Setanta Global Equity Fund – Q4 2017

Setanta
ASSET MANAGEMENT

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 a diversified, actively managed equity portfolio. As bottom-up fundamental value investors, our research process is designed to properly understand how each business functions and to consider risks pertinent to the business. Securities are chosen by a team of global sector specialists, targeting sensible diversification across industries, geographies and market capitalizations. We value each business, with the priority to pay a price that mitigates downside risk. We aim to make investments for the long-term, all the while considering the available opportunity set.

Fund Commentary

The Setanta Global Equity Fund increased in value by 8.8% (gross of fees, Euro-terms), besting the performance of the benchmark by 1.2% and adding to its exceptionally consistent long-term track record (outperformance in 15 out of 17 years since inception). Contrary to what some market gurus might be saying, 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. Making matters worse is the level of disruption that new technologies are having on all manner of industries. This is a huge risk and we are spending a lot of time thinking about how our companies could be hurt. That's not to say there aren't any good acceptably priced stocks to be found, but it's certainly slimmer pickings than we're used to.

(Fund Commentary continued on Page 3)

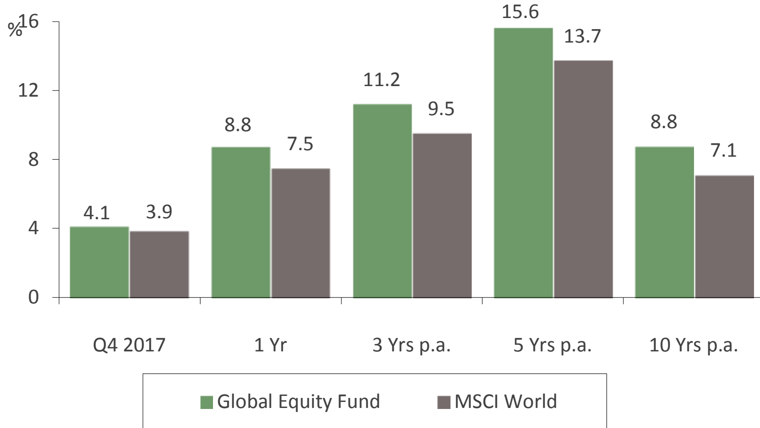
Portfolio Managers

David Coyne & Sean Kenzie

Investment Principles

- We do not believe the market is efficient.
- We aim to make investments at a price below our assessment of intrinsic value.
- We make an investment in a business rather than trade securities.
- We believe risk is the possibility of permanent impairment of value.
- We make investments for the long term.
- We invest where we see value and are not afraid to be contrarian and swim against the tide.
- We don't make forecasts, we consider scenarios.
- We demand financial strength from the companies we invest in.
- We will act with integrity and communicate with our clients in a manner representative of our investment style.
- We have the humility to know we make mistakes and embrace the need to continue learning through both experience and study.

FUND PERFORMANCE – 31.12.17



Performance Source: Setanta Asset Management Limited. Benchmark: MSCI World. The Fund returns stated are based on the movements in the unit prices of a representative account, based on mid to mid prices, and are gross of management fees. The performance will be reduced by the impact of management fees paid, the amount of which varies. **Fund Statistics Source:** Bloomberg

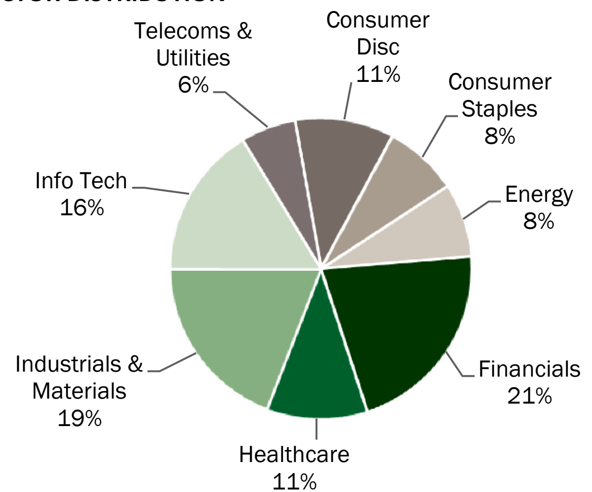
TOP 10 HOLDINGS

COMPANY	SECTOR	% OF FUND
BERKSHIRE HATHAWAY	FINANCIALS	3.3%
OWENS-ILLINOIS	INDUSTRIALS & MATERIALS	3.1%
OSHKOSH	INDUSTRIALS & MATERIALS	3.1%
DCC	INDUSTRIALS & MATERIALS	3.0%
CRH	INDUSTRIALS & MATERIALS	2.8%
LEUCADIA NATIONAL	FINANCIALS	2.7%
FEDERATED INVESTORS	FINANCIALS	2.6%
MICROSOFT	INFORMATION TECHNOLOGY	2.5%
FAIRFAX FINANCIAL	FINANCIALS	2.3%
CISCO SYSTEMS	INFORMATION TECHNOLOGY	2.2%

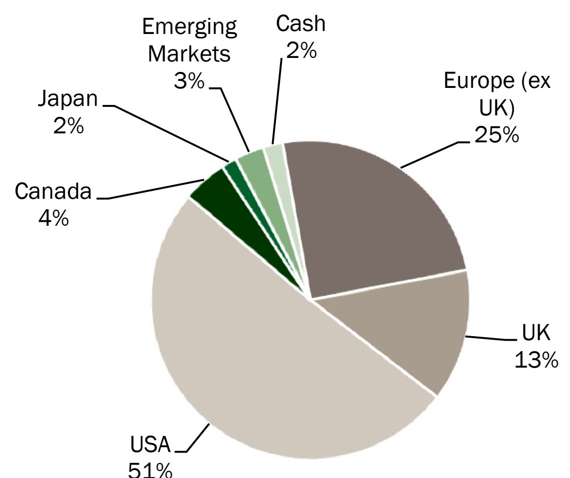
FUND STATISTICS

PRICE/BOOK	2.0
PRICE/EARNINGS RATIO (FY 1)	17.9
DIVIDEND YIELD %	1.8
AVERAGE MARKET CAP €BN	54.6
NO. OF HOLDINGS	89
ACTIVE SHARE %	87.9
DEBT/EQUITY %	55.2

SECTOR DISTRIBUTION



GEOGRAPHIC DISTRIBUTION



YEARLY PERFORMANCE

Year %	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Fund	-29.1	16.3	10.9	27.7	13.0	-1.0	-36.6	32.2	16.2	0.9	14.1	24.5	20.6	9.0	16.2	8.8
Benchmark	-32.1	10.7	6.5	26.2	7.4	-1.7	-37.6	25.9	19.5	-2.4	14.1	21.2	19.5	10.4	10.7	7.5

Market observations

Unless you've been living in a cave, you'll probably have heard about blockchain, Bitcoin and other so-called cryptocurrencies, technologies that have the potential to transform how we transact and save. For most 'knowledgeable' commentators, Bitcoin is a bubble waiting to burst. We have long learned to be humble in such bold predictions, especially in such a complex area as this one, but count us as being wary. It's the dinner party topic du jour and it seems like everyone is in. During December a Carribean island was advertised for sale on the front page of the Financial Times, with the seller only accepting digital currency (presumably because digital currency is destined to increase in value). Also in December the Long Island Iced Tea Corp changed its name to Long Blockchain Corp and said it was exploring "digital cryptocurrency technology solutions"; its share price surged by 500% in pre-market trading. This looks like the Wild West to us, very reminiscent of the heady days of the TMT bubble in the years leading up to 2000; back then scores of companies added ".com" or "internet" into their names only to fall back to earth when sense once again prevailed.

If Bitcoin is off topic for investors in an equity fund, we think the next subject – the troubles facing German-quoted / South African-based company Steinhoff International – is right on queue. As background, Steinhoff sells a range of furniture and other household goods primarily in Europe, the US and South Africa. This is a significant company. It has over 12,000 locations and a year ago it had a market capitalisation of over 20 billion euro. It is Europe's 2nd largest furniture retailer (after IKEA).

In early December Steinhoff announced that it was delaying the publishing of its annual report and was launching an investigation into accounting irregularities. Ominously, the long-serving CEO stepped down. It's all up in the air still and so far all we have been told is that its results for years 2016 and 2015 (and possibly more) may be restated. The company has been in a tailspin since, with its bankers withdrawing their support at the same time as suppliers are demanding cash on delivery, all of which is causing a severe cash squeeze. The share price was down a massive 90%+ in December.

Steinhoff is not a Setanta holding, so why are we talking about it? The main reason is because it's an excellent example of the type of company we look to avoid, a critical ingredient for investment success.

The fact is we never looked at Steinhoff in much detail at all. However, one couldn't help but take notice of the company in 2016 when it bought US-based Mattress Firm ($3.8bn) and UK-based Poundland (£600m). In the same year it also made serious efforts to acquire UK-based Home Retail (trading as Argos) and electrical retailer Darty, ultimately losing out to competing bids. Steinhoff massively grew its store base from a couple of thousand three years ago to over 12,000 stores spread across 30 countries currently.

Such explosive growth – acquisition-led and debt-funded – tends to raise a big red flag for us. There are bound to be massive operational, management and cultural issues and given the company's enormous debt pile and the on-going rent roll (which is debt-like in the short-to-medium term), there is simply little tolerance for weak business trends. It's no secret that the competitive environment in retail is changing rapidly, making life hell for a lot of bricks-and-mortor companies – and that's with a decent economic backdrop (shudder to think what a recession might do).

Large and frequent acquisitions – as was the case with Steinhoff – make it very difficult for an outsider to know for sure how an underlying business is doing. You're left relying on management to give an honest and frank assessment of trading. Faced with the option of truth or blurring the lines, some management teams will be tempted to side with the latter.

As it turned out, Steinhoff appears to have gone far further than blurring the lines. It engaged in undisclosed related-party transactions to obfuscate the truth. We don't know the details yet, but it could involve 'loans' (that are never meant to be repaid) made by Steinhoff to companies in which it owns minority stakes, on which Steinhoff accrues interest income (non-cash) and the minorities then use the loan proceeds to buy bad assets off Steinhoff at inflated prices, thereby hiding poor trading in the Steinhoff consolidated group accounts. Fraud is tough to spot for an investor, but there were clear warnings that all was not well with Steinhoff. German investigators have been looking into the company's accounting practices since shortly before its Frankfurt-listing in December 2015. In early November, Reuters wrote an article highlighting undisclosed related-party transations that experts deemed material and which should have been reported to investors under EU rules.

Was the potential upside so compelling so as to ignore these warnings? Or perhaps the case of Steinhoff is, in a way a little Bitcoin, a sign of the exuberant and care-free times we invest in? Could Steinhoff be the 'canary in the coalmine'?

Review of Portfolio and Transactions in 2017

As mentioned at the top, the fund increased in value by 8.8% over the course of the year. For those interested we have included the top and bottom five performing stocks for the year, but we caution that stock performance is best seen in a longer term context than 12 months.

2017 Top 5 Performers	Sector	Total Return, Euro
Resolute Forest Products	Industrials / Materials	82%
Euler Hermes	Financials	53%
Tupras	Energy	51%
Hollyfrontier	Energy	43%
Samsung Electronics	Technology	41%

2017 Bottom 5 Performers	Sector	Total Return, Euro
Drax Group	Utilities / Telecoms	-30%
NCR Corp	Technology	-26%
Tullow Oil	Energy	-25%
C&C Group	Consumer Staples	-23%
Tenaris	Energy	-20%

Top of the pile in 2017 was **Resolute Forest Products** (+82%), the Canadian pulp and paper firm, which benefitted from better paper pricing, capacity exiting the industry and cost-cutting. This has been a difficult investment for us, as the 2017 share price rise followed a few years of subpar performance in what is a tough industry. We continue to hold as we believe the shares are still cheap.

Another top fund performer was **Euler Hermes** (+53%), the French credit insurer that along with two peers dominates its niche industry. In November Euler was the subject of an offer by its majority shareholder, the German insurance giant Allianz. While it's always nice to get a short-term performance boost, we were disappointed with the offer as we don't think the premium reflects Euler's long-term fundamentals.

Among the detractors was **Drax**, the UK utility group. Drax's fortunes move around with the outlook for the UK wholesale electricity price in the medium term, which trended lower for most of 2017. At the current price the market is ascribing little or no value to the company after 2023, after which time government subsidies to its main biomass plants run out. This may turn out to be the case, but we believe the company has increased the quality of its cash flows and there is substantial residual value in the flexible and fast reacting generation capacity of its Selby plant, which will allow the company to generate meaningful profits longer into the future. Elsewhere, ATM maker **NCR** had a somewhat disappointing year, with less of its banking customers migrating to newer products (it should be noted also that the stock was up over 70% in Euro-terms in 2016), while trading continues to be tough for brewer C&C group due to competitive pressures.

During the year the fund added and exited 5 positions. The reasons for the sales were varied: one was a changing business model / new competition (Omnicom), a second was due to valuation (Intel), a third was acquired (VWR) and the last two were unattractive stocks that were spun out of existing holdings (Micro Focus and Adient). Obviously we think the new breed have better risk-reward prospects than those we are exiting; time will tell.

A discussion of Ericsson, Omnicom, Intel Harley-Davidson and Priceline can be found in the September and June commentaries. Adient spun off from Johnson Controls in Q1:17 (JCI) following its merger with Tyco. Adient was a much smaller subsidiary within JCI, and operated in a different industry (auto parts) and viewed as a lower quality business. These undesirable qualities contributed to a lot of forced selling post spin. We held the stock based on a very low valuation post sell off, and sold out the entire position after a subsequent 85% share price move in Q2.

	Buys	End of year weight	Sells	Start of year weight
Quarter 1	-		-	
Quarter 2	Harley-Davidson	0.5%	Adient Plc.	0.3%
	The Priceline Group	0.9%		
Quarter 3	Ericsson LM		Omnicom Group	1.5%
	Alfresa Holdings	0.9%	Intel Corp.	0.4%
Quarter 4	The Cheesecake Factory	0.6%	VWR Corp.	0.8%
			Micro Focus Intl.	-

We mentioned in the September commentary that we had begun buying an unnamed Japanese company. That company was Alfresa Holdings and we finished buying our desired holding in Q4. Alfresa is one of four dominant drug distributors in Japan, which have a market share of c.80%, including Alfresa's 24%. We have a lot of experience with distribution companies, having owned a number of them over the years. Typically they are low margin businesses. However, they put a lot of volume through their fixed assets and a well-run distributor doesn't tend to need a lot of capital, as a result they can generate a very good return on capital invested. Also, barriers to entry for dominant distributors operating in niche areas of the market can be high, not least because of strong customer relationships and the need for full trucks running all day in order for the business' economics to work. We believe all of these traits are present with Alfresa. There is a nice demand backdrop for the industry too, given Japan's aging population. Of course the bogeyman that is Amazon could try and get into this market but we think there are a lot of easier and more logical businesses for Amazon to attack before it gets involved in Japanese drug delivery, so we think this is quite a low risk.

Alfresa's operating business is very profitable (c.20% Return on Operating Capital Employed). However, group returns are dragged down by its massive net cash pile (20% of group assets and 60% of the market cap at time of purchase). A strong balance sheet is something we generally like, but in Afresa's case it's excessive. We do not put a high probability on a step change in the company's dividend and balance sheet policies but if it does the stock would be extremely cheap. In the likely scenario that nothing changes, we will have bought into a decently-run and low-risk business with an unbelievably strong balance sheet at an undemanding valuation. The purchase was primarily funded through a sale of VWR (see below).

Also in Q4 the fund bought a position in The Cheesecake Factory, the US restaurant chain. For those of you that have never heard of or experienced The Cheesecake Factory, it's something of a destination restaurant that serves a wide range of high-quality food in a casual dining setting. It has c.200 restaurants mainly in the US, located in large cities and wealthy metropolitan areas. The restaurant business can be very tough, with low margins a feature due to incessant competition. Cheesecake differentiates itself in two ways. It has a high throughput due to its consistently high food and service standards (bookings can be months in advance) and it has turned minimising food waste into an art form. In both these ways the company makes margins and returns that are far higher than industry norms. Cheesecake has been able to grow in the past by selectively adding new locations, while trying to eke out a little extra out of existing (well-run) stores. In recent quarters, growth in profits from existing stores has slowed a little, due to some cost pressures (food and staff) and slightly less footfall. Disappointed investors sold the shares down by around 40%. David Byrne, our Consumer Discretionary manager, has followed for a couple of years waiting for such an opportunity. We think the long-term potential for Cheesecake could be big. It will continue to roll out new US locations and has started to sell its products into food retailers (addressing the eat-at-home market). Also we are pretty confident the Cheesecake concept has huge international appeal and has only scratched the surface on this front.

During Q4 the fund said goodbye to VWR, the US-headquartered distributor of laboratory products as the company was acquired. We were disappointed that this happened because VWR is an excellent company that we hoped to hold on to for many years and the price at which it was acquired did not reflect its future prospects as we saw them. However, it can hardly be described as a bad outcome. We first bought VWR in February 2016 and earned a near 40% return (in Euro-terms) over the c.18 months that we held it.

Also sold in Q4 was Micro Focus (0.3% fund weight), which we ended up owning as a result of the sale of HP Software to Micro Focus in return for Micro Focus shares, which were then distributed to Hewlett Packard shareholders in the third quarter. Micro Focus funded the deal through issuance of shares and debt. As part of HP, CEO Meg Whitman attempted to restructure and transform the software business, but with little effect. Legacy software is a difficult business area and while we commend Micro Focus on their past successes in profitably managing legacy software businesses they have very ambitious plans for the acquired business, which we think they'll struggle to achieve. All of this led us to conclude that our best option was to sell our Micro Focus shares.

David Coyne – Portfolio Manager

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