Setanta Global Equity Strategy (USD)

Q4 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 year 2019 was a dramatically positive year for almost all investing asset classes. Equities turned in a particularly stellar performance, with the widely-followed MSCI World benchmark up 28% (total return, USD) – the biggest calendar year increase in the index since 1999. Whether this gain was justified is another story altogether. In general we think real value is thin on the ground, while investor underwriting standards are often low and risk appetites high.

(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

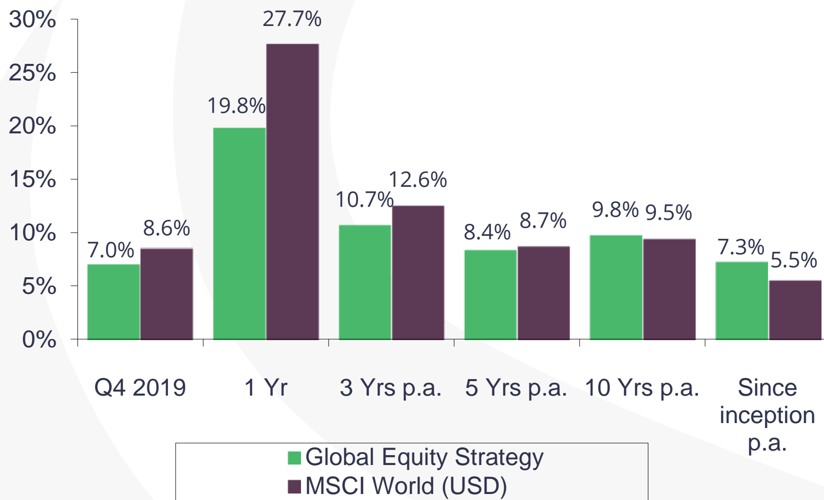
We consider scenarios rather than making forecasts

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 31.12.19 (USD)



Performance Source: Setanta Asset Management Limited. The Fund returns stated are based on the movements in the unit prices of the ILA/CLI Setanta Global Equity Fund [P-GLB1], which have been converted to USD at FX rate 1.1225 and are gross of management fees. The performance will be reduced by the impact of management fees paid, the amount of which varies. **Benchmark:** MSCI World (USD). **Holdings Source:** Setanta. Sector allocations based on invested portfolio only (excludes cash). **Fund Statistics Source:** Bloomberg

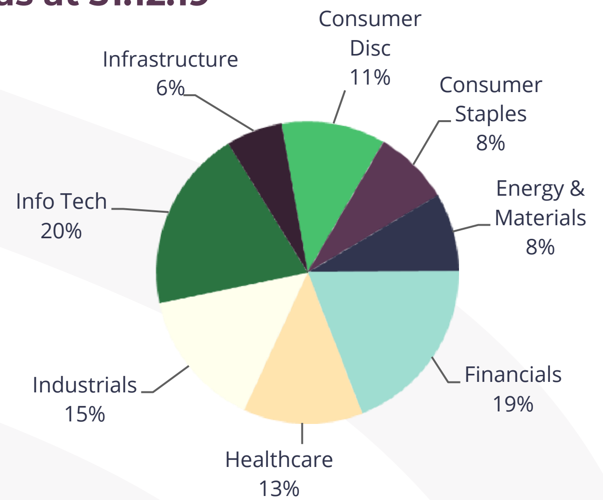
Top 10 Holdings as at 31.12.19

COMPANY	SECTOR	% OF FUND
MICROSOFT CORP	INFORMATION TECHNOLOGY	3.5%
BERKSHIRE HATHAWAY	FINANCIALS	3.3%
MELROSE INDUSTRIES	INDUSTRIALS	2.9%
DCC	INDUSTRIALS	2.7%
LANCASHIRE HOLDINGS	FINANCIALS	2.7%
FEDERATED INVESTORS	FINANCIALS	2.5%
OSHKOSH CORP	INDUSTRIALS	2.4%
KEYSIGHT TECHNOLOGIES	INFORMATION TECHNOLOGY	2.2%
JOHNSON CONTROLS	INDUSTRIALS	2.1%
NIKE INC	CONSUMER DISCRETIONARY	2.1%

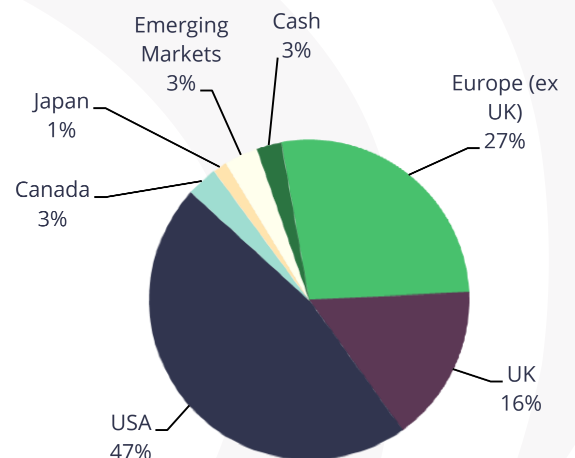
Fund Statistics as at 31.12.19

PRICE/BOOK	2.0
PRICE/EARNINGS RATIO (FY 1)	16.1
DIVIDEND YIELD %	2.2
AVERAGE MARKET CAP $BN	86.7
NO. OF HOLDINGS	87
ACTIVE SHARE %	86.3
DEBT/EQUITY %	58.8

Sector Distribution as at 31.12.19



Geographic Distribution as at 31.12.19



Yearly Performance

Year %	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Fund	-39.7	36.4	8.7	-2.4	15.9	30.2	5.9	-2.2	12.8	23.8	-8.5	19.8
Benchmark	-40.7	30.0	11.8	-5.5	15.8	26.7	4.9	-0.9	7.5	22.4	-8.7	27.7

The Fund underperformed the benchmark in 2019, for only the third time in its 19 year history. A couple of things should be pointed out. Setanta funds tend not to do as well in strong "risk on" markets. Also 'growth' stocks outperformed their 'value' counterparts to an extreme degree versus history in 2019 – more on this anon. For all the excuses however, the scale of the 2019 deficit versus the benchmark undid more than five years of cumulative Fund outperformance. This is very disappointing, but we are sticking to our tried and tested investment process which balances risk as well as return.

Value versus Growth

We tend to largely ignore investment style conversations, but it was hard to ignore the debate in 2019. According to MSCI, growth stocks have outperformed value stocks in 11 out of the last 13 years since 2007, cumulatively by more than 50% over this period and by a record 11.6% in 2019. Such a trend flies in the face of decades of previous academic research, which showed a clear preference for value. We have often referred to ourselves as value investors, so clients may have genuine questions over whether our approach is still fit for purpose.

Value and growth means different things to different people. For example, MSCI and other index providers define value as stocks that are cheap on various statistical measures, such as a low price-to-earnings ratio, while growth stocks are companies that have higher historical and projected future sales and profit growth rates. Under their approach, value stocks are for the most part distinct from growth ones. This is at odds with Warren Buffett, who famously said that value and growth are joined at the hip. We side with Buffett. We think of value investment as a qualitative endeavour that conflates the value of an asset with its price. Quite clearly, growing profitable companies are worth more than shrinking unprofitable ones and we'll look to own them where we think they are cheap based on a conservative estimate of their future cash flows.

But no matter the definition, the general feeling is that growth stocks have been the place to be, irrespective of price. Why might this be? One major reason is the current low level of interest rates. The German 30-year bond yield was 0.3% at year-end against 4% a decade ago. Over the same period, the 30-year US Government bond yield halved to 2.3%. Not only is it likely that low interest rates have stimulated global economic activity, but they have reduced the discount rate investors apply to future company profits. A lower discount rate increases the theoretical value of all companies but disproportionately so the value of long-term profitable growers, which are longer duration assets. The sanguine demand backdrop and relaxed investor mood was certainly beneficial for the share prices of *perceived* growth companies in 2019. We caution that should high expectations for future profits fail to be met, or should the low discount rate reverse, then some of these 'growth' stocks could be hit very hard at some point.

Meanwhile, the underperformance of quantitative 'value' stocks over the last decade should theoretically give us plenty of investment opportunities. Here we are careful not to rush headlong in because rather than just looking at a low price relative to current or next year's profits, we need to consider the ability to reinvest those profits at good rates of return, balance sheet strength, management quality and potentially disruptive technologies facing the business down the road. Quite often those 'value' stocks are not as cheap as they appear, all things considered. As our tagline says, v*alue is more than a number*.

We don't wade into the value-growth debate very often. Our portfolios tend not to be populated by bargain stocks as MSCI would define it, so you should not assume we will keep apace if the MSCI Value index outperforms significantly. We too have less exposure to high growth companies, so if that type of stock continues to perform well we may lag again. Our North Star has always been to judge investments individually and on merit, balancing risk and reward – not based on labels of growth or value.

In this regard we believe our approach is as relevant as ever. We are relatively happy with the current portfolio in the context of generally high equity valuations, anchored off a low equity discount rate. We are confident that should investors become less sanguine the Fund will do relatively well as it has done in such periods in the past.

Performance review

As mentioned already, the Fund lagged the benchmark during the year, 20% versus 28% (USD terms). As always there were a number of big winners (11 stocks were up over 50%), as well as some notable fallers, but the real story was that the median and average stock in the fund rose 18% and 20% respectively. In other words, our stocks were 'typically' less in favour, which we think reflects the value-growth commentary above. There were also big gains in stocks we don't own, especially **Apple** which was up a whopping 90% in 2019, accounting for 1.2% of the fund's 8% performance deficit in the year.

2019 Top 5 Contributors To Performance	Sector	Contribution (USD)	Performance (USD)
Microsoft	Technology	+1.6%	+58%
Melrose Industries	Industrials	+1.2%	+56%
Oshkosh	Industrials	+1.2%	+57%
Keysight Technologies	Technology	+1.2%	+65%
Steris Plc	Healthcare	+0.8%	+44%

2019 Bottom 5 Contributors To Performance	Sector	Contribution (USD)	Performance (USD)
Saga Plc	Financials	-0.7%	-44%
O-I Glass	Industrials	-0.5%	-22%
Origin Enterprises	Consumer Staples	-0.4%	-33%
Occidental Petroleum	Energy / Materials	-0.3%	-28%
DXC Technologies	Technology	-0.3%	-28%

Source: Bloomberg, Dec 18 – Dec 19 (in USD) based on the ILA/CLI Setanta Global Equity Fund [P-GLB1]

In terms of losers over the year, we already discussed the issues facing **Saga** and **Owens-Illinois** in the Q2:19 and Q3:19 reports; there have been no new developments on either. Also disappointing was **Origin Enterprises**, which fell by 33% (USD terms). We acquired a stake in Origin Enterprises in late 2015. Origin is an agri-services business that provides products (primarily seeds, crop protection chemicals and fertilizer) and agronomy services to farming customers, primarily in Europe. It has a historically strong position in the UK and Ireland and had used that as a platform to expand its operations into Eastern Europe (primarily Poland, Ukraine and Romania) and more recently Brazil, via acquisition. The problems the business has encountered have been numerous.

Agricultural commodity prices have been generally low over the period of ownership which has pressured farmer incomes. The acquisitions strategy has produced poor results so far with Origin facing integration challenges in Poland and a breakdown of the competitive market structure in Ukraine. As a result of these challenges in Eastern Europe Origin has had to invest significant additional working capital and has yet to see a return on this investment. We have been terribly disappointed by the performance of the business and believe poor execution by management has been an underlying problem that must be addressed. We have made this view clear to the executive team and the Board and are optimistic that there are self-help opportunities that can be implemented to improve Origin's results, namely a greater emphasis on cost reduction and a pause/cessation of acquisitions. Despite the clear degradation in our original investment thesis, we believe the stock is cheaply valued and if self-help measures are successfully implemented there is significant upside potential from current levels. Hence we are retaining the position.

Microsoft was up 58% (USD terms) in 2019 and was the biggest contributor to fund performance. It is now the largest fund weight (3.5% at year-end) and our history with it is worth a recap as it demonstrates the capriciousness of investors and the rewards of a long-term investment approach. We have owned the stock since the fund's inception in mid-2000 but between 2009 and 2013 Microsoft's valuation de-rated from 20-25x earnings to just 10x, on fears that new cloud based competitors, primarily Google and Apple with their strong consumer franchises, would entrench in Microsoft's stronghold, the Enterprise. We thought this was highly unlikely, as Microsoft software is so deeply embedded in the corporate world and replacing it would be a major upheaval for businesses. We materially increased our Microsoft weight in the Fund in the years after the financial crisis.

In the last 10 years to end-2019 Microsoft has doubled operating profits and bought back 15% of shares outstanding, which along with a drop in the tax rate in the US has led to a tripling of per share profits. Extra juice came from a re-rating of the shares, now trading on c.30x earnings. Over this period investors have earned nearly 24% per annum (total return, Euro), nearly double the return of the market (13% p.a.).

So what happened? Our original 'stickiness' thesis proved correct, but on its own doesn't account for the share price performance. What we didn't anticipate was the subtle changes in the business model introduced since 2014 by new CEO Satya Nadella, like making Microsoft products available on competitors' hardware devices, as well as Microsoft's enormous success with Azure which, along with Amazon Web Services, dominates the increasingly important outsourced cloud services industry. You might fairly argue that we got lucky with these unforeseen positives, but you should also see that our willingness to be contrarian when others were down on the stock, flexibility in incorporating Microsoft's new opportunities into our thinking and our long investment horizon all helped to facilitate this good investment outcome. Of course Microsoft has benefitted from the lower discount rate phenomenon described above, but over time we think investors should do fine in Microsoft relative to alternatives, despite the high current headline valuation.

Portfolio Activity

Portfolio buys and sells for the year are listed below. It's a longer than normal list, largely due to some rearrangement of sector responsibilities among the team. This was discussed in the Q2 report, but briefly coverage of the Materials sector was combined with Energy under Richard Doyle, while David Pastor's expanded remit now includes Real Estate and the Cable industry under the Infrastructure banner. We do not consider the change in sector responsibilities to be a major development and have made similar modifications on a handful of occasions in the past.

In addition, the Fund received two spin offs from stocks already held in the healthcare sector.

Commentary

	Sells			Buys		
	Stock	Sector	Start of year weight	Stock	Sector	End of year weight
Quarter 1	Diamond Offshore Parmalat	Energy / Materials Consumer Staples	0.3% 0.6%	Covetrus ^	Healthcare	0.1%
Quarter 2	Fortum NTT DoCoMo Resolute Forest Swatch Group United Utilities	Infrastructure Infrastructure Industrials Consumer Discretionary Infrastructure	0.1% 0.4% 0.6% 0.4% 0.3%	Air Liquide Alcon ^ BASF National Grid Viscofan	Energy / Materials Healthcare Energy / Materials Energy / Materials Energy / Materials	0.6% 0.2% 1.6% 0.8% 1.2%
Quarter 3	Imperial Oil Tullow Oil	Energy / Materials Energy / Materials	0.2% 0.4%			
Quarter 4	Cheesecake Factory	Consumer Discretionary	0.6%	Alphabet Close Brothers Heineken	Consumer Discretionary Financials Consumer Staples	0.5% 0.2% 0.5%

Based on the ILA/CLI Setanta Global Equity Fund [P-GLB1]
^Spin offs from existing holdings

Activity in quarters 1 to 3 was discussed already in previous reports.

Within our Consumer Discretionary sector, we sold out of US restaurant chain **The Cheesecake Factory** and purchased Alphabet in the fourth quarter. We first purchased Cheesecake in Q3:2017, believing this best-of-breed operator could maintain margins and grow into new locations, but we have since realised our thesis was incorrect. Margins have been pressured due to increasing supply, falling demand and rising labour costs. We had thought that the industry supply growth might subside but in fact malls, where Cheesecake restaurants are primarily located, are repurposing space from mainly selling clothes to having a greater food offering. Also, sales of goods online are still growing, which is reducing trips to the mall and as a result Cheesecake footfall. While the stock does not appear expensive trading on 15x current profits, we are not confident that cash earnings in the business can be maintained given the supply-demand conditions. Fortunately the cost of this mistake was low as we sold out at around the same price we bought (although there was an opportunity cost as stock markets have risen since).

Alphabet is a conglomerate with several different businesses housed under the parent structure (including Google Search, YouTube, Waymo, Google Cloud Partners and Android). We believe c.80% of the group's value lies in the search business. The general search business is used by people the world over to answer almost any question imaginable. It is particularly useful for providing users answers to commercial questions in the travel, financial, legal and healthcare verticals. We increasingly learned of the power of Google search through our investment in Booking Holdings. At this stage it's likely that desktop search is reaching maturity but mobile search should still grow for some time as consumers spend more time on their mobile devices. Mobile devices should continue to expand in emerging markets, offering another avenue of growth. Although we think we bought Alphabet at about a 4% free cash flow to enterprise value, we think the search business alone is capable of earning well over $25bn in free cash a year for the next few years. This should give us a respectable return and is a worthy replacement for the proceeds of the Cheesecake sale.

In the consumer staples sector we bought **Heineken**, the owner of the eponymous beverage as well as a host of other local beer brands around the world. Heineken is a beneficiary of strongly growing demand for beer in emerging markets, which account for 60% of group sales (in contrast to Western markets, where beer volumes are declining by c.1% a year). Also driving growth in sales and profits is the global 'premiumisation' effect – people drinking less but better quality. This plays into the hands of the Heineken brand (c.25% of group sales but c.40% of profits) and recently volume growth has accelerated to more than 7% from c.5% p.a. in the last 5 years. The Heineken family still controls the group, but has outsourced management to outside professionals. The result of this combination is a group that invests for the long-term and has a very good track record of returns and capital allocation. The group spends considerable sums of money developing new products (e.g. Heineken 0.0) and maintaining / enhancing their brands, so it's likely its margins are understated versus peers (for example, Anheuser-Busch InBev margins are double Heinekens). At a time when many consumer staples companies have had to take a margin reset to grow their top line, Heineken has not. This gave us confidence to buy the shares following a 10% fall in the stock in October / November on an unlevered 4% cash earnings yield (with earnings likely to grow over time) – a valuation discount to consumer staples peers.

Finally we purchased a starter position in **Close Brothers**, the UK financial services company that, among other things, lends into a host of niches in the UK – from loans and invoice financing to small and mid-sized companies, to insurance and motor financing in the consumer space. The lending business is based around strong relationships and high levels of service, consistent underwriting standards through the cycle and conservative funding, capital and liquidity. We believe there is an entrepreneurial spirit at the company (in contrast to the large banks) that continually seeks out under-served areas of the market in which to grow, so long as minimum return hurdles are met.

Close Brothers has an excellent, long track record of growing profitably and doing so in a conservative manner. It aims to lend counter-cyclically and so while its competitors retrenched and repaired balance sheets following the financial crisis, Close Brothers remained profitable throughout and has organically tripled the size of its loan book since. We believe its robust business model can continue to thrive in the future, even in the face of Brexit and a general lending environment where competitors have relaxed their underwriting standards in recent years.

David Coyne MSc, B.A – co-lead Fund Manager

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IMPORTANT INFORMATION

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