Global Focus Fund (EUR) – Q4 2017

Setanta
ASSET MANAGEMENT

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, concentrated Global Equity Fund that is invested in circa 20 stocks. As a Fundamental value investor our research is designed to properly understand how each business functions and to consider pertinent risks to the business. We attempt to value each business, incorporating relevant upside and downside scenarios. As such the Fund attempts to invest in the most attractive stocks across all the firm's strategies using a risk-return framework. Investments are made for the long-term and are based on investment merit rather than with reference to benchmark. This Fund is mandated to be fully invested in equities. Due to the concentrated nature of the Fund, performance may be volatile. The investment objective of the Fund is to outperform the MSCI World index over periods of three years or more.

Fund Commentary

The Setanta Global Focus Fund increased in value by 9.7% (gross of fees, Euro-terms), which was 2.2% ahead of the benchmark (+7.5%). The fund is broadly in-line with the benchmark over 3 and 5 years and over the last 10 years is ahead by 2.3% p.a.

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.

Portfolio Managers

Rowan Smith & David Coyne

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.

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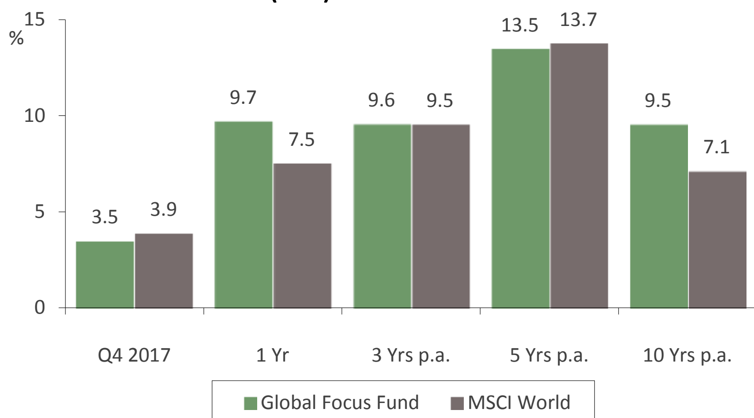
FUND PERFORMANCE (EUR) – 31.12.17



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 (Valuation) Median ex Financials

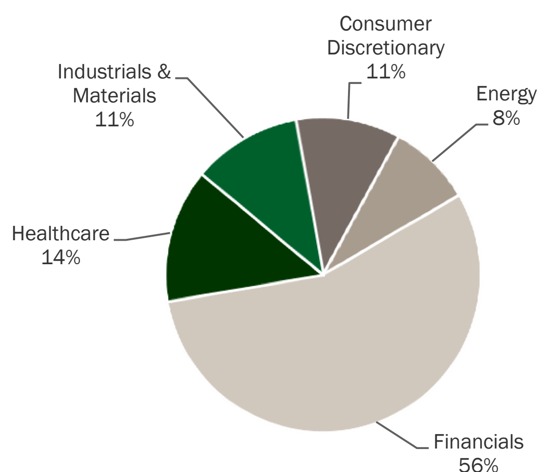
FUND HOLDINGS

COMPANY	SECTOR	% OF Fund
BERKSHIRE HATHAWAY	FINANCIALS	8.4%
FAIRFAX FINANCIAL HOLDINGS	FINANCIALS	8.3%
LSL PROPERTY SERVICES	FINANCIALS	7.9%
MINCON GROUP	INDUSTRIALS & MATERIALS	7.4%
LEUCADIA NATIONAL	FINANCIALS	6.5%
JOHNSON & JOHNSON	HEALTHCARE	6.1%
STERIS	HEALTHCARE	5.8%
MARKEL	FINANCIALS	5.2%
DIAMOND OFFSHORE	ENERGY	4.9%
RICHEMONT	CONSUMER DISCRETIONARY	4.9%
LANCASHIRE HOLDINGS	FINANCIALS	4.4%
GRANITE REAL ESTATE	FINANCIALS	3.7%
NATIONAL OILWELL	ENERGY	2.5%
RYANAIR	CONSUMER DISCRETIONARY	2.4%
DCC	INDUSTRIALS & MATERIALS	2.3%
BROOKFIELD ASSET	FINANCIALS	2.1%
SWATCH GROUP	CONSUMER DISCRETIONARY	2.0%
GREAT EAGLE HOLDINGS	FINANCIALS	1.8%
CASH		13.2%

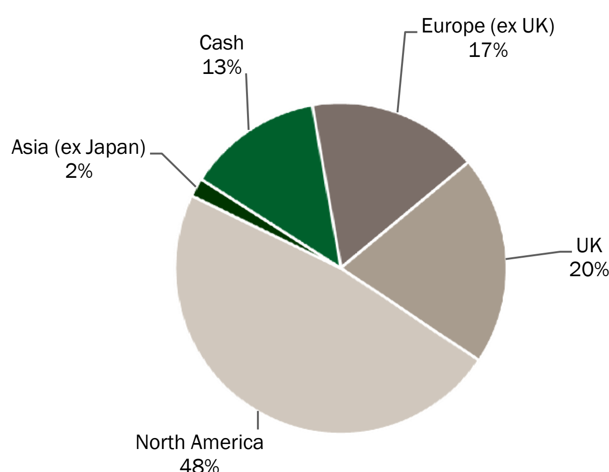
FUND STATISTICS

PRICE/BOOK	1.7
PRICE/EARNINGS RATIO (FY 1)	18.3
DIVIDEND YIELD %	1.5
AVERAGE MARKET CAP € BN	47.6
NO. OF HOLDINGS	18
DEBT /EQUITY %	33.0
ACTIVE SHARE %	91.6

SECTOR DISTRIBUTION



GEOGRAPHIC DISTRIBUTION



YEARLY PERFORMANCE

Year	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Fund	-35.6	3.9	7.6	27.3	17.0	-2.7	-35.2	44.0	28.2	1.5	9.0	20.0	19.1	7.3	11.7	9.7
Benchmark	-32.1	11.3	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 9.7% over the course of the year. As share prices and valuations of certain portfolio holdings have continued to rise, your managers chose to trim a number of existing positions. Cash increased from 9% at year-end 2016 to 13% at year-end 2017. This cash will be deployed as opportunities arise.

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	Year-end Weight	Total Return, Euro
Mincon Group	Industrial	7.3%	39%
Richemont	Consumer Discretionary	4.9%	22%
LSL Property Services	Real Estate	8.1%	22%
DCC Plc	Industrial	2.3%	21%
Brookfield Asset Management	Financial	2.1%	18%

2017 Bottom 5 Performers		Year-end Weight	Total Return, Euro
Great Eagle Holdings	Real Estate	1.8%	1%
Fairfax Financial Holdings	Financial	8.3%	-1%
Lancashire Holdings	Financial	4.4%	-4%
Diamond Offshore Drilling	Energy	5.0%	-8%
National Oilwell Varco	Energy	2.5%	-15%

Top of the pile in 2017 was Mincon (+39%), the Irish manufacturer of drilling tools and equipment for the mining industry. Mincon benefitted from more robust customer demand, but also continues to take market share from its larger competitors due to the high quality of its products (which save its customers time and money). We are excited about Mincon's prospects and continue to believe the stock will prove cheap over the long run.

The two worst performers in the fund in 2017 were Diamond Offshore and National Oilwell Varco (NOV), which are both in the energy services business. As a result of a collapse in the oil price, 2016 was the lowest number of new drilling projects in more than 70 years, according to the Paris-based International Energy Agency; 2017 wasn't much better. Diamond Offshore and NOV are very dependent on new drilling activity and in such a tough environment they have struggled (we have covered this in previous reports e.g. Q4:16 here). We are hesitant to say it, but the worst looks behind them due to a higher oil price and failing competitors.

We don't know how it will all play out, but it is a cyclical industry – both positively as well as negatively. One scenario is that the demand for drilling rigs and equipment could turn sharply positive, far quicker than anyone currently anticipates.

Portfolio activity was muted in 2017 and during the year the fund took a small position in one new company, Ryanair Holdings (year-end weight 2.4%). This was covered in the Q1 commentary. Ryanair was in the news quite a lot in the second half of the year, firstly for having to cancel flights due to a mistake in pilot rostering (bad publicity that we think has blown over) and subsequently when management reluctantly agreed to recognise and negotiate with unions for the first time ever. In an industry that has been hamstrung by unions historically, this has led to some investor concern. We believe that union recognition will not have much impact on profitability, as management should be able to make offsetting adjustments; for example it can nudge up pricing off a very low base, without impacting volumes. The bottom line is that Ryanair will continue to have significant cost advantages over its peers. However, we will be keeping a close eye on developments.

David Coyne – Portfolio Manager

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