# Setanta Global Equity Fund (CAD)
Q3 2019

## 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 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 Fund is to outperform the MSCI World index over the long term.

## Fund Commentary

The Fund returned -0.1% in the third quarter, lagging the 1.9% return of the benchmark. Year to date the Fund is ahead by 8.5% relative to the MSCI World Index up 14.0%.

*(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

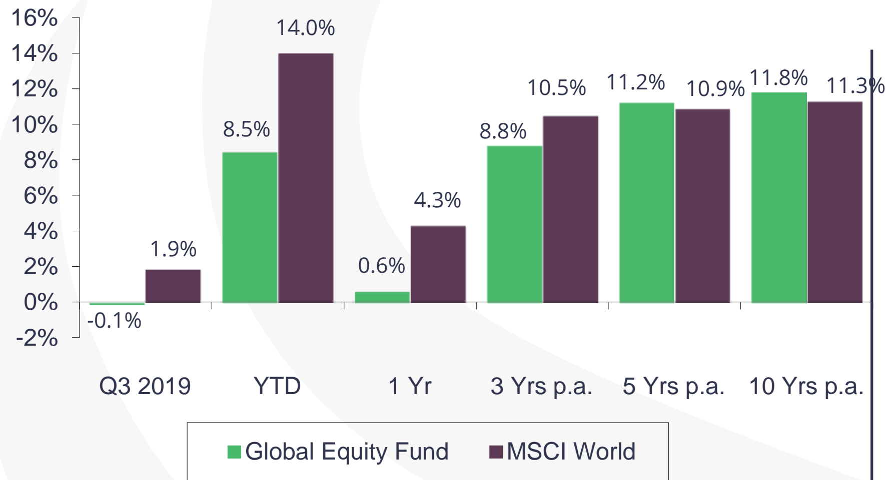
We consider scenarios rather than making forecasts

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

## Fund Performance – 30.09.19




**Performance Source:** Unit prices: GWL. Returns are based on London Life Global Equity Account (S034 4.03), gross of management fees in CAD. Benchmark is MSCI World in CAD. 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

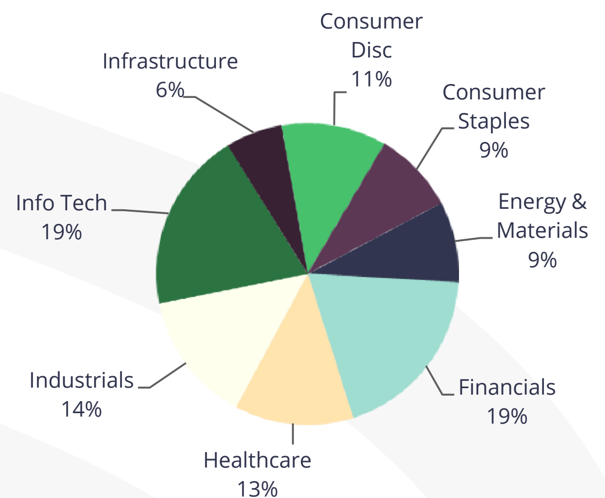
## Top 10 Holdings

| COMPANY | SECTOR | % OF FUND |
|---|---|---|
| MICROSOFT CORP | INFORMATION TECHNOLOGY | 3.3% |
| BERKSHIRE HATHAWAY | FINANCIALS | 3.2% |
| DCC | INDUSTRIALS | 2.9% |
| FEDERATED INVESTORS | FINANCIALS | 2.7% |
| LANCASHIRE HOLDINGS | FINANCIALS | 2.6% |
| MELROSE INDUSTRIES | INDUSTRIALS | 2.5% |
| JOHNSON CONTROLS | INDUSTRIALS | 2.4% |
| KEYSIGHT TECHNOLOGIES | INFORMATION TECHNOLOGY | 2.2% |
| OSHKOSH CORP | INDUSTRIALS | 2.1% |
| ORACLE CORP | INFORMATION TECHNOLOGY | 2.1% |

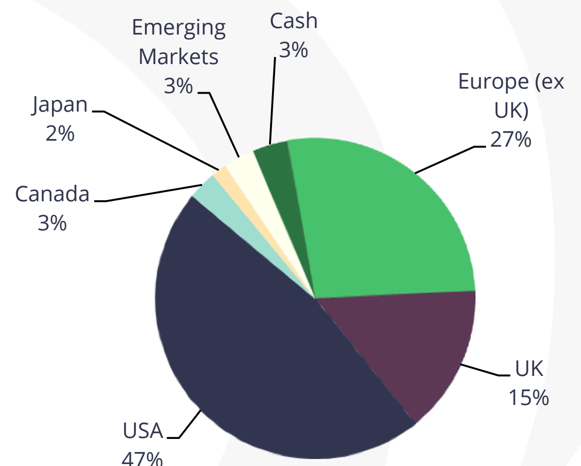
## Fund Statistics

| | |
|---|---|
| PRICE/BOOK | 2.0 |
| PRICE/EARNINGS RATIO (FY 1) | 15.2 |
| DIVIDEND YIELD % | 2.4 |
| AVERAGE MARKET CAP C$BN | 94.2 |
| NO. OF HOLDINGS | 86 |
| ACTIVE SHARE % | 86.3 |
| DEBT/EQUITY % | 60.9 |

## Sector Distribution




## Geographic Distribution




## Yearly Performance

| Year % | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Fund** | -7.4 | -26.8 | 16.1 | 2.4 | 0.1 | 13.4 | 38.5 | 15.3 | 15.8 | 9.7 | 15.8 | -0.7 |
| **Benchmark** | -7.5 | -25.8 | 10.4 | 5.9 | -3.2 | 13.3 | 35.2 | 14.4 | 18.9 | 3.8 | 14.4 | -0.5 |

# Commentary

We have discussed the bifurcation in equity market returns for some time now. Our observation is that since the Global Financial Crisis (GFC), market participants have been chasing asset classes and investment styles that are expected to have lower volatility or lower drawdown risk.

Seeking safety or perceived safety has become paramount in a zero interest rate environment, with political instability manifesting in trade wars and currency wars challenging decades of globalisation; all the while technology disrupts industry after industry, creating new jobs while destroying many old jobs. It's not surprising many investors have crowded towards quality, visible and disruption free-growth –albeit irrespective of price.

What once seemed remarkable in 2012, when the valuation of low-volatility stocks were close to historical highs relative to the highest volatility (value, cyclical) stocks has only become more acute. Indeed, in June 2015 we wrote:

*Those that justify continued ownership of these companies borrow the Warren Buffett maxim of "it's far better to buy a wonderful company at a fair price than a fair company at a wonderful price". In practical terms this means that those companies that can generate returns of capital employed of say 20% will deliver an attractive return on investment over the long term. But the more investors crowd into such "wonderful" companies at the expense of other investments,* [pushing up their valuations] *the more risk is transferred to what was originally perceived as a safe asset.*

At the time, we sold Waste Management on the grounds that investors were willing to pay 50% more for each dollar of operating cash flow than 12 months previously, while company fundamentals were deteriorating. Revenues, profits and cash flows had been fairly flat from 2004-2014 yet the dividend had been growing at 5% per year and all we could see was the rapidly falling spread between the cash generated by the business and the continuing ability of WM to fund increasing distributions to shareholders. Further discussion of the sale rationale is discussed in our Q2 2015 report.

Fast forward four years later, in August 2019, the valuation spread between "value stocks" and "low volatility" stocks blew out to the highest in recorded market history, including the dot-com bubble. Investors in Waste Management are now prepared to pay 40% more again per dollar of operating cash flow for a business whose growth prospects have not fundamentally changed (10 yr. sales growth 1.1% pa), albeit they have improved operational performance.

This picture is mirrored in many other sectors but a couple of examples in the Consumer Staples sector are instructive. Nestle and Procter & Gamble are both priced at 25x forward price-to-earnings i.e. an earnings-to-price yield of 4%.  On these measures of value they are trading some 50% above valuation levels of 10 years ago. There is nothing inherently wrong with a 25x earnings multiple if a company has the growth profile and the ability to generate superior returns on investment over time. Indeed, we own some companies like this (examples are DCC, Nike, Steris and Microsoft). However, at these valuations investors may not do much better than a 4% return because these companies have not been growing at a pace to justify their trading multiple. Rather, investors are willing to capitalise the perceived safety and low volatility of these earnings streams at ever lower discount rates, clambering to pay more and more for visible, steady growth. Moreover, with online retailing eroding the advantages these businesses had over many years, with scale advantages and preferential access shelf space and strong pricing power, the considerable challenge for these companies will be to grow organically at a pace that can, at the very least, justify the current premium valuation rating.

**Portfolio Activity**

| Top 3 Contributing Stocks | Contribution to Performance |
| --- | --- |
| NIKE INC | 0.25% |
| MELROSE INDUSTRIES PLC | 0.24% |
| KEYSIGHT TECHNOLOGIES | 0.22% |

| Bottom 3 Contributing Stocks | Contribution to Performance |
| --- | --- |
| OWENS-ILLINOIS INC | -0.82% |
| DXC TECHNOLOGY CO | -0.42% |
| ERICSSON | -0.27% |

Source: Bloomberg (Absolute Contribution) Jun19 – Sep19 based on a representative Setanta Global Equity account in CAD

On the flip side of the current investment environment is an abhorrence of cyclical, lower multiple, smaller capitalisation companies with some elevated level of uncertainty surrounding the industry. Any disappointment relative to expectations in this environment, seemingly irrespective of valuation, is met with a swift and sometimes brutal selloff. We had two such examples this quarter with glass packager Owens-Illinois (O-I) and IT Services company DXC.

O-I missed earnings expectations in Q2, citing one-off factors, negative exchange rate impacts as well as cost overruns resulting from bringing on new capacity to meet new demand. Some context here is useful.

O-I operates in a global oligopoly. It has a 25% market share in a market with only 3 global players and large barriers to entry; competition comes in the form of other substrates, notably plastic and aluminium cans. The demand picture has been relatively stable with weakness in beer (switching from glass to cans) offset by increased demand from premium food and drink products. Overall the glass category was coming back to a good demand environment after a tough 5 years.

New management under O-I veteran Andres Lopez was just what the company needed in 2016. He emphasised investment in the asset base to drive the operational flexibility to cater for different demand patters. Simply put, the ability to produce different shapes of bottles in different colours to meet varying customer demands in the most efficient manner possible. The first phase of the Andres Lopez plan in the 2016-18 period was a success, with objectives for volume growth, margin expansion and operational flexibility all met.

After declaring victory on stage one of their plan, Lopez set out a growth based plan in November 2018. He claimed that that 80% of the volume growth they needed in 2019-21 was secured and initiated a dividend as evidence of a business on a more stable footing. The really interesting development was the unveiling of manufacturing technology that would be incrementally rolled out across the group addressing key constraints of the glass manufacturing process, allowing the business to flex with customer demand, requiring less capital intensity per tonne of production and a substantially lower manufacturing cost base. This will take time to roll out across the manufacturing base.

# Commentary

Sentiment was positive heading into 2019 and so the Q2 earnings disappointment sent the shares down 37.6% in the quarter. Our job amid the disappointing results is to separate the transitory effects (volume weakness) from the embedded effects (increasing complexity costs) and their attendant effects on medium-term cash flows / profits, and make a judgement relative to current valuation and the condition of the balance sheet. We had a detailed call with management post results and a number of consultations with former executives at the company and competitors. The stock is under review and we are actively discussing options with the company. Our current assessment is the share price reaction is overdone; more from a loss of management credibility, rather than permanently impaired company fundamentals.

DXC was formed with the merger of HP Enterprises Services division and Computer Sciences in 2017. It was run by a management team that had a cost-focused private equity background. In short, their plan placed a heavy emphasis on operational margin improvement, supporting a ~$10, 2020 earnings per share target which, off a $70 2017 stock price, looked attractive to us.

Management was confident it could offset an expected decline in its traditional IT outsourcing business by growing its cloud-based business over time. With a no. 3 positon behind IBM and Accenture, success along their planned development was impressive until Q3 2018.

The problem was a lack of growth in the traditional services business at DXC far below an industry growing at 6%. Management over-emphasised financial targets, encapsulated by a refusal to sacrifice 16% operating margins to invest in a growing cloud market and this became the seeds of a very rapid demise. IT services is a relationship business and so firing specialist sales people in the cost cutting program and replacing them with generalists did not turn out to be a winning strategy. DXC board have opted to relinquish CEO Mike Lawrie of his role and this admission of defeat, in addition to weak results, drove down the share price by 44%, or (40bps) in fund performance.

Both O-I and DXC's problems stem partly from a judgement on assumed stability of cash flows, supporting a higher level of financial leverage than we typically hold in the portfolio. Leverage is common in the packaging industry and in private equity as a means of driving equity value. In both cases low valuations versus said cash flows did not shield from disappointment relative to market expectation.

After six quarters of showing improving revenue and earnings, Ericsson had a slight stumble in Q2 2019 as higher costs associated with 5G field trials with customers held back profitability. These field trials are part and parcel of investing for growth so while they are a short term pain we think they help position the company very well for the pending arrival of 5G. Investors also were spooked to read the potentially material impact from an SEC investigation into foreign corrupt practices in six countries stretching as far back as 2011.

On the flip side, our other investment in 5G, Keysight, had strong quarterly results which more than helped offset concerns over tariff wars between the US and China, exposure to Huawei and fears that Huawei products would be banned in many countries globally. 5G continues to be a significant tailwind and the long tail in 4G continues to surprise on the upside.

*Sean Kenzie – Portfolio Manager*

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