Setanta Global Equity Strategy (USD)

Q2 2019

Strategy Description

The **Global Equity Strategy** ('the Strategy') is managed by Setanta Asset Management Limited ("Setanta"). The Strategy is available to US Investors on a separate account basis. The Strategy is an actively managed equity portfolio which holds c.80-100 global stocks. The portfolio is managed in accordance with the Setanta investment philosophy by a team of eight global sector specialists, overseen by two lead portfolio managers. The aim is to achieve a sensible level of diversification on a sector and geographic basis. Reflecting this, portfolio sector weights are generally set so as broadly similar to the sector weights in the benchmark. Within each sector, stocks are chosen through bottom-up analysis, based on investment merit. 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. The investment objective of the Strategy is to outperform the MSCI World index over the long term.

Fund Commentary

The pullback in global stock markets towards the end of 2018 proved to be short lived and since the turn of the year the MSCI World Total Return (USD) has risen by 17.0%, setting a new all-time high.

The Setanta Global Equity Strategy increased by 13.4% over the same period, lagging the benchmark by -3.6% in what was the second worst rolling 6-month relative performance period in its near 20-year history.

(Fund Commentary continued on Page 3)

Portfolio Managers

David Coyne & Sean Kenzie, CFA

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

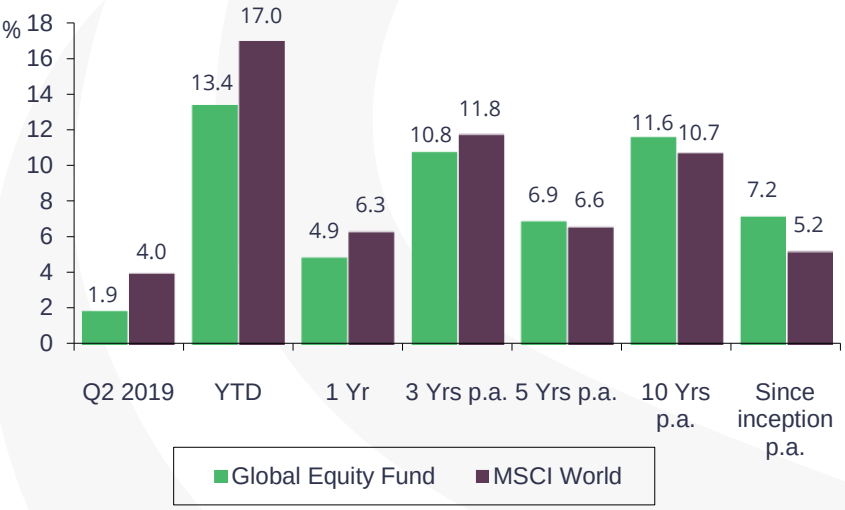
We consider scenarios rather than making forecasts

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

Strategy Performance to 30.06.19 (USD)



Performance Source: Unit prices: representative account converted to USD at FX Rate 1.1388. 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. **Holdings Source:** Setanta. Sector allocations based on invested portfolio only (excludes cash). **Fund Statistics Source:** Bloomberg

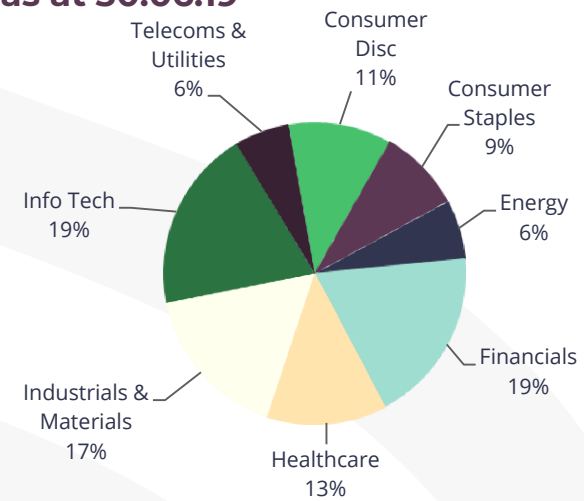
Top 10 Holdings as at 30.06.19

COMPANY	SECTOR	% OF FUND
MICROSOFT CORP	INFORMATION TECHNOLOGY	3.3%
BERKSHIRE HATHAWAY	FINANCIALS	3.2%
DCC	INDUSTRIALS & MATERIALS	2.9%
FEDERATED INVESTORS	FINANCIALS	2.6%
LANCASHIRE HOLDINGS	FINANCIALS	2.4%
STERIS PLC	HEALTHCARE	2.2%
JOHNSON CONTROLS	INDUSTRIALS & MATERIALS	2.2%
MELROSE INDUSTRIES	INDUSTRIALS & MATERIALS	2.2%
CISCO SYSTEMS	INFORMATION TECHNOLOGY	2.2%
OSHKOSH CORP	INDUSTRIALS & MATERIALS	2.2%

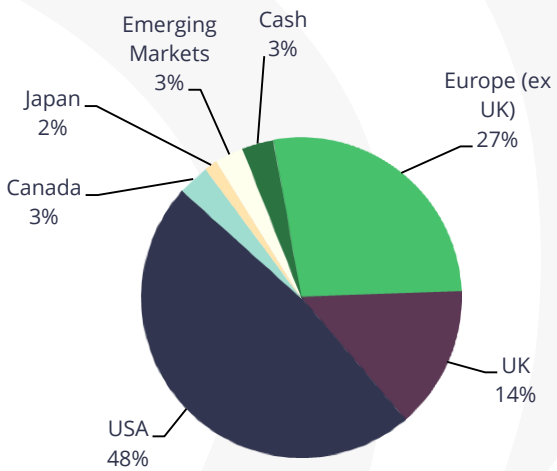
Fund Statistics as at 30.06.19

PRICE/BOOK	1.9
PRICE/EARNINGS RATIO (FY 1)	15.4
DIVIDEND YIELD %	2.4
AVERAGE MARKET CAP $BN	71.4
NO. OF HOLDINGS	87
ACTIVE SHARE %	86.5
DEBT/EQUITY %	60.0

Sector Distribution as at 30.06.19



Geographic Distribution as at 30.06.19



Yearly Performance

Year %	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Fund	9.8	-39.7	36.4	8.7	-2.4	15.9	30.2	5.9	-2.2	12.8	23.8	-8.5
Benchmark	9.0	-40.7	30.0	11.8	-5.5	15.8	26.7	4.9	-0.9	7.5	22.4	-8.7

SETANTA Asset Management

Commentary

As mentioned in the Q1 report, the Fund tends to lag very strong markets such as we have just experienced. We also perceive that stocks that have even a sniff of bad news are getting unfairly punished, especially smaller companies with limited sell-side analyst coverage, a factor compounded by the MIFID II regulations introduced in Europe last year that unbundled the costs of equity research and trading, which has led to a decline in research coverage. An example of this is Origin, the agri-services group, whose share price fell 10% in H1:19, lagging its peers and the overall market by more than 25%. If anything, Origin's recent results were better than expectations, but Brexit-related fears and thin analyst coverage means its cheap valuation is going unnoticed. There is a risk this issue persists, which may affect our ability to keep pace with the benchmark for long periods, but ultimately we think good companies with growing profits will be recognised.

One of our holdings, Saga Plc., fell by 64% in Q2 (USD terms) following a profit warning and it contributed to around -1% of our -2.1% relative performance. To recap, Saga sells travel and insurance services to the over-50s the UK. We bought into the stock following a previous profit warning in late-2017, when management announced they were cutting insurance prices to win back lost customers. We believed a stabilisation of insurance profits, combined with a transformation of profits at its travel division post the delivery of two new cruise ships in 2019 and 2020, rendered the stock too cheap. Unfortunately the insurance division needed further corrective action and this led management to further lower their profit expectations. The UK home and motor insurance market is highly competitive, made more difficult by the presence of Price Comparison Websites (PCWs), now a dominant route to purchasing insurance in the UK. The competition has driven down prices to the point where new policies are barely profitable after costs of paying the PCW and other operating costs. Saga's current turnaround plan will look to win back customers by offering them unique and genuinely differentiated insurance products which are only available to purchase directly from the company. Another problem they've had to deal with is the ongoing regulatory investigation into the insurance industry's practice of offering cheaper prices to new customers, with loyal or inert customers being charged more. Management's new profit projections include a plan to address this ahead of the results of the investigation. Also, since the turn of the year the UK travel industry has suffered a sharp drop in demand and while Saga is relatively sheltered from this (its older customer base are wealthier and less economically sensitive) it is nevertheless suffering some effects. Lastly, the market is rightly concerned that Saga's debt load, which will balloon as the new cruise ships arrive at a time of weakening travel demand, will struggle to be serviced by lower profits. These are valid reasons to be very worried.

Following an extensive re-evaluation of the company, including around 8 hours of discussions with the company, we have decided to continue to remain shareholders. Although it is very early days, the insurance turnaround is showing promising results. The cruise business is the jewel in the crown and bookings remain robust; this business is particularly cash generative and should allow for rapid debt repayment over the coming 3-4 years. There are risks that we are wrong, but we think at this share price the risk-reward is very much in our favour.

Is it 1999 all over again?

As regular readers will know, we are not macro investors, but neither do we operate in a bubble without regard for the mood of 'Mr. Market' (the personification of the average investor, as described by legendary investor Ben Graham). Anecdotally it appears to us that investors' willingness to accept higher risks for lower expected returns has increased and should give the cautious investor give pause for thought.

Commentary

Stock markets are at all-time highs. As measured by the MSCI World Total Return in Euro (our benchmark), equities have risen around 15% per annum compound since their March-2009 low. It seems crazy to think that had you perfect foresight of the coming Global Financial Crisis in June 2007 and sold out of equities, you would have missed out on a very respectable compound return of 6% per annum through a buy-and-hold strategy in the 12 years since then.

When stock markets go up by more than their profits, the result is multiple expansion. This has been a feature of the last decade. Arguably the least biased valuation measure is the Cyclically-Adjusted P/E (aka the "Shiller P/E"), which is based on average inflation-adjusted earnings from the previous 10 years. The current Shiller P/E for the US stock market is 30x, a level that has only been higher during the technology bubble between 1997 and 2001 (peaking at 44x in 2000). We can argue the toss what the *correct* US Shiller P/E should be. To take two yardsticks, the average over the last c.150 years is 17x and the average over the last 10 years is 25x. "On the expensive side" is a fair-to-understated summary.

One-quarter of all issued sovereign debt globally has a negative yield, according to Bloomberg. Issuers with less than stellar credit histories are doing a brisk trade. Less than four years ago Greece was an *enfant terrible* of the sovereign bond world and its 10-year bonds were yielding more than 18%. In March this year, the Greek state issued a 10-year bond with a 3.9% coupon. At the time of writing that same bond was yielding 2% (unbelievably, the same as US Treasuries). All being equal, low interest rates can justify higher equity market valuations, but things aren't always equal. For example, zombie companies are more likely to be kept alive by low interest rates, resulting in more competition for customers, lower corporate profit margins and consequently a structurally lower stock market valuation. This broadly describes the Japanese economy and stock market over the last few decades.

Parts of the IPO market appear frenzied, particularly so-called 'disruptor' companies. A noteworthy example is Beyond Meat, the maker of plant-based protein foods that taste like meat. It listed in early May and 'popped' 163% on its first day of trading; by the end of the quarter it had risen by 544%. With a market cap of $9bn, the stock trades on 78x the $115m of revenues it made in the year to March 2019, off which it made a $30m net loss. Naturally, it is expected that Beyond Meat will grow, as customers look for healthier and more environmentally friendly alternatives to real meat. The questions are: how fast and how profitably. *Very* is the market's current response (notwithstanding the likelihood it will face many current and future competitors). Overall the IPO market looks less frothy than in 1999/2000 and I've seen estimates of 200 IPOs and $70bn in capital raised expected in 2019, which compares to 486 and $92bn respectively in 1999. That said, the current rush to float is being at least partly driven by memories of the Q4:18 stock market sell off, when appetite for IPOs suddenly dried up.

If your local stock broker didn't get you an allocation to your favourite IPO, perhaps not all is lost. A recent Financial Times article highlighted how stocks with similar names or ticker symbols, are seemingly being bought in error by people desperate for a piece of the action. A recent example was Zoom Video Communications, the $20-odd billion company that listed in April (first day pop +74%). At the same time, volume of shares traded in Zoom Technologies, a tiny $5 million market cap company which has been listed since the early '90s, were four times the norm and the share price doubled. It reminds us of a local story from the height of the 2000 bubble, when a frantic private client called his broker saying "Get me shares in Mountain High". His broker replied "Hmm, I've never heard of a company called Mountain High. Do you mean Riverdeep (a hot Irish media IPO)?" Client: "Yeah, whatever. Just buy it".

Private equity groups are aggressively competing with each other to invest the $2.5 trillion of 'dry powder' they have available to make acquisitions, a record amount and double what they had at their disposal in 2007/08, according to data provider Prequin.

Commentary

Not only are valuations paid rising but, according to S&P Global Market Intelligence, more than 50% of private equity buyouts are now financed with recorded Debt-to-EBITDA greater than 6x, eclipsing levels see in 2007. Some industry veterans warn that the above statistic doesn't fully reflect the true leverage ratios due to the current pervasive use of "adjusted EBITDA" numbers, which can account for 30% or more of regular EBITDA (itself a construct of the private equity world).

Comparisons to the late 1990s abound, but there are big differences too. Most obviously the overall headline market valuation in the late 1990s was far higher than today; so too were interest rates, with US 10 year government bond yields in the 5-7% range. In that context, the current mood of stock market positivity could credibly endure or even grow from here.

Perversely, from our perspective we are finding today's market more difficult to manage. Back then there were lots of good quality so-called *old economy* companies trading at very attractive valuations. Of course there were fears that established companies were going to be swept away by new business models, but mostly the share prices of old economy companies languished because low double-digit returns were deemed too low by investors who had grown used to 10s of percent annual returns (the NASDAQ index, a proxy for *new economy* stocks, rose 40% in 1998 and 85% in 1999!). In other words, even in the midst of an overall stock market bubble there were (sizeable) pockets of good value on offer.

Those same quality established companies, which have proved a rich hunting ground for Setanta portfolios in the past, have substantially re-rated since. Reflecting generally high market valuations, we currently own some stocks that are trading at somewhat stretched valuations versus history. We are reluctant to sell them because we are mandated to be fully invested and struggle to find compelling alternatives; comparable business quality elsewhere is as or even more expensive. Today the out of favour pockets of the market are fewer and include UK companies, the auto sector, European banks and the energy sector. Here headline valuations are lower, but very often it's not clear there is good value on offer for the risk involved. Rest assured we are not being complacent and continue to evaluate our options to deliver you the best risk-adjusted returns we can.

Portfolio Activity

During the quarter the fund made four new purchases, sold out of five companies and received spins from existing holdings. At end-June the fund held 87 securities. This was an unusually high level of turnover. Over the last 12-18 months we have considered whether there was a way we could reorient the responsibilities of the eight global sector portfolio managers to achieve a better fund outcome. Traditionally we have tended to split sector responsibility according to the Global Industry Classification System (GICS), with a few tweaks. However it has slowly dawned on us that the choice of quality, differentiated companies available to our Energy and our Telecoms & Utilities managers has been far too limited. The oil price is the primary driver of businesses in the energy sector; utility and telecom companies are often fairly homogeneous. The upshot is there can be limited insights gained from deep-dive company research – the basis for our investment approach. The decision was made to bring together the Energy and Materials sectors. Similarly Real Estate, TV Broadcasters and Cable & Satellite have been brought together with the Telecom & Utilities sectors; we have named this new collection the Infrastructure sector. Along with greater choice and relevance, we believe similarities and linkages will make these new sector combinations easier to analyse. For example, oil is the primarily input for chemical companies in the Materials sector; wireless telecom towers and data centre companies in the Real Estate sector are an integral part of the broadband network, which in turn is increasingly affecting TV networks' business models.

As part of this transition, new Materials stocks were bought (BASF, Viscofan, Air Liquide) and one sold (Resolute Forest Products). In the Infrastructure sector there was one purchase (National Grid) and three sales (NTT DoCoMo, Fortum, United Utilities). We expect there will be further related activity in the coming months.

Outside these sector changes there was one other sale, Swatch, which we've held the Fund for more than 10 years. The current management team have been excellent at developing their flagship brands Omega and Longines, particularly in Asia. However, their move to acquire and develop luxury jeweller, Harry Winston, has yet to bear fruit. Also their low and mid-priced brands are coming under increasing pressure from Wearables. The stock price has fallen a lot from its high and it could be argued that it represents good value here but we felt that Booking Holdings represented better value and we added to our position here with the proceeds from our Swatch sale.

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

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