Setanta Global Equity Fund (CAD)
Q4 2018

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 year began calmly but finished dramatically. To illustrate, in February the S&P500 set the dubious record for the longest period (over 400 trading days) without a 5% pullback, while in August it set another record for the longest period (over 9-and-a-half years) without a 20% correction. The 5% and 20% falls duly arrived in the fourth quarter of the year. It was a timely reminder to everyone that investing isn't a one-way street.

(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

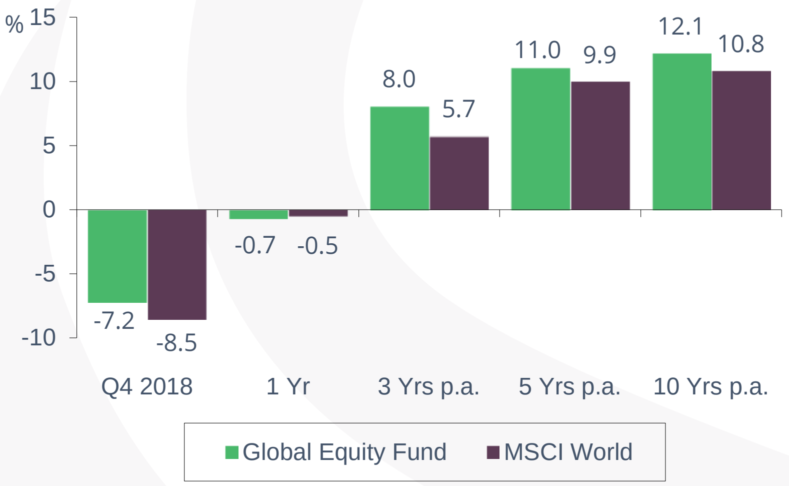
We consider scenarios rather than making forecasts

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 – 31.12.18

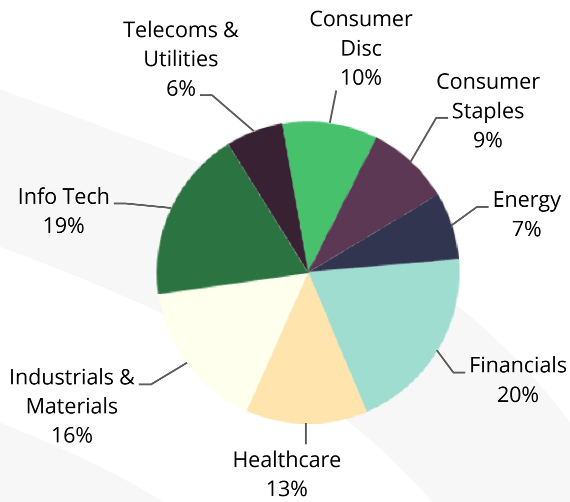


Performance Source: Unit prices: GWL. Returns are based on London Life Global Equity Account (S034 4.03), gross of management fees in CAD. Benchmark is MSCI World in CAD. The performance will be reduced by the impact of management fees paid, the amount of which varies. **Fund Statistics Source:** Bloomberg

Fund Statistics

PRICE/BOOK	1.7
PRICE/EARNINGS RATIO (FY 1)	14.1
DIVIDEND YIELD %	2.6
AVERAGE MARKET CAP C$BN	85.4
NO. OF HOLDINGS	88
ACTIVE SHARE %	86.5
DEBT/EQUITY %	52.5

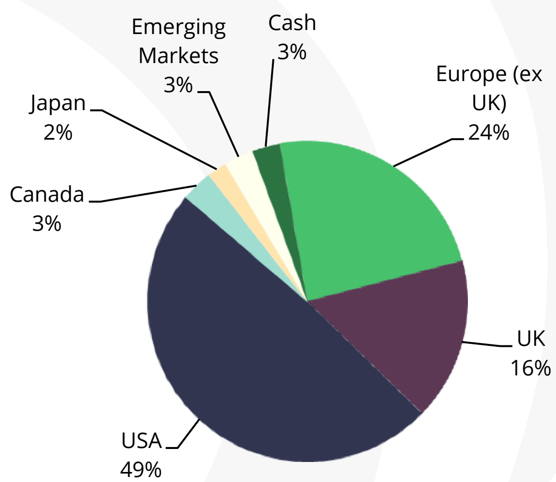
Sector Distribution



Top 10 Holdings

COMPANY	SECTOR	% OF FUND
BERKSHIRE HATHAWAY	FINANCIALS	3.4%
MICROSOFT CORP	INFORMATION TECHNOLOGY	2.9%
DCC	INDUSTRIALS & MATERIALS	2.9%
OWENS-ILLINOIS	INDUSTRIALS & MATERIALS	2.6%
LANCASHIRE HOLDINGS	FINANCIALS	2.4%
FEDERATED INVESTORS	FINANCIALS	2.3%
ERICSSON	INFORMATION TECHNOLOGY	2.3%
OSHKOSH	INDUSTRIALS & MATERIALS	2.2%
JEFFERIES FINANCIAL	FINANCIALS	2.1%
MELROSE INDUSTRIES	INDUSTRIALS & MATERIALS	2.1%

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

SETANTA Asset Management

Commentary

In the 2017 year-end fund report I mentioned how tough we were finding it:

"We think this is an exceptionally difficult market to navigate. We regularly observe ordinary companies trading at gold-plated valuations. There are very few beaten up stocks to be found – typically a good place to look for cheap companies – and when we find them there's often just too much hair on them for us to consider as an investment."

As we sit here in early 2019, has our opinion changed? Not really. Overall the MSCI World (Total Return, CAD) fell by less than 1% in 2018, although some pockets of the market have been hit hard and as we sift through the wreckage over the coming weeks and months we might find some good quality bargains.

Our difficulty in finding good investment opportunities is at odds with the attractive headline market valuations you may read about. According to my Bloomberg screen, the consensus sell-side one-year forward price-earnings ratio is 13x for Europe and 15x for the US, undemanding in a historic context. In short, we are sceptical of the earnings numbers used in those P/Es. Most obviously, they are based on peak sales and peak margins, as most of the world's big economies are at full employment, interest rates are very low and consumer confidence is generally strong. On top of this, sell-side analyst forecasts are always biased upwards, typically omitting a host of legitimate business expenses, giving the appearance of higher than actual profits. We would also throw in the potential for systemic corner-cutting that can accompany times of exuberance. For example, in late-December US-listed healthcare company Perrigo (not a fund holding) fell 30% on the news that it has been ordered by the Irish Revenue Commissioners to pay a massive $1.9bn in back taxes relating to Elan, bought by Perrigo in 2013. Elan had previously sold intellectual property rights to Biogen and treated the event as trading income (12.5% tax rate) rather than a capital gain (33% tax rate). This is a specific Perrigo event, but could hint at general corporate behaviour, under pressure by the large body of short-term investors that demand results, now, by whatever means! This risk is most definitely not captured in forward P/Es. Setanta doesn't calculate bottom-up earnings across the market, but we regularly find that decent companies typically trade on scrubbed down, cyclically-adjusted P/Es of 20-30x, on the expensive side versus history.

You may have seen that the share prices of "FANG"-types came under pressure during the second half of the year. FANGs is shorthand for Facebook, Amazon, Netflix and Google, but more broadly is a catch-all for trailblazers of the information age (including Bitcoin, which I sceptically featured in the 2017 year-end fund review). A full discussion of this topic is a thesis in itself but, in brief, we have avoided the FANGs typically because their business models are relatively new and unproven, meaning their warranted valuations are hard to determine (who would have guessed the data privacy issues Facebook and others have faced in the last year?). Some of the FANGs may dominate their fields for years to come, but for a long time it looked to us that investors too easily bought the hype — the mere mention of "network effect" seemed to free companies of the need to turn a profit. We are happy to see investors begin to cast a more critical eye now.

Commentary

Fund Review 2018

The Fund fell by 0.7% during the year, slightly underperforming its benchmark which fell by 0.5%. We were somewhat disappointed because the types of companies we invest in have tended to do relatively well in weak markets in the past. That said, the Fund is ahead of the benchmark by 2.3% per annum over the last 3 years and ahead by 1.1% over 5 years, is a very solid achievement when a sizeable majority of funds have underperformed.

In 2018 a number of our UK stocks fared poorly due to a combination of Brexit fears, expected cyclical demand weakness, general competitive struggles and/or valuation e.g. **DCC** and **Melrose** both lost around 19% of their value in the year, CAD-terms. Elsewhere, the share prices of what we consider high-quality albeit cyclical companies fell surprising sharply, such as luxury goods maisons **Richemont / Swatch** (down around a quarter in 2018) due to fears of slowing Chinese demand, a key consumer of luxury products. Also, some of our financial stocks were heavily hit during the year, notably **Jefferies Financial Group**, formerly known as Leucadia, which was down 27% due to continued poor performance at its key investment banking subsidiary. Some of the above listed risks and worries will prove to be real and long-lasting, while others will be overblown or fleeting and these latter cases and their share prices will recover. At an individual stock level we cannot tell which will occur, it is just the nature of investing. However at a portfolio level, we remain confident that the fund will prove more durable than the market if there is a prolonged spell of economic or stock market weakness.

As always there was a wide spread between the top and bottom performing fund holdings in 2018, though as always we caution that individual stock performance is best seen in a longer term context than 12 months. For example, **Drax Group** was up 42% in 2018 but was down 30% in 2017 and so isn't really worthy of a comment.

2018 Top 5 Performers	Sector	Total Return, Euro
Keysight Technologies	Technology	+63%
Ericsson	Technology	+48%
Drax Group	Telecoms / Utilities	+42%
Pfizer	Healthcare	+36%
Steris	Healthcare	+35%

2018 Bottom 5 Performers	Sector	Total Return, Euro
DXC Technology	Technology	-29%
Vodafone	Telecoms / Utilities	-28%
Liberty Global	Consumer Discretionary	-34%
Diamond Offshore	Energy	-45%
Playtech	Technology	-52%

The performance of telecom equipment supplier **Ericsson** was particularly satisfying, as it was purchased in mid-2017 with the shares at that point having spent more than a decade in the doldrums, against a backdrop of FANG stocks seeming like a one-way bet. If you recall from our discussion at the time, the company had had problems of its own doing. It had a grow-at-all-costs mentality which led them to take on low- or no-margin customer service contracts and in general the organisation had become bloated. Ericsson's core products and services were still held in high regard, especially where governments are wary of allowing their Chinese competitors a look-in. The company's new CEO has since trimmed the business back to basics and removed excess costs; margins have already recovered. We believe there is more to come.

US-based **Steris** is also worth a mention, as its 35% share price rise in 2018 should be seen in the context of its purchase in 2010 at around $30 per share versus a year-end 2018 price of over $100 (with dividends on top of this – equating to a total return of close to 20% p.a. since initial investment). A review of Steris highlights the difficulty we currently face in trying to sensibly deploy the fund's capital. Steris' main business involves making sterilisation equipment and consumables for, and providing related services to, hospitals and laboratories worldwide. It has a strong market position with sizeable barriers facing potential new entrants, highlighted by the fact that customers rarely switch suppliers. We believe that the company will continue to grow profitably for many years. At purchase Steris was relatively unknown in the investment community and was valued on a mid-teens P/E (using our own conservative earnings estimate), which we considered highly attractive as we saw considerable potential for after-tax profit margins to increase alongside steady revenue growth. However, while the business has grown nicely since, the share price has increased at a faster rate, and so the valuation is now over twenty times earnings. Furthermore there is far less potential for profit margins to rise given the significant increase in recent years. We still believe the current valuation is justifiable because of the strength of the business, but returns for shareholders over the long term are highly likely to be well short of those achieved in the past eight years. While this might not excite, finding better investment candidates – cheaper and of sufficient quality – is not an easy task in the current market.

At the other end of the performance spectrum was **Playtech**. We purchased a small position in Playtech in the first half of 2018. Playtech provides the software to online gaming companies that allows their businesses to operate by integrating critical business functions (e.g. linking up regulatory systems with CRM systems). We believe this business is nicely profitable and sticky. Playtech also provides game-only content to some customers. We view this other business as profitable but much less sticky. Our thesis was that Playtech is a nicely cash generative business with a strong position in its market, providing products that customers need. However in July 2018 the company announced a profit warning on foot of weak sales of its gaming products in China. We had always considered this particular segment as somewhat vulnerable to new competition so we viewed this update as very unfortunate but not completely shocking. Having reviewed the position we believe the business in China has stabilised and we see its software businesses in the rest of the world as being far more durable. As such we don't consider this deterioration to be terminal and believe the overall business remains well positioned and undervalued currently. We added to our holding following the profit warning and again in Q4 as the share price continued to fall.

Diamond Offshore also fell sharply in 2018. The offshore oil and gas driller typically benefits from a high oil price, but the oil price collapse in Q4 (Brent price per barrel -40%) may have put the skids on a demand-led recovery for the time being. This has been a very challenged investment for us in the 6 years since we first purchased (a function of the exceptionally difficult drilling industry backdrop rather than Diamond-specific issues), but we remember that the environment for drilling rigs can be exceptionally favourable for prolonged periods too.

The performance of **Liberty Global**, the European cable operator, is noteworthy. During the year it agreed to sell part of its operations to Vodafone at an attractive price. The rub is that the competition authorities have yet to approve the deal and, if they do, subject to what conditions. However, if the deal does go through, the rump of Liberty Global (with just UK and Irish assets) would look exceptionally cheap. At that point the company will have nice options. It could carry out a large share buyback, which would be highly accretive to value, or the entire business could be sold.

Fund Transactions in 2018

During the year the fund added 3 and exited 4 positions.

The summary reasons for sale were as follows: valuation (FICO); being acquired (Euler Hermes, by Allianz); a disagreement with management strategy (Kennemetal); and increased valuation / risk profile (Brookfield). The first three of these are described in the Q1 and Q2 reports. Brookfield is discussed below.

Similarly, the rationale for buying Saga, Playtech and Applegreen was discussed in the Q1, Q2 and Q3 fund reports.

	Buys	End of year weight	Sells	Start of year weight
Quarter 1	Saga	1.5%	Fair Isaac	0.5%
			Euler Hermes	1.7%
Quarter 2	Playtech	1.3%	Kennametal	0.3%
Quarter 3	Applegreen Plc.	0.3%	-	-
Quarter 4	-	-	Brookfield A.M.	1.0%

Brookfield Asset Management ("BAM") was first purchased for the fund in early 2013 and the stock generated a handsome 15% p.a. total return until sold in November. BAM is among the world's largest managers and operators of property, infrastructure, renewable energy and private equity assets on behalf of 3rd party clients as well as for its own account. BAM has a lot of positives going for it. Management takes a long-term approach and specialises in doing large, complex deals that others are typically unable or unwilling to execute on. It aims to buy high grade assets that have fallen out of favour and, because it operates globally, management believes it can always find some asset or other that is selling on the cheap. The vast majority of BAM's capital is long-term, matching the long-term assets it owns and also giving the group good visibility on a portion of the management fees it charges 3rd party investors.

Now while the assets that BAM owns are typically very simple, the group is complex to analyse because its numerous funds and platforms typically co-invest in projects; as a result there is a risk we don't properly understand all the moving parts. For all the positives outlined above, this has been a risk we were willing to bear until now. However, we have become concerned at the pace at which BAM has continued to raise and invest 3rd party capital in recent years. We are sceptical of management's claim that it can always find cheap assets because after years of low interest rates and a decent economic backdrop there's a lot of competing capital looking for a home, which surely reduces BAM's odds of getting a bargain. If our concerns are realised, at the very least it will make it harder for BAM to earn performance management fees as it has done in the past. There is also the risk of a sharp fall in the value of the assets it has bought for its own account, which are keyed off favourable interest rates. At the current valuation, investors expect continued good business performance, with little priced in for risk we feel. Taking these points together we decided to sell our remaining holding but this is a stock we might consider again in the future at a lower valuation.

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