

Setanta Global Equity Fund (CAD)

Q3 2020

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 Setanta Global Equity Fund returned 2.7% in the quarter, lagging the MSCI World Index by 3.1%.

Having invested through the dot-com bubble we feel like we are living through a version of the same thing as investors clamour to buy growth at any price and a handful of extreme winners dominate index returns.

(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

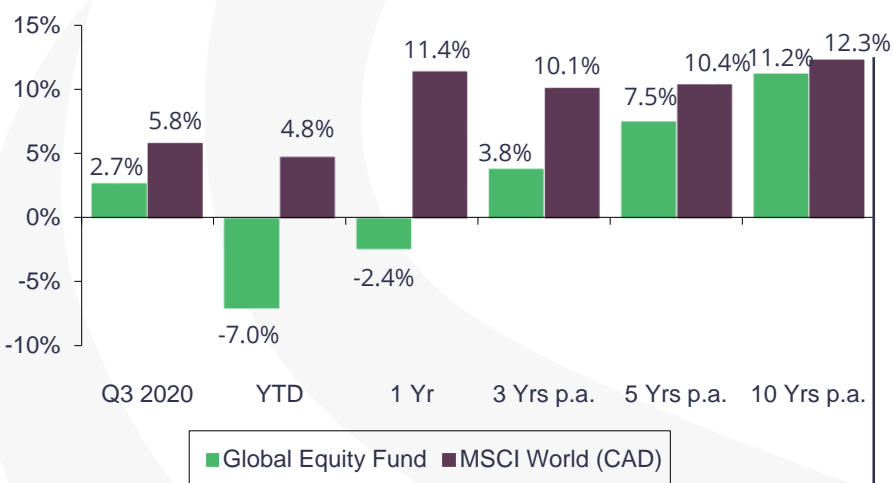
We consider scenarios rather than making forecasts

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 – 30.09.2020 (CAD)



Performance Source: Setanta Asset Management Limited. The Fund returns are based on the movements in the unit prices of the London Life Global Equity Fund (S034) 4.03SAM [IEC15001] 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 (CAD). **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	4.8%
BERKSHIRE HATHAWAY	FINANCIALS	3.4%
DCC	INDUSTRIALS	2.9%
ORACLE CORP	INFORMATION TECHNOLOGY	2.6%
ERICSSON	INFORMATION TECHNOLOGY	2.5%
JOHNSON & JOHNSON	HEALTHCARE	2.5%
KEYSIGHT TECHNOLOGIES	INFORMATION TECHNOLOGY	2.4%
JOHNSON CONTROLS	INDUSTRIALS	2.4%
NIKE INC	CONSUMER DISCRETIONARY	2.4%
LANCASHIRE HOLDINGS	FINANCIALS	2.2%

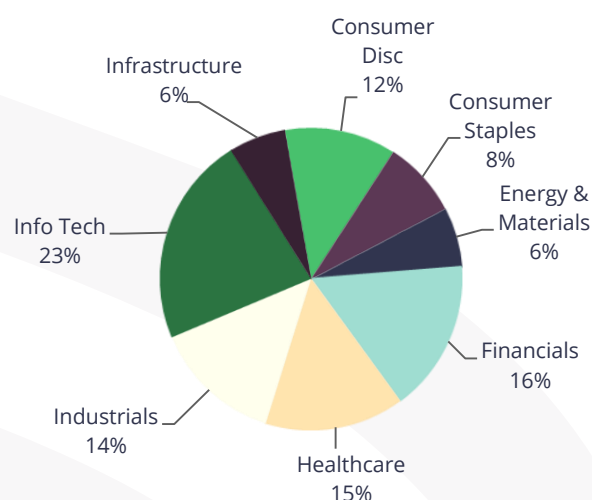
Yearly Performance

Year %	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Fund	-26.8	16.1	2.3	0.1	13.4	38.5	15.3	15.8	9.7	15.8	-0.7	13.8
Benchmark	-25.8	10.4	5.9	-3.2	13.3	35.2	14.4	18.9	3.8	14.4	-0.5	21.2

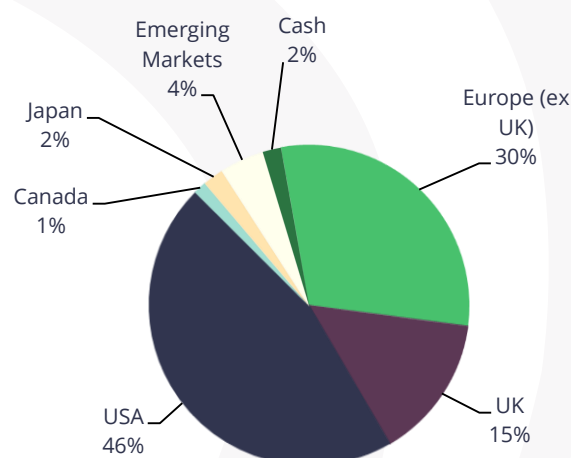
Fund Statistics

PRICE/BOOK	1.7
PRICE/EARNINGS RATIO (FY 1)	17.3
DIVIDEND YIELD %	2.3
AVERAGE MARKET CAP C\$BN	123.7
NO. OF HOLDINGS	84
ACTIVE SHARE %	86.4
DEBT/EQUITY %	61.8

Sector Distribution

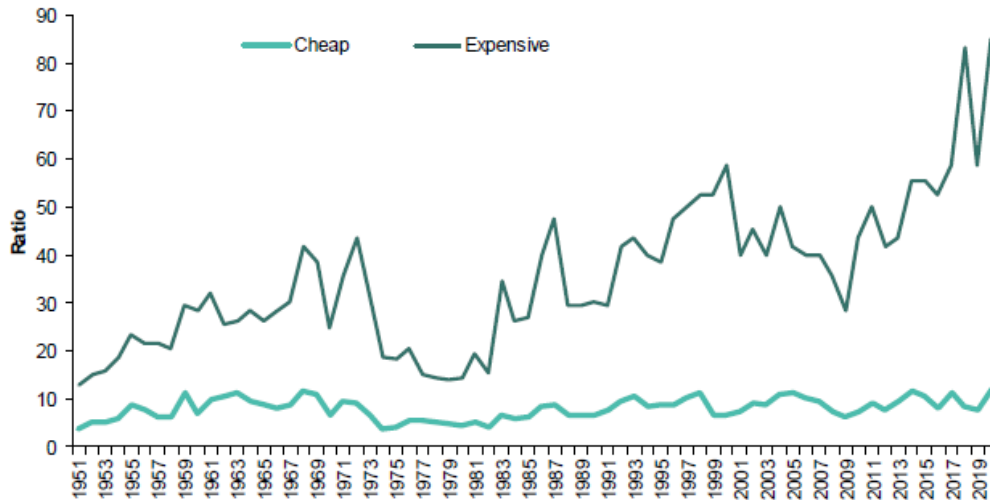


Geographic Distribution



Commentary

Meanwhile "value" equities remain, perhaps, the only cheap asset among the major assets classes for the longer term, now at 90 year valuation extremes versus growth equities. The chart below shows the current market-cap-weighted trailing PE ratio for expensive stocks in the US at 85x, while cheap stocks trade on the same multiple as they did in the early 1960's even though discount rates are a lot lower now than they were then. Remarkable.



The historic series is derived from the Ken French Data Library and it is the market cap weighted inverted trailing earnings yield for the most expensive and cheapest quintile of stocks out of the largest 1200 US stocks. The latest data point (the dots) on the chart are estimates derived by us from current valuation data. Note that we exclude stocks with negative trailing earnings.

Source: Ken French Data Library, MSCI, Bloomberg, Factset, Bernstein analysis

With governments globally pledging fiscal support on top of the extraordinary levels of monetary stimulus and the US Federal Reserve now explicitly targeting inflation, the ground may be set for an environment where some inflation returns. This will potentially raise long term interest rates, which disproportionately hurts the present value of longer duration assets like growth stocks. Value, international and small/mid-cap equities have traditionally done very well in such an environment.

But perhaps we don't need a helping hand from macroeconomics as imbedded expectation weighs heavily on many of the market's leading companies. We've mentioned previously how 1% of the names of the S&P500, namely Apple, Microsoft, Amazon, Google and Facebook make up 22.6% of the index, adding \$5trn of the index's \$12.8trn market cap increase in the last 5 years. It gets better, as a piece on investment bubbles by Horizon Kinetics, points out. Expected revenue growth for this group out to 2025 is 18% per annum.

To put this in context, if market capitalisations for these five companies rise in lockstep with revenue growth, and the remaining 99% of S&P500 companies grow in line with nominal GDP, at 4% annually, then FANMG companies would collectively comprise 39% of the index by 2025. If you include the next tier of high growth technology companies (Netflix, Intel, Nvidia, Adobe & Salesforce) just ten companies would account for 44% of the S&P500 index.

Similar growth expectations were embedded in March 2000 and, as our colleague Conor Walshe points out, the problem with this approach is that it leaves very little margin for error before we consider the slowdown in advertising spending growth, maturing cloud spending and growing anti-trust concerns. Looking back at the nine largest technology stocks as of March 2000, only two have surpassed that level of market cap since.

Commentary

Justifying very rich multiples on the basis that today's successful companies can grow far into the future carries significant risks. Sustaining growth over the long term is challenging. Analysis by Bernstein shows that just 6% of S&P500 companies sustained >5% year-over-year earnings growth for five consecutive years in the 1980-2019 period. Less than 1% managed the same feat for 10 years.

We continue to try to be disciplined on price while acknowledging, selectively, that high quality companies with good growth prospects earning attractive returns merit higher multiples.

Portfolio Themes

The largest detractor in the portfolio this quarter was distribution company **DCC Plc**, long exemplified as a Setanta holding. DCC distributes product across Fuel, Technology & Healthcare platforms using its expertise in sales, marketing and logistics to connect suppliers' product to millions of customers.

The company brings together two aspects of what we look for in a superior management team. Foremost, a focus on the daily operational excellence required to be a competitive distributor, in addition to allocating surplus cash flow in a manner that drives long term growth while maintaining strong returns on capital. For example, in the LPG business, scale built up over many years allows DCC multiple benefits; buying product better and in bulk, having better terminal access, superior logistics network density, benefitting from low churn from good customer relationships and indeed with their equipment installed at each customer base. Capital allocated to extend market share in this context strengthens the scale advantages described.

Financially, this model has driven operating profit at a compounded 13.7%pa since 1994 and all of this profit over 26 years has converted to free cash, totalling £3.3bn after reinvestment in the business. £1.1bn has been paid out as dividend to shareholders and £3.2bn spend on acquisitions, the deficit funded by disposals and equity raises.

These statements of fact mask something impressive going on under the surface here that speaks to the essence of what makes a good business. Many good businesses make good returns on capital from a core product, think Coca Cola, WD-40 or Gillette razor blades. These businesses typically have limited opportunities to earn anything like the returns they make on their core business.

However DCC falls into a different class of business, one with the ability to keep consuming most of the surplus cash flows it generates to acquire adjacent businesses in each of its four verticals. Warren Buffett calls this type of company a compounding machine. And that is precisely what DCC has become over the decades, deploying £3.3bn on top of its initial capital and still earning 16-20% Return on Capital Employed on an annual basis, with a long term equity total return to match. Until recently.

DCC has been essentially flat in equity performance terms from FY2016 to date, substantially trailing the market, despite profits growing from £300m to nearly £500m in FY2020, a nudge below the 13.7% long term growth rate. Looking forward, profits should grow towards £550m in FY2022, excluding any assumptions for M&A they are sure to complete. Nevertheless, value creation is a function of growth and returns on capital. Profit growth is not the issue here. The recent underperformance is instead a function of falling returns on capital over the past 4 years from 20% to 16.5%, a trend that investors have extrapolated into the future, which has manifested in a lower valuation multiple for DCC.

Commentary

Part of the stress on returns comes from very high level of M&A activity in 2016-18 where full benefits have not accrued yet, increased investment in organic growth via capital expenditure, as well as weakness in the technology division. The market further worries about future challenges for DCC in a lower carbon world of the future.

The negative thesis on DCC anchors on a future energy transition where organic growth will be negatively impacted. This completely ignores that 1) profit can go up as volumes decline as pricing is adjusted to compensate 2) LPG, or liquid based fuels more generally, are likely to be an important part of the "new" energy mix and can use DCC's existing infrastructure 3) DCC, as distributor, sits in between supplier and customer, possessing the essential infrastructure to sell, market & distribute product and therefore facilitate an energy transition. Admittedly, to date DCC has not been on the front foot on this latter point.

We believe the de-rating towards a five year valuation low, £1bn of M&A firepower with no current debt and more geographic & product investment platforms on which to invest all combine to a very attractive risk reward equation for DCC over the next 3-5 years.

Portfolio Activity

We sold out of **Henry Schein** having owned the company since 2013. The company ticked lots of boxes: market leader in an oligopoly with growing end markets; genuine cost synergies from acquiring smaller rivals; proactive management with long tenure; good record of growth in per share earnings and cash flow; high ROIC; well invested asset base; conventional accounting was understating earnings power, meaning stock was cheaper than it looked.

Over time, problems stemmed from two sources:

- (1) customer consolidation – customer base moved from overwhelmingly sole-trader to a higher mix of chains. Consolidated buying power has put pressure on prices and working capital requirements.
- (2) Ecommerce start-ups have proven to be niggly competitors at the margin – market share loss has probably been modest, but their presence has probably accentuated pressures from (1) above.

The very low cost of capital has meant competitors have been able to fund the business when the long-term economics are unclear. Quarter after quarter the adjusted margin announced by Schein management overstated what they were actually achieving, particularly on a cash flow basis – more investment in inventory and receivables was required as a competitive weapon. We believe the pressures above led to management deciding to merge its veterinary distribution business with a private company ("Vets First") and then spin it. This looks to us to have been a rushed and ill conceived, leading to further value-destruction and a loss of confidence in the management team.

We sold a small remaining position in **HP Inc** as work-from-home benefitted PC sales, while commercial print suffered in terms of volume and machine usage.

Commentary

Conclusion

We remain of the view that, similar to previous bubbles, the elastic band has stretched too far. MSCI US growth stocks have yielded 22% annualized total return from December 2017- August 2020 peak with only 1% per annum of that coming from fundamentals (growth + income), the remainder from dramatic valuation expansion. Even if this stellar performance was backed by strong fundamentals there would be cause for caution.

We continue to remind that the Fund is materially underexposed to the excesses manifested in the above mentioned category of stock. We are attracted to high return growth companies and constantly endeavour to find ones that are priced attractively – an increasingly difficult task in this market. Our goal is to be opportunistic when the opportunities arise.

The Fund has a material exposure to companies that have suffered what we believe are temporary earnings declines and dividend cuts due to the pandemic, which we believe have a lot to gain from a world returning towards 'normal'. In addition, we have disproportionately more small- and mid-cap companies and more international companies than the US dominated benchmark, which we think are very out of favour. We believe this discipline will ultimately be rewarding for clients.

As ever, we thank you for your continued support.

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IMPORTANT INFORMATION

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