Setanta Global Equity Strategy (USD)

Q1 2020

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

Firstly to all our clients and readers, we hope all of you and your families are staying safe during this difficult time.

The Global Equity Fund returned -26.1% in the quarter to 31st March 2020, some 5.0% behind the MSCI World Index -21.1%.

(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

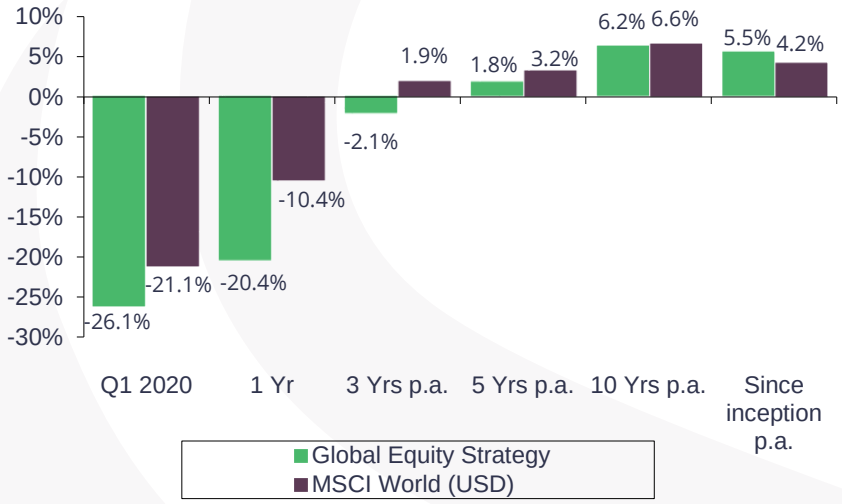
We consider scenarios rather than making forecasts

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 (USD) to 31.03.2020



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 1.0973 and are gross of management fees. The performance will be reduced by the impact of management fees paid, the amount of which varies. Inception date: December 2000. **Benchmark:** MSCI World (USD). **Holdings Source:** Setanta. Sector allocations based on invested portfolio only (excludes cash). **Fund Statistics Source:** Bloomberg.

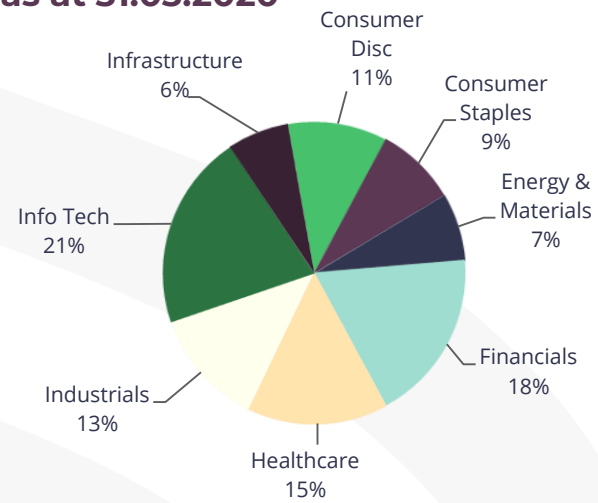
Top 10 Holdings as at 31.03.2020

COMPANY	SECTOR	% OF FUND
MICROSOFT CORP	INFORMATION TECHNOLOGY	4.5%
BERKSHIRE HATHAWAY	FINANCIALS	3.6%
LANCASHIRE HOLDINGS	FINANCIALS	2.8%
DCC	INDUSTRIALS	2.7%
JOHNSON & JOHNSON	HEALTHCARE	2.5%
KEYSIGHT TECHNOLOGIES	INFORMATION TECHNOLOGY	2.5%
ORACLE CORP	INFORMATION TECHNOLOGY	2.4%
NIKE INC	CONSUMER DISCRETIONARY	2.3%
OSHKOSH CORP	INDUSTRIALS	2.2%
GPE BRUXELLES LAMBERT	FINANCIALS	2.2%

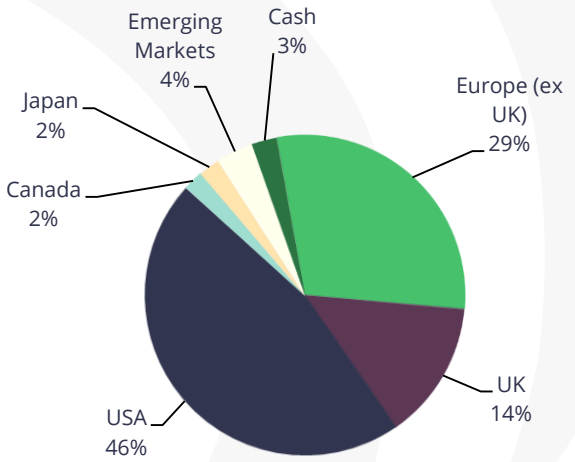
Fund Statistics as at 31.03.2020

PRICE/BOOK	1.5
PRICE/EARNINGS RATIO (FY 1)	13.3
DIVIDEND YIELD %	2.9
AVERAGE MARKET CAP $BN	73.3
NO. OF HOLDINGS	87
ACTIVE SHARE %	85.5
DEBT/EQUITY %	57.0

Sector Distribution as at 31.03.2020



Geographic Distribution as at 31.03.2020



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

SETANTA Asset Management

Commentary

We are living through a historic pandemic whose impact could be felt for some time. Although we expect to return to some sort of "normal" later this year, the world is heading for the sharpest and deepest economic contraction since WW2. No one can say with precision the ultimate depth or duration of the recession or the lasting and second order impacts.

At the same time, in boardrooms across the world, companies are grappling with how much liquidity and balance sheet resources they have to survive our self-imposed lockdown on large parts of the economy. The longer the world takes to bring the virus under control, the deeper the economic contraction and greater the time frame to recovery in demand. *How* and *when* restrictions are eased are unknown at this point – neither the potential for a second wave of the virus, whether austerity measures will be required to repay the rise in public debt or the level of consumer demand as economies open back up.

Encouragingly, policy response has been both rapid and extreme, with most world governments running aggressive fiscal deficits in addition to monetary stimulus – again akin to WW2 levels. Equity market reaction has been one of extreme volatility with the market both down and up 20% in the last month alone as investors struggled to price in the depth and duration of the current recession. Initially the reaction was one of broad based selling, then aggressive and indiscriminate de-risking where volatility was extreme and liquidity very poor. As investors assessed their portfolios for liquidity and solvency risk and identifiable earnings sensitivity from the COVID-19 pandemic, pricing became somewhat more sensible – but within an overall context of high volatility and extreme dispersion in earnings expectations.

Coincidentally, rapidly rising unemployment and cratering consumer demand were further exacerbated by collapse in an agreement between OPEC & Russia to support the price of oil with production. The fallout resulted in a simultaneous demand and supply shock driving a 45% fall in the price of all into the end of the quarter, with associated stresses to energy companies in the portfolio – dividend cuts, capital spending cuts and balance sheet stresses.

Following the market reaction pattern discussed above, DCC (75% earnings related to energy) fell 41% into St. Patrick's Day, similar order of magnitude to pure play energy companies in the portfolio, Exxon & ENI. The nuance is DCC has *no exposure* to the price of energy, rather takes a fixed distribution margin on volumes sold. Coupled with minimal net debt, ample liquidity and the aforementioned insensitivity to energy prices, the market woke up to DCC's merits into the end of the month as the stock rallied 32% (but still down 22% overall in Q1).

Commentary

In the past number of weeks, the main questions being asked of us are as follows:

1) Why is the Fund not exhibiting lower downside capture?
2) What decisions have we made during the quarter amid all the volatility?

We are disappointed with how the portfolio performed in the quarter. Anyone that has studied our performance over time has noted how in past negative and bear markets we almost always outperform.

In recent years we have been very mindful that following a prolonged period of exceptionally low interest rates, low volatility in asset markets and a general absence of 'fear', there was possibly a lot of risk-taking in the financial system and we tried to incorporate this into our thinking and our stock selections. At the same time, we felt that the overall valuation of the stock market was very high (due to the aforementioned benign backdrop), with a certain cohort of the market – namely stable, growing companies –even more expensive again. In many cases these were companies we would love to have owned, but high valuations discouraged us from doing so. In some instances we consciously bought or held on to more cyclical or mediocre or in some cases subpar companies because, while there was risk, we felt we were *being more than compensated by valuation from a risk / reward perspective.*

It is important to keep things in perspective. This sell off is only a few weeks old and there is little doubt in our mind that in many cases investors are not fully discerning between good and bad, cheap and expensive. Nevertheless, that cohort of quality / growth company has once again outperformed into the downturn, outperforming the overall index by 5.6% and value by 11.5% in Q1[1]. While we do wonder how much recession risk Large-Cap Technology and Growth stocks have priced in, many of these stable quality companies have very strong balance sheets and will survive come what may.

Another headwind for the Fund was the disproportionate impacts of indiscriminate sell-offs on our smaller and mid-cap stocks from where we have historically done well. A quarter of the Fund is invested in stocks with market capitalisations under $5bn compared to the index with 3.6%. Our allocation to sub-$5bn stocks contributed 80% of our underperformance in the quarter. As we have experienced in the past, this can turn around very quickly.

Emphasising value over quality has in some cases proved costly but, in the round, makes sense from a long term perspective. Indeed, history provides a useful guide – observing bear markets across the technology bubble, Japanese bubble, 1973 bear market; low valuation assets typically outperform as drawdowns deepen and particularly as they end[2].

[1] As measured by MSCI World Quality, the MSCI World Value and the MSCI World Indices. [2] GMO research

Commentary

The coming weeks will tell much as companies begin reporting and expectations are calibrated then discounted.

The bottom performing stocks in the Fund includes one of last year's top performing stocks, Melrose, and two of last year's bottom performing stocks (Playtech, DXC), as well as Federated Hermes and UK pub operator Wetherspoon. Our top 5 performing stocks added 1.4% to performance, while our bottom 5 detracted -3.3%. In addition, not owning Apple and Amazon (material weights in index) cost the fund 0.8%. Below is a discussion of some of the main detractors to performance year-to-date.

Melrose

One of largest stocks in the Fund at the beginning of the year, Melrose was originally purchased in August 2014. Melrose is currently executing its buy, improve, sell model on UK conglomerate GKN Plc which it bought by way of hostile takeover in Q2 2018. Until end-March, Melrose had delivered margin improvements far ahead of expectations from a range of internal actions. Melrose is an example of a business operating with the sole objective of maximising business value for ultimate sale, to the exclusion of all other agendas – a model that has delivered 23% IRR for shareholders since 2005.

We were patient through Brexit related supply chain concerns, looking through the market marking down the shares some 35% in 2018 only to be rewarded by 63% subsequent return as the business fundamentals regained prominence in investors' collective attention.

Today the business has some leverage at 2.25x Net Debt/ EBITDA which was appropriate for the business model under historically observed stressed scenarios and entirely manageable from a liquidity point of view with their flexibility on capex and restructuring cash spending. Moreover, Melrose was in the midst of selling HVAC assets worth approximately £2.4bn, which will allow the business to further de-lever and return capital to shareholders.

COVID-19 has had a devastating short term affect across their Automotive and Powder Metallurgy business segments with wide scale shuttering of production across Western Europe and North America as well as significant downtime across their Aerospace footprint.

We have re-examined the operating and liquidity position of the business in conjunction with the CFO and, although the current situation is both unprecedented and acute, Melrose has adequate liquidity on hand, has taken proactive steps with their bankers to ease covenant restrictions and has reoriented internal priorities solely around cash generation, including sensibly cancelling their dividend.

We have been well rewarded over time in backing this management team and see significant longer term upside in the value of the group as operating restrictions ease, absent further significant deterioration in trading conditions. We have added to our position during the downturn.

Playtech

Playtech has faced a perfect storm of factors in its three largest markets, China, Italy and the UK. China and Italy are COVID-19 related. Despite China being online, the authorities have taken down the internet at various points over the past 2 months and as gambling is a discretionary spend many Chinese gamblers have been more concerned about preserving their health and wealth rather than partaking in leisure activities.

The Italian business, Snaitech, has a mix of retail, gaming machines and online. Retail and physical machines in cafés, pubs etc. make up over 80% of revenues. These are all closed as the country is in lockdown.

In the UK there is regulatory risk as the gambling commission is looking at online gambling, with a view to imposing stake limits similar to what they have done with FOBTs.

We are deeply engaged with management and the board in trying to separate transitory from structural risks as well as encouraging sales of non-core assets to address a leveraged position.

DXC

With DXC, we endorse management's plans to dispose of three non-core businesses with $5bn in revenues (25% of total) and to pay down the outstanding $8bn net debt with the proceeds. During March they announced the sale of one of these to Veritas for $3.8bn (after tax), a healthy 3.5x multiple of sales. This leaves them with two businesses with $3.6bn in sales to sell. Based on 2020 forecast EBITDA of $3.3bn it leaves ND/EBITDA at 1.3x.
We added to the position during the quarter, at 9x our estimate of sustainably earnings and under new management who we have confidence will achieve the right balance between a healthy margin and reinvesting in the business' core capabilities to drive growth.

Federated Hermes Investors

FHI is a US-based asset management company. We like that it is diversified by asset class (primarily equities, bonds and money market funds), conservatively financed (c.$200m net cash on the balance sheet) and is run by a competent management team that invests in the business for the long term. We first purchased FHI in May 2013 and up to year-end 2019 the total return to shareholders has been solid, if sometimes volatile.

Commentary

During the quarter the Fed cut interest rates to near zero and this will likely challenge the ability of all managers of money funds to charge a full or perhaps any asset management fee. Depending on the duration and economic impact of COVID-19, it is possible this situation could last years,although we cannot envisage the money fund industry being unable to charge for its services indefinitely. On top of this, the fall in equity markets (and likely client withdrawals) will have reduced FHI's equity fund assets under management and so also the fees that the company will earn.

We have run fairly drastic scenario analyses to quantify these largely temporary (albeit potentially prolonged) headwinds and we estimate that the company can remain healthily profitable. We think we will be well-rewarded in the long term by continuing to hold.

JD Wetherspoon

JD Wetherspoon (JDW) owns and operates just under 900 pubs throughout the UK and Ireland. They own the freehold to 63% of these and lease the remainder. The company aims to provide good quality food and drink at reasonable prices. They are typically significantly cheaper than their rivals. We think in a "normal" year, JDW is capable of generating sales of £2.1m a pub. We would also expect them to earn £150k in cash profit per pub. That would equate to around £130m of cash profit across the estate. At their most recent results JDW reported Net Debt of £804m with an unutilised debt facility of £192m. While this level of debt is higher than we would like, however there is substantial property asset-backing on the balance sheet.

As a result of COVID-19 related social distancing measures put in place in the United Kingdom and Ireland, all pubs and restaurants remain currently shut. As the pub/restaurant sector is a high fixed cost business (labour is a large percentage of sales) the whole sector requires support. JDW has taken mitigating actions, cancelling the dividend and reducing capex as well as engaging with employees, governments, suppliers, landlords and their banks. JDW are in a relatively strong position compared with most competitors and we would hope that they can emerge from this crisis in good shape.

Portfolio activity

We sold Nortonlifelock in mid-February 2020 after a period of strong performance post the completion of the disposal of their Enterprise Security business and the subsequent return of capital to shareholders. Proceeds were partly invested in DXC Technologies and partly left in cash.

We sold Harley Davidson in the quarter as we assessed its prospects in the current environment as incrementally negative. Unit sales in the US, their largest market by a distance, have been declining for four years, which we expected them to make up for in price and international sales.

Harley has a very strong position in large, high margin bikes and we foresaw an end to the supply bubble in used bikes. Demand, however has deteriorated further and bikes are lasting longer than we previously estimated, exacerbating the problem from a supply and demand perspective, in turn pressuring Harley's margins. We no longer have confidence in the company's ability to navigate through this environment.

UK conglomerate Smiths Group Plc was added to the Fund during the quarter. The stock has been held in other Setanta portfolios for over a decade, so it is a business that we know well. The share price fell substantially in Q1 due to concerns about demand for their products, especially in their Detection/scanner business (used in airports) as well as in John Crane, a seals business that serves mainly downstream oil and gas markets. We like the strong levels of returns exhibited by the group over time as well as its low-to-average net debt, but we particularly like the material discount to a sum-of-the-parts valuation on a normalised earnings basis.

Summary

We are acutely aware of the confidence placed in us as managers of investors' capital. We have employed an investment framework since the inception of the firm that has delivered substantial outperformance based on, in summary, investing in higher than average quality businesses at better than average prices.

Our recent unwillingness to pay high prices (30-40x earnings) for high quality businesses has hurt our relative performance. In lieu of buying these businesses, we own a subset of businesses that are either more cyclical or lower growth/ quality than we have historically looked for. These stocks trade at ~1/3 of the market valuation and this segment of the market is where greatest long term opportunity lies. The earnings yield spread of the cheapest decile of smaller capitalisation stocks relative to the most expensive decile of large cap growth stocks is in the 98th percentile – only 1.7% of historic observations have equal or higher spreads. The Fund has a healthy allocation to this section of the market and in the decade following past extreme observations, smaller capitalisation value returned almost 17% per annum more than large cap growth[3].

We thank you for your patience and will do everything we can to deliver on your expectations of us, over time. If you have any further questions do not hesitate to contact us.

Sean Kenzie, CFA
Co-Lead Global Equity Fund

[3] OSAM research

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IMPORTANT INFORMATION

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