Setanta Global Equity Fund (USD) – Q1 2018

Setanta
ASSET MANAGEMENT

Fund Description

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

The Fund is a diversified, actively managed equity portfolio. As bottom-up fundamental value investors, our research process is designed to properly understand how each business functions and to consider risks pertinent to the business. Securities are chosen by a team of global sector specialists, targeting sensible diversification across industries, geographies and market capitalizations. We value each business, with the priority to pay a price that mitigates downside risk. We aim to make investments for the long-term, all the while considering the available opportunity set.

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 a very 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, such opportunities never materialised.

(Fund Commentary continued on Page 3)

Portfolio Managers

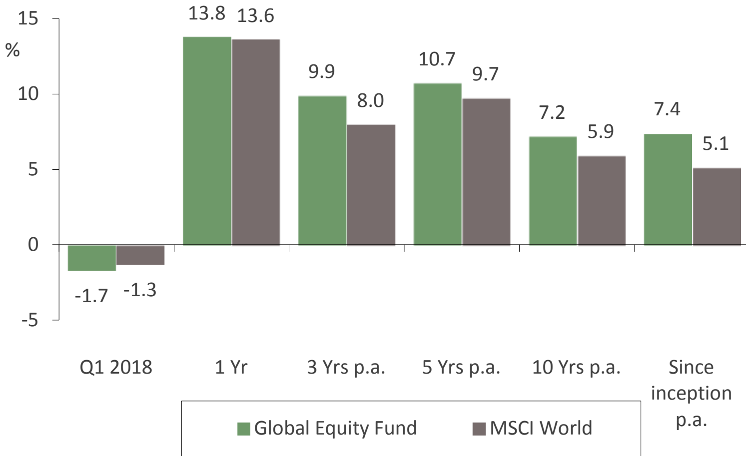
David Coyne & Sean Kenzie, CFA

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.

Setanta
ASSET MANAGEMENT

FUND PERFORMANCE – 31.03.2018 (USD)

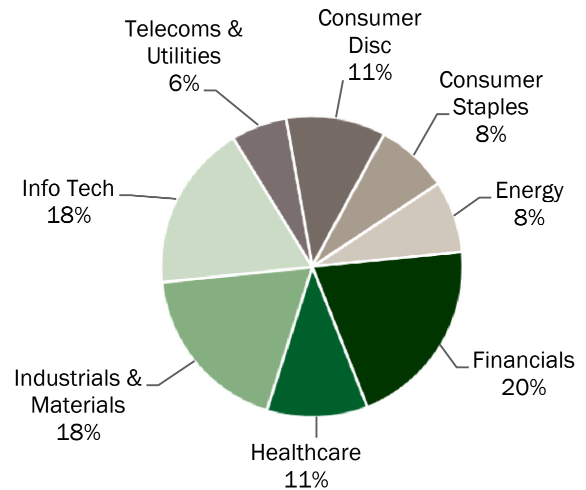


Performance Source: Unit prices: representative account converted to USD at FX Rate 1.2299. Benchmark: MSCI World (USD). The Fund returns, in USD, stated are based on the movements in the unit prices of a representative account, based on mid to mid prices, and are gross of management fees. The performance will be reduced by the impact of management fees paid, the amount of which varies. **Fund Statistics Source:** Bloomberg

FUND STATISTICS

PRICE/BOOK	1.9
PRICE/EARNINGS RATIO (FY 1)	15.7
DIVIDEND YIELD %	1.9
AVERAGE MARKET CAP $BN	63.9
NO. OF HOLDINGS	89
ACTIVE SHARE %	88.0
DEBT/EQUITY %	53.8

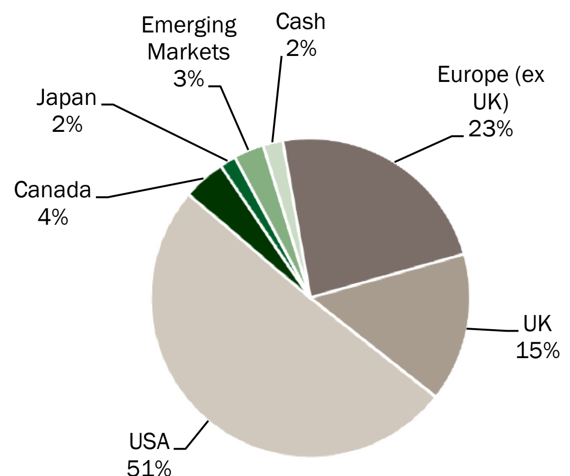
SECTOR DISTRIBUTION



TOP 10 HOLDINGS

COMPANY	SECTOR	% OF FUND
OWENS-ILLINOIS	INDUSTRIALS & MATERIALS	3.0%
BERKSHIRE HATHAWAY	FINANCIALS	2.9%
MICROSOFT	INFORMATION TECHNOLOGY	2.8%
DCC	INDUSTRIALS & MATERIALS	2.8%
MELROSE INDUSTRIES	INDUSTRIALS & MATERIALS	2.7%
FEDERATED INVESTORS	FINANCIALS	2.6%
OSHKOSH	INDUSTRIALS & MATERIALS	2.5%
CISCO SYSTEMS	INFORMATION TECHNOLOGY	2.5%
FAIRFAX FINANCIAL	FINANCIALS	2.5%
CRH	INDUSTRIALS & MATERIALS	2.5%

GEOGRAPHIC DISTRIBUTION



YEARLY PERFORMANCE

Year %	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Fund	39.8	19.5	10.8	26.3	9.8	-39.7	36.4	8.7	-2.4	15.9	30.2	5.9	-2.2	12.8	23.8
Benchmark	33.1	14.7	9.5	20.1	9.0	-40.7	30.0	11.8	-5.5	15.8	26.7	4.9	-0.9	7.5	22.4
Relative Performance	+6.7	+4.8	+1.3	+6.2	+0.8	+1.0	+6.4	-3.1	+3.2	+0.1	+3.5	+1.0	-1.3	+5.3	+1.2

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 hits, 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 are wrong about this company 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 better.

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 >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 is a dividend cut or increased borrowings). This compares with A$50-60m 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

We initiated one new positon in the quarter and bade farewell to two companies for very different reasons.

Saga Plc sells tailored financial services (mainly motor and home insurance) and holidays to the over-50s in the UK. It might look like an odd combination, but Saga is a trusted brand and its multi-product strategy has enjoyed great success since it broadened out its travel-only offering in the 1980s. Although a relatively minor profit contributor, one of Saga's greatest assets is its very popular cruise liner business, where it provides a first rate, hassle free service to passengers, which in turn helps strengthen the overall Saga brand and keep customer loyalty high (reducing the need for high levels of 'traditional' advertising).

That's not to say that Saga has it all its own way and indeed an unexpected step-up in the competitive environment in insurance in the last couple of months in 2017 caused management to reduce its expectations for company profit over the next year or two. The share price reacted by falling by more than one-third. We have extensively researched the company since then. We believe investors have placed too much emphasis on near-term profit and are ignoring its undoubted strengths that will play out over the long term including: a growing over-50s demographic; an insurance operation that is capital light and has a significant cost advantage over peers; two new highly-efficient (read: very profitable) cruise ships that will come into operation over the next couple of years; and a brand new IT system that will reduce costs and hopefully allow them better win and retain customers. At acquisition we believe Saga was trading on less than 10x P/E and had a dividend yield of 7.5%. We believe these profits are broadly sustainable over the medium term and if we are correct the stock will prove to be exceptionally cheap.

As mentioned in the Q4:17 report, our holding in credit insurer **Euler Hermes** was the subject of an offer by its majority shareholder, the German insurance giant Allianz. We tendered our shares in February. We initiated our position in Euler in October / November 2016 and made around 50% on our investment – not a bad outcome at all. Nevertheless it was with a heavy heart we sold because we think Euler is an exceptional company that will continue to dominate its global niche for many years to come.

We sold **Fair Isaac** (FICO) which had been one of the best performers in the Technology sector portfolio since initial acquisition in July 2010. The stock was purchased at an average price of $22.77, generating a return for the portfolio of 548% versus a return of 225% for the MSCI IT Benchmark.

Fundamentally, the strength of FICO's business model is highly attractive - they have an almost monopoly like position in credit scoring and have proven they can leverage this technology into other areas like Falcon fraud protection, Triad customer management software and other Decision Management Software products which have helped revenue and profitability growth.

We had been trimming the stock as valuation became increasingly expensive, trading on a P/E of 28x or 33x including stock based compensation. Since the financial crisis, US consumer credit has grown at a 5% CAGR, with the current economic expansion 103 months old, some 44 months longer than the average of the prior 11 business cycles. Essentially our fear was that much of the growth that is required for FICO to maintain its lofty valuation will not materialise as inferred by the market.

Sean Kenzie – Portfolio Manager

Contact Details:

Setanta Asset Management Limited,
Beresford Court,
Beresford Place, Dublin 1, Ireland.

Alan Hickey, Tel: + 353 1 612 4903
Email: Alan.Hickey@setanta-asset.com
www.setanta-asset.com

IMPORTANT INFORMATION

The Setanta Global Equity Fund is managed by Setanta Asset Management Limited and is a representative account of the Setanta Global 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.
Setanta Asset Management Limited is regulated by the Central Bank of Ireland, New Wapping Street, North Wall Quay, Dublin 1, Ireland and has been granted the International Adviser exemption from registration in Manitoba, Ontario, Quebec, British Columbia and Alberta. This exemption enables it to provide advisory services to clients in these provinces in accordance with the applicable securities legislation of Manitoba, Ontario, Quebec, British Columbia and Alberta. Setanta, who is an investment sub-advisor to a number of Great–West Life Group companies, does not trade on its own account. Units in the Canadian segregated and mutual funds are not offered for sale by Setanta but may be acquired by prospective investors via the relevant Great–West Life Group company. This factsheet, which is for information purposes only, does not form part of any contract. This is a marketing communication that (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research, and (b) is not subject to any prohibition on dealing ahead of the dissemination investment research. The information contained in this document is based on current legislation and is, therefore subject to change. The contents are intended as a guideline only and should not be construed as an interpretation of the law. You should always seek the advice of an appropriately qualified professional. Performance disclosures are stated above.
Setanta Asset Management Limited has also been approved by the SEC (CRD # 281781/ SEC # 801 – 107083) as an Investment advisor firm.
The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the foregoing, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages

WARNING: Past performance is not a reliable indicator of future results. The price of units and the income from them may go down as well as up and investors may not get back the amount invested. The return may increase or decrease as a result of currency fluctuations. Forecasts are not a reliable indicator of future performance