Setanta Global Focus Fund

Q2 2020

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 equity portfolio which holds c.20 global stocks. The portfolio is managed in accordance with the Setanta investment philosophy. That is, the managers seek to own good businesses for the long-term at prices below what they think they're worth, carefully considering each investment's risk profile. Stocks are chosen through bottom-up analysis, based on investment merit. Due to the Fund's concentrated nature, investments require an even greater than normal margin of safety. The Fund can hold up to 30% cash where investments of sufficient quality cannot be found. 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.

Fund Commentary

The Bloomberg headline on the 1st of July pretty much said it all: "S&P 500's Past 100 Days Were Its Best in Almost Nine Decades". That followed the fastest ever 30% decline for the index – 22 days – in February / March.

(Fund Commentary continued on Page 3)

Portfolio Managers

David Coyne & Rowan Smith

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

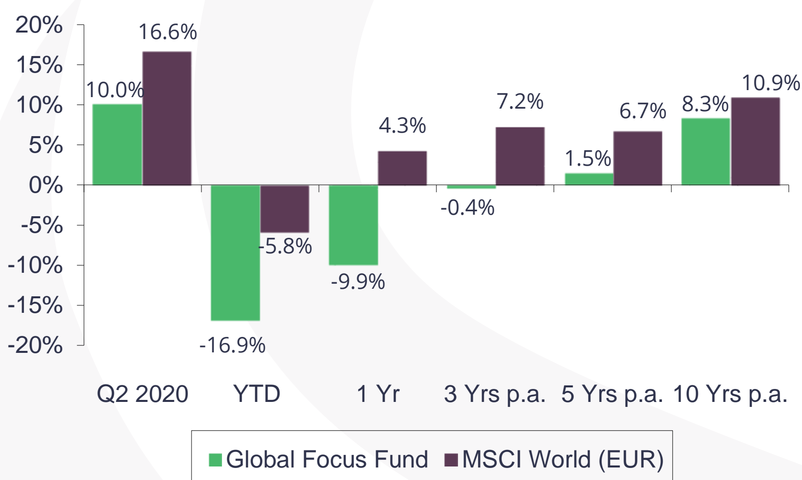
We consider scenarios rather than making forecasts

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 – 30.06.2020 (EUR)



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 Focus Equity Fund [IEC4001] 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 (EUR). **Holdings Source:** Setanta. Sector allocations based on invested portfolio only (excludes cash). **Fund Statistics Source:** Bloomberg

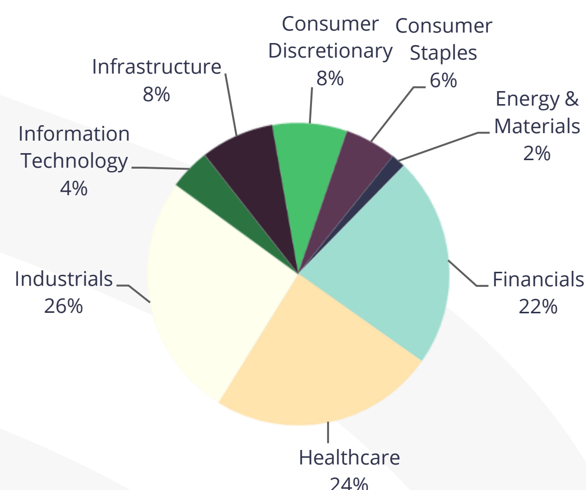
Top 10 Holdings

COMPANY	SECTOR	% OF FUND
LANCASHIRE HOLDINGS	FINANCIALS	8.1%
DCC	INDUSTRIALS	8.0%
BERKSHIRE HATHAWAY	FINANCIALS	8.0%
JOHNSON & JOHNSON	HEALTHCARE	7.6%
ALFRESA HOLDINGS	HEALTHCARE	7.5%
STERIS PLC	HEALTHCARE	7.2%
MINCON GROUP	INDUSTRIALS	6.6%
RICHEMONT	CONSUMER DISCRETIONARY	5.8%
LSL PROPERTY SERVICES	INFRASTRUCTURE	5.7%
RYANAIR	INDUSTRIALS	5.6%

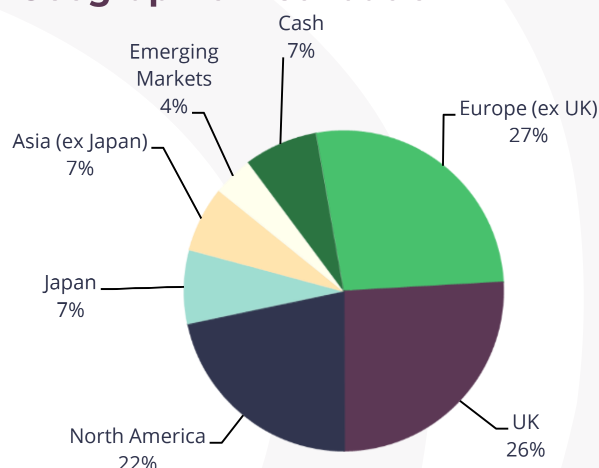
Fund Statistics

PRICE/BOOK	1.3
PRICE/EARNINGS RATIO (FY 1)	18.0
DIVIDEND YIELD %	2.0
AVERAGE MARKET CAP € BN	62.1
NO. OF HOLDINGS	17
DEBT /EQUITY %	39.6
ACTIVE SHARE %	94.8

Sector Distribution



Geographic Distribution



Yearly Performance

Year %	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Fund	-2.7	-35.2	44.0	28.2	1.5	9.0	20.0	19.1	7.3	11.7	9.7	-6.4	17.8
Benchmark	-1.7	-37.6	25.9	19.5	-2.4	14.1	21.2	19.5	10.4	10.7	7.5	-4.1	30.0

SETANTA Asset Management

Commentary

Due to the damaging effects of COVID-19, the OECD recently forecast the global economy to shrink by between 6% and 7.6% in 2020 (depending on whether or not there is a second wave). It will be the worst peacetime recession since the Great Depression. This is despite unprecedented levels of wage and business subsidies by governments around the world, which unquestionably prevented mass unemployment and bankruptcies. While a recovery is expected in 2021 and beyond, this very much depends on economies being able to reopen, with few COVID-induced hangovers (including weening economies off subsidies). That is far from certain.

Quite remarkably, in our opinion, at a general level investors have largely bought into the recovery story. The MSCI World rose 16.6% in Q2 (Euro-terms) and finished the first half of the year down just 5.8% (Euro-terms). The Fund lagged this strong performance by 6.6% in Q2 and year-to-end June was behind by 11.1%.

In contrast to the 5.8% first half fall in the MSCI World, which is a market cap-weighted performance of 1,600 stocks, the 'typical' stock in the benchmark fell by around double that rate (the median fell 12.7% and the simple average stock fell 11.3%). In other words, large capitalisation companies materially outperformed.

The outperformance by large cap companies has not been evenly distributed unfortunately – some stocks have hogged more of the limelight than others. At one end of the spectrum is **Berkshire Hathaway**, the $440bn diversified financial conglomerate. Berkshire fell 5% in Q2 leaving the share price down 20% for H1, despite a cheap valuation, a collection of generally good-to-excellent assets and a cash rich balance sheet that should be the envy of the world. The share price performance of Berkshire is all the more confusing seeing as Berkshire owns nearly 6% of Apple (+25% in H1) and which now accounts for over 20% of Berkshire's market cap.

At the other end of the spectrum, there are many high quality companies that we follow but don't own, some of which are currently trading at extremely high valuations (over fifty times earnings). Their valuation premium over the rest of the market has widened again this year, perhaps the result of their near-term earnings certainty combined with ultra-low interest rates. You should not expect us to buy these stocks at these valuations.

If the valuation of some high quality growth names is raising an eyebrow, other areas of the market are truly eye popping. Stocks that are favourites with day traders have in some cases risen by hundreds of percent this year. Nikola Corp (electric trucks) is a good example of this. Its charismatic CEO promises a great future and its share price rose by 550% in the first half of the year, reaching a market cap of $28bn at one point – not bad for a company currently with no revenues. Pinduoduo (ecommerce platform, $100bn market cap, +130% year-to-date), Shopify (ecommerce platform, $115bn cap, +150% ytd), Moderna (biotech, $23bn cap, +200% ytd), Tesla (electric cars, $250bn cap, +200% ytd) and Beyond Meat (plant-based foods, $9bn cap, +90% ytd) are in the same category: loss-making, promising high growth and highly speculative valuations. Of course, some of this crop might one day produce business performances to justify their current valuations, just as Amazon has been a spectacular winner from the 'class of 1999'. However it looks probable that collectively the 'class of 2020' will fail to produce good investment returns. The Fund is and will remain underweight these types of companies.

Despite disappointing Fund performance in recent years, we continue to believe that the businesses owned are good quality yet underappreciated by the market. However we recognise that near term earnings for a number of holdings will be a challenge given the COVID backdrop.

These include: oil services company **National Oilwell Varco**; **Ryanair**; the two luxury goods companies (**Richemont** and **Swatch**); and UK estate agency **LSL**. In all cases we have confidence that they have the financial strength to pull through and get back to earning 'normal' profits, which we believe will then result in a sharp re-rating of share prices.

The twin challenges for us are the market's narrow focus on large, expensive high quality growth as well as speculative growth companies, cohorts that are winning investor votes over 'value' (including small and mid-cap) stocks. If this environment continues the fund could continue to underperform; were this to happen the valuation spread between growth and value, already the widest it has ever been, would continue to widen. Our investment philosophy centres on identifying quality businesses but crucially being price-conscious, risk averse and long-term orientated – the tenets of our long-held investment approach. We believe our clients will ultimately be rewarded for this discipline.

Portfolio Activity

During the quarter the Fund purchased two new stocks (Coca-Cola Amatil and Samsung Electronics) and sold out of two existing holdings (Fairfax Financial and Covetrus).

Coca Cola Amatil is the bottler of Coca Cola products in Australia, New Zealand and Indonesia. Bottling and distribution is a low margin business. Significant operating scale and efficiency are needed in order to generate reasonable returns on investment. These requirements represent barriers to entry and have helped to foster a stable competitive backdrop for the industry. Industry demand is, however, mature. Normally this demand is also fairly shock-resistant but the COVID-19 lockdowns across Amatil's markets has had a substantially negative impact on its operating performance. Fewer gatherings have led to lower consumption of Coca Cola products. Particularly painful has been the significant declines in the "on the go" category; impulse purchases, which tend to be the highest margin product categories. As a result of these pressures, the stock declined substantially in the first half of the year. We believe this presented a good buying opportunity since we contend that demand will recover in time. Amatil has the support of the Coca Cola Company and will benefit from Coca Cola's continued shift towards low-sugar and healthier drink options for consumers. Furthermore we believe that Amatil's network would prove very difficult to replicate and so we believe the business is under-appreciated.

Samsung Electronics is a company that we have followed for many years. It is famous for its consumer electronic devices but we think the group is somewhat misunderstood. In particular we believe that its semiconductor business, accounting for more than half of group profits, is in a very good position. The structural demand backdrop for semiconductors appears very strong; underpinned by a variety of drivers, including the growth in cloud computing, demand for autonomous vehicles, the internet-of-things, working/learning from home, 5G, and the continued demand for more bandwidth. All of this requires more and more semiconductors. Samsung's semiconductor business appears very well positioned to meet this demand as a result of the industry consolidation that occurred in the past ten years or so. For example, in 2009 there were 10 manufacturers of DRAM (a critical memory chip) – today, just three companies (SK Hynix, Micron and Samsung) account for over 90% of the industry, with Samsung being the market leader. Samsung is also well positioned in a range of other industries, such as display (LCS and OLED screens) and mobile phones. The Balance Sheet is in a net cash position and the stock valuation is appealing with the stock currently trading at a little above book value.

Fairfax Financial is a Canadian headquartered insurance company with global operations. Fairfax was purchased for the Fund in 2011 and while money was made on the investment, the opportunity cost versus the benchmark was large.

Commentary

The bottom line is that Fairfax has struggled to make consistent, attractive returns. Insurance companies perform two roles: to underwrite and price policies in a prudent manner, and to invest the 'float' that arises from customers paying upfront. While Fairfax produced a solid margin on the insurance side, its investment returns have been woeful. Over the 9 years it was owned in the Fund, Fairfax produced a return on equity of around 6%. With low confidence in management and their ability to improve returns, we preferred the long-term risk-reward trade-off for SEI.

Lastly we sold out of **Covetrus**, a US animal health services company. We received shares in this company in February 2019 in a spin-out from Henry Schein, the market leading distributor of products and services to office-based healthcare professionals. Just prior to the spin, Covetrus merged with a company called Vets First and while we expected some teething problems, the company significantly undershot its own performance projections. Management did not impress on the conference calls and investors questioned the merits of the merger, leading to a collapse in the share price (-85% from spin to March 2020). Following a partial recovery of the shares we fully sold out our holding. Luckily Covetrus was always a small position in the fund (0.8% at its highest), so the impact on performance was small. However this debacle caused us to lose a fair degree of confidence in the judgement and motivations of the Henry Schein senior management team, who arranged and wholeheartedly backed this merger and spin. To say that these judgements now look poor would probably be an understatement. Indeed it led us to reduce our position in Henry Schein in the Global Equity Fund towards the back end of 2019.

David Coyne
Co-Lead Global Focus Fund

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IMPORTANT INFORMATION

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