

Fund Description

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

The Fund is an actively managed equity portfolio, with a long-term investment horizon. Our aim is to invest in European companies that are trading below their intrinsic value. Our investment process seeks to invest in companies that exhibit a combination of low financial risk, low operational risk and low valuation risk. We believe that if we can invest in companies that possess these characteristics then we can reduce the risk of a permanent loss of capital and enhance our chances of outperforming our benchmark over the long term.

The investment objective of the Fund is to outperform the MSCI Europe index over the long term.

Fund Commentary

After a blazing opening to the new year, markets sold off sharply in the first week of February. The talking heads explained the cause of the decline, with the usual assurance, but nobody ever really knows what causes sell-offs such as these and there were probably various factors at work. The market had been setting records for the longest stretch without a 5% correction (over 400 days for the S&P 500), bond yields had been rising quite sharply in the preceding months and volatility had been extremely low for an extended period. A correction was probably overdue and when it came it was sharp but fleeting and fairly modest overall in magnitude. In such instances almost everything sells off and there is often seemingly little discrimination between different companies and their stocks. Had the sell-off been sustained for a period we suspect the market may have begun to discriminate and this may have started to throw up some opportunities for us. Alas despite some renewed volatility later in the quarter such opportunities didn't materialise.

(Fund Commentary continued on Page 3)

Portfolio Managers

Fergal Sarsfield CFA & David Byrne CFA

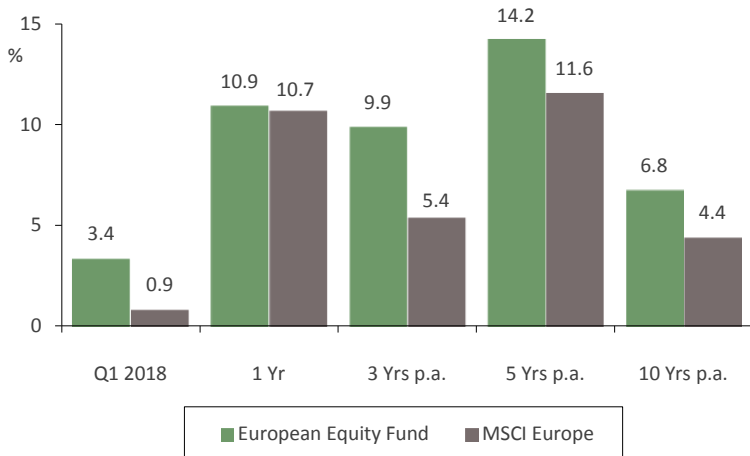


Investment Principles

- 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.



FUND PERFORMANCE – 31.03.18 (CAD)



YEARLY PERFORMANCE

Year %	2012	2013	2014	2015	2016	2017
Fund	18.0	35.8	1.3	27.7	-0.8	15.3
Benchmark	16.5	33.6	2.3	16.5	-3.9	17.3

Performance Source: GWL Unit Prices. Based on CLA European Equity (SF037). Returns are in CAD and are gross of management fees. Benchmark is MSCI Europe. The performance will be reduced by the impact of management fees paid, the amount of which varies. **Fund Statistics Source:** Bloomberg

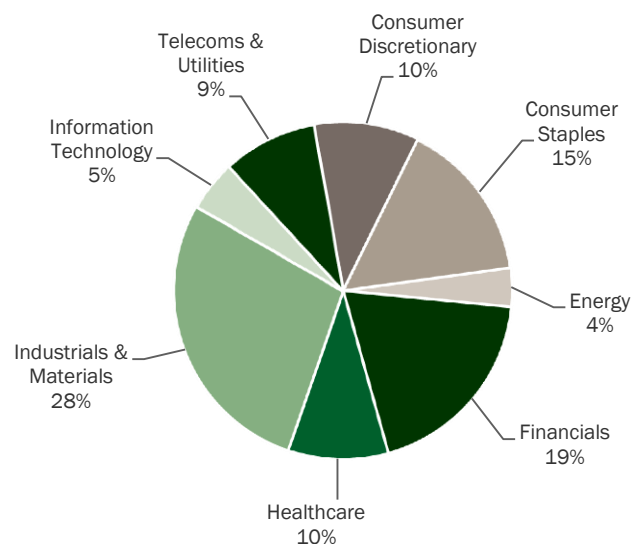
TOP 10 HOLDINGS

COMPANY	SECTOR	% OF FUND
MELROSE INDUSTRIES	INDUSTRIALS & MATERIALS	6.6%
DIAGEO	CONSUMER STAPLES	6.0%
GPE BRUXELLES LAMBERT	FINANCIALS	5.9%
FENNER	INDUSTRIALS & MATERIALS	4.9%
DCC	INDUSTRIALS & MATERIALS	4.9%
ERICSSON	INFORMATION TECHNOLOGY	4.4%
CRH	INDUSTRIALS & MATERIALS	3.7%
RYANAIR	CONSUMER DISCRETIONARY	3.6%
UNILEVER	CONSUMER STAPLES	3.3%
ORIGIN ENTERPRISES	CONSUMER STAPLES	3.3%

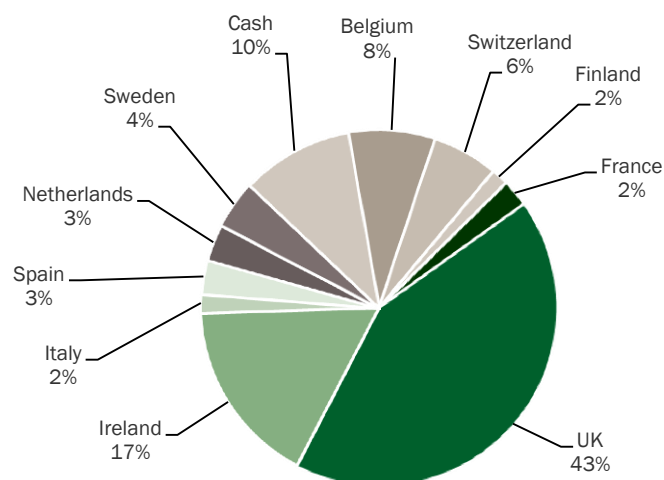
FUND STATISTICS

PRICE/BOOK	1.7
PRICE/EARNINGS RATIO (FY 1)	15.9
DIVIDEND YIELD %	3.1
AVERAGE MARKET CAP C\$BN	53.2
NO. OF HOLDINGS	28
ACTIVE SHARE RATIO %	82.2
DEBT/EQUITY %	54.4

SECTOR DISTRIBUTION



GEOGRAPHIC DISTRIBUTION



New opportunities are in short supply these days. These are the most difficult market conditions I have had to confront in the past twenty years. In the TMT bubble of the late nineties, some sections of the market were extremely expensive. Stocks in the tech, media, telecom, biotech and other “new economy” sectors routinely traded on PEs of 100 or more – and that’s if the companies made any money. The over-valuation wasn’t confined solely to these sectors but there were plenty of other segments of the market where good businesses traded at reasonably low prices. There were ample opportunities for patient long-term investors. Today virtually all corners of the market are priced richly. The obscene valuations of 1999 are not really evident but neither are the pockets of abundant value that were once apparent. This equity market doesn’t look like a classic bubble, but valuations are high broadly across the board. Value is now really only evident on a relative basis, and even at that is hard to find.

In reviewing the current portfolio and when considering new ideas, probably the most important factor now is balance sheet strength. This is always important but takes on particular significance in the current market with interest rates rising and valuations high. Whenever the next bear market arrives, and we have no idea when that will be, it seems quite conceivable that companies with plenty of debt will be de-rated most aggressively. So we are especially wary of these.

The numbers rarely tell the whole story

Despite the hype surrounding ‘Big Data’ and the seemingly relentless momentum of passive investing, we remain convinced that traditional fundamental research, *when conducted to a high standard*, continues to offer an attractive and differentiated proposition for patient investors.

Investment success often hinges on actions one decides not to take rather than the actions one does. When we at Setanta consider an investment proposition the key question we ask ourselves is; *if we invest in this company but are proven wrong is it likely that a substantial portion of the invested funds will be lost?* If the answer is in the affirmative, then we’ll walk away and move on to the next proposition.

However it’s the subtleties underlying the “facts” that often give the best insight into this evaluation. A recent example might help to make the point.

Recently I reviewed a potentially attractive investment candidate; Sigma Healthcare, one of the largest distributors of pharmaceuticals in Australia. Sigma “screened” well on traditional quantitative metrics:

- Dividend yield of 6%, with no withholding tax payable by foreign investors
- Modest levels of debt
- The company produced a perfectly good Return on Tangible Equity of over 13% at the last reporting date
- Revenues and profits have been growing in recent years
- Cash conversion, i.e. how much profit is turned into cash flow, has been good in recent years
- Listed on Australia’s main ASX 200 index with ample stock trading liquidity
- At a price of A\$0.92 the stock traded on a PE of 17x using reported earnings over the last twelve months; a discount to the broader market.

What’s not to like?

There are a number of ‘softer’ but highly relevant factors that become apparent only to those investors that are prepared to dig a little. These include the following;

- The company has been in dispute with its largest customer over its plans to source supplies from one of Sigma’s competitors. To me, it seems possible that this account could be lost in its entirety when the contract expires within the next few years. The customer accounts for almost 40% of Sigma’s annual group revenues.
- We have studied various distribution businesses in detail over the years. One typical feature is that they tend to be particularly sensitive to changes in volume and price. This is because the profit margins are very low (operating margin of around 2% for Sigma) in relation to the fixed costs of the business. Simply measuring the profits of the company misses this critical feature. So if Sigma were to lose its largest customer, or a large share of this business, the impact on profits would likely be substantial.
- The company is undertaking a significant expansion with capital expenditure expected to total over A\$200 million in the three fiscal years to 2020. This compares with annual profits of around A\$60 million and an annual depreciation expense of around A\$9 million. Since the company typically pays out most or all of its profits as dividends, much of the cash required to fund the investment will probably be borrowed. As such, debt and costs are on the rise at the same time as concerns are growing about the longevity of the relationship with its largest customer. Debt magnifies the effect on shareholders of changes in operating results so higher debt levels would mean greater pain for shareholders if any adverse scenario materialised.
- Cash flow has been strong in recent times, thanks in part to a reduction in working capital (the amount of cash tied up in inventories and trade debtors) in recent years. This may not be sustainable, especially with competitive pressures heating-up in the industry. If Sigma has to reinvest cash into working capital this could put extra pressure on the balance sheet. Reduced working capital produced a cash inflow of over A\$90m in the 2017 fiscal year. If that were to reverse, over A\$90m in cash would have to be reinvested (resulting in a dividend cut or increased borrowings). This compares with around A\$60m in annual profit.

In short, the “facts” point to an attractive investment candidate but upon closer inspection there are risks growing beneath the surface that make us too uncomfortable. We decided to walk away.

Transactions during the first quarter

There were no transactions in the first quarter.

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IMPORTANT INFORMATION

The Setanta European Equity Fund is managed by Setanta Asset Management Limited and is a representative account of the Setanta European Equity strategy. The Fund is available on a separate account basis to institutional investors. Investors should consider the investment objectives, risks, charges and expenses carefully before investing. See ‘WARNING’ and ‘IMPORTANT INFORMATION’ sections below.

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