Global Focus Fund (EUR) – Q4 2016

Setanta
ASSET MANAGEMENT

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, concentrated Global Equity Fund that is invested in circa 20 stocks. As a fundamental value investor our research is designed to properly understand how each business functions and to consider pertinent risks to the business. We attempt to value each business, incorporating relevant upside and downside scenarios. As such the Fund attempts to invest in the most attractive stocks across all the firm's strategies using a risk-return framework. Investments are made for the long-term and are based on investment merit rather than with reference to benchmark. This Fund is mandated to be fully invested in equities. Due to the concentrated nature of the Fund, performance may be volatile. The investment objective of the Fund is to outperform the MSCI World index over periods of three years or more.

Fund Commentary

There are 17 holdings in the fund currently . Regarding sector exposures, the fund currently holds no direct exposure in Consumer Staples, Information Technology or Telcom/Utility companies; there is a substantial weighting (c.30% on a look-through basis) in a diversified group of financial companies. Such sector skews are not unusual in this fund, by virtue of its concentrated nature. At year end, cash accounted for 9% of the fund.

Over the past year there were three new additions (Swatch, Richemont, National Oilwell Varco) and three outright disposals (Melrose, Tesco, Sysco); each of these was discussed in the first three quarterly reports of the year.

Turnover has been somewhat lumpy from year to year, however as can be seen in the chart below, over the past five years 13 new stocks were added and 13 sold*. This corresponds to 80-90% of fund value, somewhat higher than we might have anticipated in advance.

(Fund Commentary continued on Page 3)

Portfolio Managers

Rowan Smith & David Coyne


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.

Irish Pensions AWARDS 2015 WINNER Equities Manager of the Year

Irish Pensions AWARDS 2016 WINNER Equities Manager of the Year

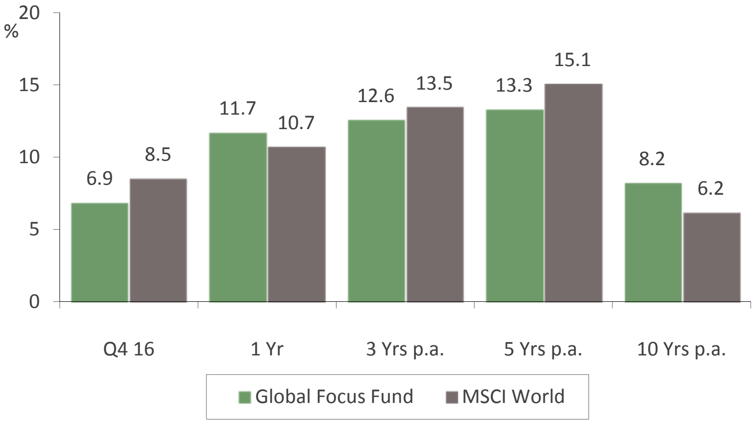
Irish Pensions AWARDS 2014 WINNER Equities manager of the year

Irish Pensions AWARDS 2013 WINNER Equities Manager of the Year

Irish Pensions AWARDS 2012 WINNER Equities Manager of the Year

Setanta
ASSET MANAGEMENT

FUND PERFORMANCE (EUR) – 31.12.16



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 (Valuation) Median ex Financials

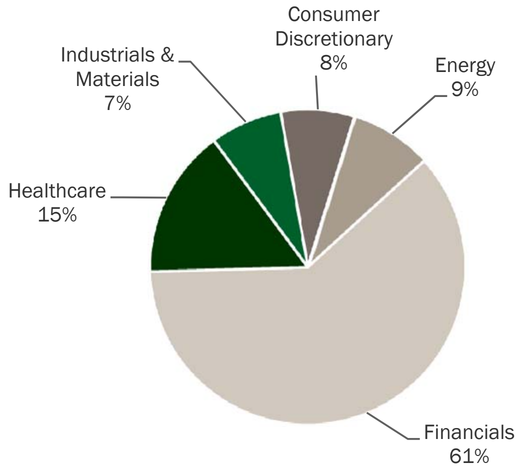
FUND HOLDINGS

COMPANY	SECTOR	% OF FUND
LEUCADIA NATIONAL	FINANCIALS	9.2%
LSL PROPERTY SERVICES	FINANCIALS	8.8%
FAIRFAX FINANCIAL	FINANCIALS	7.8%
BERKSHIRE HATHAWAY	FINANCIALS	7.2%
JOHNSON & JOHNSON	HEALTHCARE	7.0%
STERIS PLC	HEALTHCARE	6.8%
BROOKFIELD ASSET MGMT	FINANCIALS	6.0%
MARKEL CORP	FINANCIALS	5.8%
DIAMOND OFFSHORE	ENERGY	4.9%
MINCON GROUP	INDUSTRIALS & MATERIALS	4.9%
GRANITE REAL ESTATE	FINANCIALS	4.8%
RICHEMONT	CONSUMER DISCRETIONARY	4.7%
LANCASHIRE HOLDINGS	FINANCIALS	4.3%
NATIONAL OILWELL	ENERGY	2.7%
SWATCH GROUP	CONSUMER DISCRETIONARY	2.2%
DCC ORD	INDUSTRIALS & MATERIALS	1.8%
GREAT EAGLE HOLDINGS	FINANCIALS	1.7%
CASH		9.3%

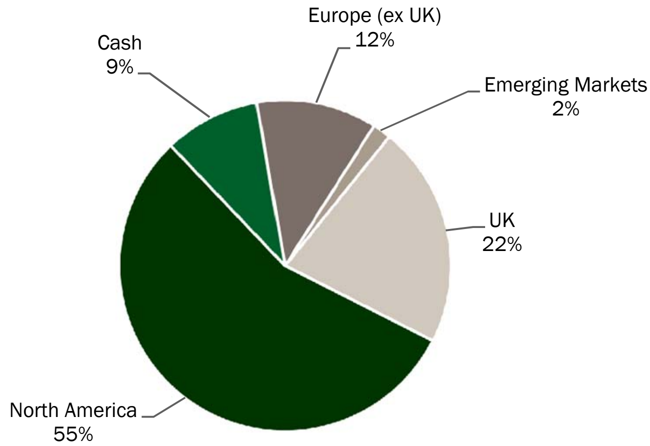
FUND STATISTICS

PRICE/BOOK	1.4
PRICE/EARNINGS RATIO (FY 1)	16.8
DIVIDEND YIELD %	1.7
AVERAGE MARKET CAP € BN	46.0
NO. OF HOLDINGS	17
DEBT /EQUITY %	39.3
ACTIVE SHARE %	98.2

SECTOR DISTRIBUTION



GEOGRAPHIC DISTRIBUTION



YEARLY PERFORMANCE

Year	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Fund	-35.6	3.9	7.6	27.3	17.0	-2.7	-35.2	44.0	28.2	1.5	9.0	20.0	19.1	7.3	11.7
Benchmark	-32.1	11.3	6.5	26.2	7.4	-1.7	-37.6	25.9	19.5	-2.4	14.1	21.2	19.5	10.4	10.7

Global Focus: Portfolio Changes 2011-2016			
	Bought	**Sold**	**Rationale for Sale**
1	FAIRFAX FINL	OPAP	*Investment Case Failed*
2	SWATCH	BELGACOM	*Valuation*
3	RICHEMONT	WINCOR NIXDORF	*Investment Case Failed*
4	MINCON GROUP	TOTAL	*Valuation*
5	DCC	NTT DOCOMO INC	*Valuation*
6	LANCASHIRE HLDGS	KOMORI	*Valuation*
7	LSL PROPERTY SER	ASTELLAS	*Valuation*
8	GREAT EAGLE HLDGS	EVEREST RE GP.	*Valuation*
9	BERKSHIRE HATHAWAY	MICROSOFT	*Valuation*
10	BROOKFIELD ASSET MGT	PFIZER	*Valuation*
11	DIAMOND OFFSHORE	SYSCO	*Valuation*
12	MARKEL CORP	TIDEWATER	*Investment Case Failed*
13	NATIONAL OILWELL	*Tesco*	*Investment Case Failed*

Tesco was bought and sold with the period

Buys and Sells listed in no particular order

Performance

As usual, we present the fund performance over 1, 3, 5 and 10 year periods relative to the benchmark in the table on the top left hand side of page 2. We believe the fund has been conservatively positioned over the past ten years and results over this timeframe have been good. However, relative performance over the most recent three and five year periods has been disappointing. We can attribute this broadly to three factors:

1. Strong bull markets generally don't suit our conservative investing style
2. Cash, averaging in the range of 5-10% over the past five years, proved to be costly insurance
3. Two particular investment mistakes, namely Tesco and Diamond Offshore, each discussed below, were a heavy burden in such a concentrated portfolio.

Review of errors and lessons learned

Tesco

Tesco was added to the fund in 2012. In a nutshell the thesis was that its scale provided a competitive advantage in what we expected to be a relatively stable industry; trading difficulties were believed to be the result of temporary demand-side factors and previous management mis-steps, which were in the process of being corrected; consequently the valuation was attractive. However the competitive structure of the industry proved to be much more challenging than we expected in part because of "barriers to exit" among existing retailers, as well as changed consumer behaviour. We probably fell in love with the narrative, to which there were numerous appealing strands, including:

- Market leadership in a historically stable industry
- Online and convenience businesses were established and provided growth potential
- Stock had recently fallen for seemingly "cyclical" reasons
- Price-to-Earnings multiple looked low
- Warren Buffett was invested in the stock

The siren song of the "narrative" drowned out the noise from some highly pertinent observations, some of which we identified beforehand but were too forgiving of. These included:

- Management playing fast and loose with standards of good practice (e.g. booking gains from property sale & leaseback transactions involving the company's pension fund)
- High financial leverage, considering the pension deficit and leases (which we excused in light of seeming operating stability)
- Operating margin was low and the business model is inherently geared. Our assumptions for future operating margins were in the range of 5-6%, in effect anchored around what had been achieved historically. We scarcely considered a 2% margin, which is what the group earned in fiscal years 2015/2016 (albeit the margin should improve in the medium term).
- Industry capacity continued to expand despite poor trading conditions

When we invested in Tesco in 2012 we made a mistake because we misjudged the risk-reward profile. Though the losses suffered weren't catastrophic the experience has been painful and the analysis probably consumed more man hours than any stock we've ever owned. However it is important to remember that there are uncertainties and risks with every investment – even those with strong attributes have numerous potentially serious weaknesses. The *ex-ante* difference between winners and losers is often a lot smaller than it seems after the investment case has played out. Furthermore Buffett was also caught on Tesco so we need to keep things in perspective.

What can we learn from the experience? The most pertinent lessons are probably the following:

- Be extra wary of financial leverage, especially in cases with relatively high operating leverage and low profit margins – had Tesco possessed less in the way of financial obligations the share price would have declined less.
- Be careful not to base a valuation case off a tight operating margin range.
- Management behaviour that could be deemed "sly" should raise a red flag.

<u>Diamond Offshore</u>

The offshore energy drilling contractor was added to the portfolio in 2013. In a nutshell the thesis was that management were proven counter-cyclical investors that were in the process of upgrading the fleet. At the time the stock was trading at less than half its all-time high and debt levels were modest thereby enabling the company to acquire good assets at distressed prices in the event of a severe downturn. The company's long-term track record, whilst volatile, was strong.

The collapse in the oil price significantly undermined the investment case. Realistically we should not expect to have foreseen such a commodity price decline but there were other risk factors that we should probably have been more wary of. These include the following:

- The economics of the business were virtually dependent on one variable: the oil price
- Offshore drilling, at the high end of the industry cost curve, was especially vulnerable to any oil price decline
- ROEs achieved over the cycle were good and peak levels were fantastic but may not have warranted the Price-to-Book of c.2x that we opened the position at.

Two other points of note:

- Some contracts with customers, that we reasonably believed to be watertight, were cancelled: when trading conditions become distressed rule-books can be torn-up – this can apply to many businesses.
- Diamond is majority owned by Loews, in which the esteemed Tisch family are shareholders. We probably placed an excessive value on this factor.

Concluding observations

The long-term performance track record of the fund is good but the relative results have been disappointing in more recent years. The above discussions on Tesco and Diamond Offshore are highlighted because being honest, humble and learning from mistakes are key elements of our investment principles. We believe that over the years we have become better at limiting the impact of errors.

We should stress that your fund managers are also doing a lot good work and are sticking to the knitting of buying good quality companies at valuations that imply above average risk-adjusted returns. We do not buy what is popular or big in the benchmark, nor do we impose macro or thematic considerations. We don’t profess to have views on the outlook for markets or whether 2017 will be a good or bad year for investors, but believe that Setanta’s investment style is best positioned to satisfy investors in the long-run. We are quite happy with the current portfolio, although valuations are more elevated than we would like (a function of broader market conditions), which tempers our enthusiasm somewhat for absolute returns in the future. Reflecting this, the fund currently has cash of around 10% of the fund value, as we wait for better opportunities to present themselves.

David Coyne – 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