by looking at businesses one by one and hoping to find a level of insight that will give us confidence in the competitive picture. This part of the job is never ending, we are constantly looking to where the excess has shown up, might show up or is in retreat.

Today, restaurants and car manufacturers (to name but a few) seem to have taken the brunt of the capital infusion over the last number of years. One might have guessed that hotels and the housebuilding industry could have seen a significant influx of capital over the last decade, given the conditions. To be sure they have attracted capital but it doesn't look like on today's evidence that they've grown excessively. Perhaps the shortage of skilled labour in construction has been the bottle neck rather than availability of capital. Or perhaps the real estate excesses in the noughties have chastened the bank lending channel to such "risky" real estate projects.

When the economy can take no more stimulus and eventually recedes it's likely that restaurants and car manufacturers are going to be in a difficult spot. Supply will likely need to contract, perhaps significantly. For each and every investment we are wary of the implications for money with no cost. We can't eliminate this risk but are very cognizant of it and the ability of new previously unknown risks to surface and manifest. This type of risk management can steer us into better industries with more favourable outcomes. Furthermore, if we see signs of capital contracting amongst the industries that are currently exhibiting signs of overheating, we may see some opportunities. We are actively thinking about such scenarios today across the team.

The reemergence of negative rates for the Bund has tested the markets resolve and ability to price securities sensibly. At this point we think the pricing continuum is fairly efficient, from what we observe in the market from our analysis of portfolio holdings and potential new holdings. We are seeing excellent businesses trade for greater than 30X our earnings estimates, mediocre businesses trade at and above 20X and poor businesses trade for more than 15X. We are not sitting and waiting. We are actively trying to find new candidates for investment but find that potential new ideas are either too highly valued or we uncover more problems as an investment case evolves. We are, if you wish, busy and waiting. Of course, it would be better if pricing conditions were at least a little keener. In this game, we must play the hand we are dealt. Forward returns will likely be lower in the next ten years than the previous ten. In this environment we must accept lower returns relative to recent history. We will have to maintain our standards for intellectual curiosity and flexibility and be ready to capitalize on the inevitable dislocations that occur in the future.



# Commentary

## Transactions during the year

We disposed of our small position in **Ultra Electronics** in January 2019. As long term investors with a typical holding period of 5 years, Ultra was a relatively short-lived investment with our investment lasting slightly less than a year. Ultra is a great example of how we aim to compound our knowledge of each company throughout our holding period and when the facts change or when we think we may have made a mistake at the initial research stage we are not afraid to change our minds.

So what changed with Ultra Electronics?

- 1) We were always aware that their accounting was complex but the more we dug into it the more uneasy we became with the extent of this complexity and when combined with very weak cash conversion over our holding period it made us increasingly more concerned. Red flag
- 2) Change in management – a new CEO which brings with it a potential change in strategy. Red flag
- 3) Brexit – the MoD is a very large customer for Ultra and with the potential fallout from Brexit and the impact it may have on UK budgets unknown it just added to the riskiness of the investment. Red flag

The 3 points above all raised red flags for us which ultimately proved our investment in Ultra became untenable.

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