Setanta EAFE Equity Fund (CAD)

Q4 2019

Fund Description

The **EAFE Equity Fund** ('the Fund') is managed by Setanta Asset Management Limited ("Setanta") and is a representative account of the EAFE Equity strategy.

The Fund is an actively managed equity portfolio which holds c.30-35 stocks in the European, Australasian and Far East regions. The portfolio is managed in accordance with the Setanta investment philosophy. The Fund is managed by three portfolio managers, who also look to leverage off the experience and knowledge of their colleagues. The aim is to achieve a sensible level of diversification on a sector and geographic basis. The Fund can hold up to 10% cash where investments of sufficient quality cannot be found.
The investment objective of the Fund is to outperform the MSCI EAFE benchmark over the long term.

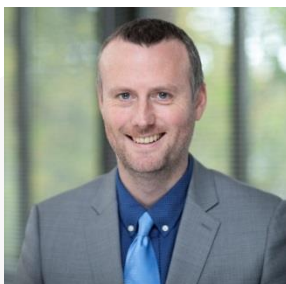
Fund Commentary

The Setanta EAFE strategy produced a strong result in calendar 2019, returning a gross +13.1% in CAD terms. This however lagged the MSCI EAFE index, which returned +15.8%. Clearly our aim is to exceed the benchmark index and so there is a sense of disappointment that we didn't achieve that this year. On the other hand there is also a sense of pragmatism; even the very best managers experience periods of under-performance and this year's "risk-on" market has been hard for those, like us, with a conservative investing style to keep up with.

(Fund Commentary continued on Page 3)

Portfolio Managers

Rowan Smith; Fergal Sarsfield, CFA & Conor Walshe



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

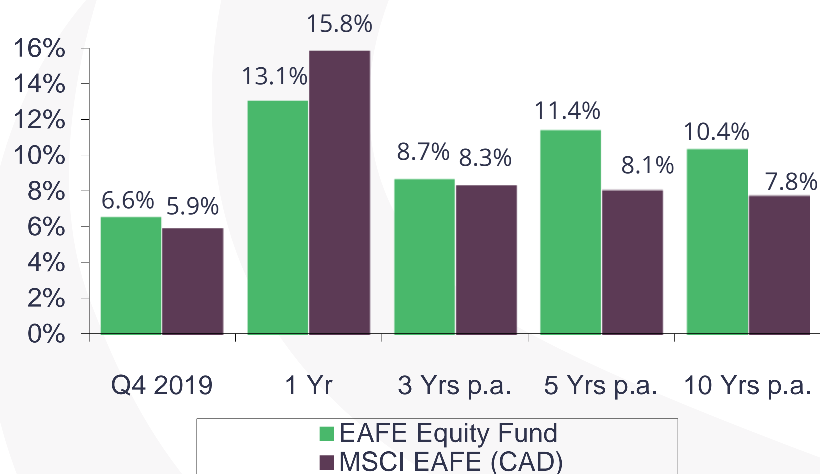
We consider scenarios rather than making forecasts

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 – 31.12.19 (CAD)



Yearly Performance

Year %	2015	2016	2017	2018	2019
Fund	25.2	7.0	16.7	-2.7	13.1
Benchmark	19.0	-2.5	16.8	-6.0	15.8

Performance Source: Setanta Asset Management Limited. The Fund returns stated are based on the movements in the unit prices of the CLA CA Managed EAFE Portfolio SF035 [IEC11007] 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 EAFE (CAD) **Holdings Source:** Setanta. Sector allocations based on invested portfolio only (excludes cash). **Fund Statistics Source:** Bloomberg

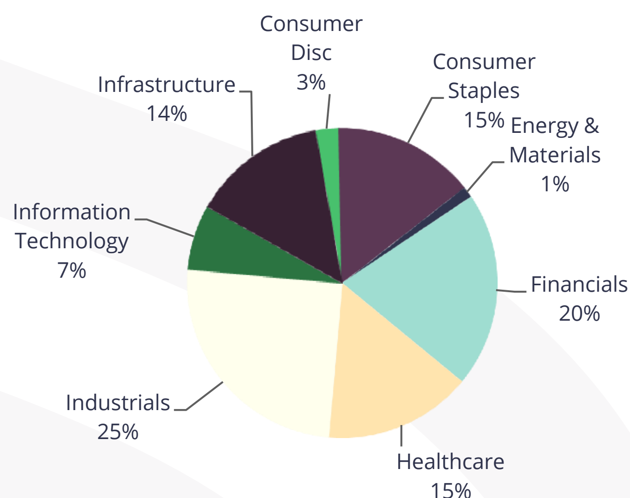
Top 10 Holdings

COMPANY	SECTOR	% OF FUND
GPE BRUXELLES LAMBERT	FINANCIALS	5.6%
DCC	INDUSTRIALS	5.4%
MELROSE INDUSTRIES	INDUSTRIALS	4.9%
RYANAIR	INDUSTRIALS	4.0%
SANOFI	HEALTHCARE	3.6%
KDDI CORP	INFRASTRUCTURE	3.5%
LSL PROPERTY SERVICES	INFRASTRUCTURE	3.4%
UNILEVER	CONSUMER STAPLES	3.4%
COCA-COLA AMATIL	CONSUMER STAPLES	3.3%
NOVARTIS	HEALTHCARE	3.3%

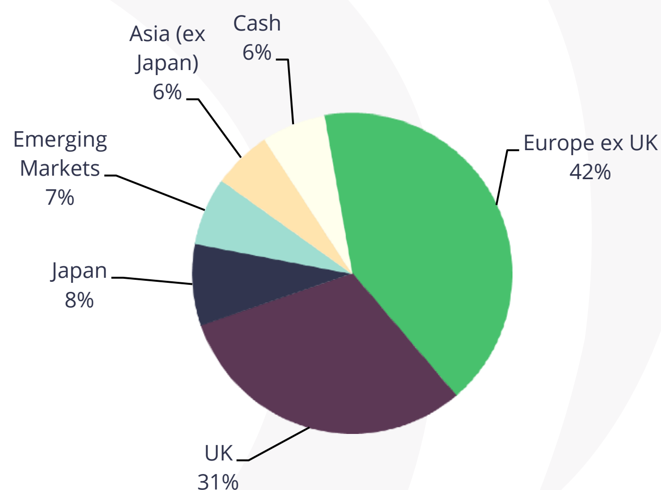
Fund Statistics

PRICE/BOOK	1.8
PRICE/EARNINGS RATIO (FY 1)	15.3
DIVIDEND YIELD %	3.2
AVERAGE MARKET CAP C$BN	54.4
NO. OF HOLDINGS	35
DEBT/EQUITY %	63.9
ACTIVE SHARE %	90.5

Sector Distribution



Geographic Distribution



Commentary

2019 saw a considerable shift in interest rate expectations as central banks, spooked by weakening trade data, associated political tensions and the sharp slide in US stock prices in the fourth quarter of 2018, began to cut interest rates unexpectedly and signalled a more dovish attitude to policy. The ten year US treasury yield declined to 1.9% at end 2019 from 3.2% in November 2018 and the ten year German Bund ended 2019 yielding minus 0.2% (the all-time low was set at an eye-watering minus 0.69% in August 2019).

Financial markets work as extraordinarily complex systems that are unpredictable and difficult to decipher. However we believe that the decline in interest rate expectations probably helped to turbocharge returns in a few categories of the market, including the following;

- High growth companies – longer duration assets with more of the cash flow in the distant future benefit disproportionately from lower discount rates
- Bond Proxies – high calibre businesses that are seen as highly predictable probably benefited from comparison with government bond valuations
- Highly leveraged companies than can potentially benefit from lower interest costs / improved refinancing opportunities in a highly supportive financing market.

We are under-exposed to the first and third categories because of our approach to risk management – we consider too many of these stocks to be priced too highly or to present excessive financial risk to the portfolio. As such, we believe our portfolio was probably adversely impacted, on a relative basis, by the behavioural effects of changing interest rate policy over the past year. The fund's sizeable cash holding was also a clear drag, and admittedly it has been for some time. The cash weighting has been in the 5-10% range for a number of years now. Our thinking has been that in the face of generally high valuations we wanted some dry powder to enable us to take advantage of any market set-backs. There are a range of companies we would like to invest in, or increase exposure to, if share prices were to decline but opportunities for action here have been few and far between in recent years. So this strategy has not paid dividends so far but we still believe it is the right approach.

Key Contributors and Detractors

The fund had a number of significant winners, a few of which are worth mentioning.

Thai Beverage is the largest alcoholic beverage producer and distributor in Thailand. We have been invested in this company for over twelve years and the business and stock have performed remarkably well over that period. The vast bulk of the group's profits come from its spirits business where Thai Bev distils and distributes a range of brown and white spirits to both the on- and off-trade segments across the country. It has a roughly 90% market share in this business, underpinned by extremely strong distribution capabilities and entrenched brands. 2018 saw the share price fall by around one third as pressure on agricultural incomes, and a prolonged period of national mourning following the passing of King Bhumibol, hurt domestic consumption. There was also some concern about the price paid, and debt assumed to acquire majority control of Sabeco, the largest beer business in Vietnam. In 2019, as we had anticipated, results have been much better, and it seems that weak demand trends in the domestic alcohol business were transient. We are also beginning to see improved revenue and profitability in Sabeco after recent product relaunches and price increases. We continue to believe there is potential for Sabeco to benefit from procurement synergies as part of the wider Thai Beverage group and this potential is untapped at this point. All of this led to the stock price rising by almost 50% in local currency in 2019, recovering all of its 2018 losses.

Melrose PLC returned 50% in local currency terms, recovering from a negative return in 2018. To refresh readers, Melrose is essentially an industrial holding company that specialises in business turnarounds. The largest acquisition in its history, GKN Ltd, was completed in 2018. GKN's businesses interests primarily encompassed the production and sale of components for the automotive and aerospace industries. GKN was widely considered to have strong engineering and production capabilities and many, deep customer relationships but perennially achieved rates of profitability below levels that investors believed was attainable for business of its calibre. Melrose management believed it could improve the performance of GKN quite materially. However the acquisition appeared to be getting off to an inauspicious start when the auto industry entered a fairly broad-based slowdown shortly after the deal closed. It was the contention of the Melrose management team that there were enough sources of potential self-improvement in the auto division to substantially weather any slowdown in demand. However investors were sufficiently concerned that the share price declined by over 20% in 2018. As the dust has begun to settle, the company's published results suggest that management's contention was correct – while there has been a fairly modest decline in revenues for the automotive business, this has been offset by cost reduction measures such that divisional profits have been insulated. Furthermore the aerospace business has been performing very well. We are hopeful that trading conditions might be a bit more supportive for the group in 2020 which would clearly help the share price further. We are also hopeful that 2020 might present opportunities for Melrose to dispose of parts (or perhaps all) of Nortek, the company it acquired in 2016 and significantly improved the performance of. This would further demonstrate to investors the strength of the Melrose management model and would allow the group to reduce the level of group borrowings further.

Coca Cola Amatil, the bottler and distributor of Coca Cola products in Australia, New Zealand, Indonesia and Papua New Guinea returned approximately 40% in 2019. Our investment thesis has been playing out pretty well. The largest sales region for the company is Australia and here the portfolio has increasingly shifted away from original coke towards zero sugar coke, energy drinks, water, sports drinks and coffee, which has meant that Amatil's sales volumes have been increasing. Helping here has been investments in the sales force aimed at strengthening ties with retail customers to help improve product positioning, utilisation of coolers and pricing, for example. The New Zealand business continues to perform extremely well, reflecting its dominant market position, and we were glad to hear the company also announce the disposal of its loss making fruit processing company, SPC, which has been a bit of a drag on the group for some time.

That brings the good news section to a close. Clearly performance was impacted by a few painful detractors, most notable of which was Origin Enterprises.

We acquired a stake in **Origin Enterprises** in late 2015. Origin is an agri-services business that provides products (primarily seeds, crop protection chemicals and fertilizer) and agronomy services to farming customers, primarily in Europe. It has a historically strong position in the UK and Ireland and had used that as a platform to expand its operations into Eastern Europe (primarily Poland, Ukraine and Romania), and more recently Brazil, via acquisition. Origin's agronomy services are designed to help farming customers to maximise productivity by advising on how to better use products to improve yields on their land. We felt that the product offering and services complemented each other, made the customer relationship more durable and thereby reinforced Origin's competitive position. As the company rolled this offering into new regions, which were comparatively under-developed, there was significant growth potential.

Commentary

However this thesis has simply not played out and the stock has performed very poorly, declining from around €6.30 at the time of purchase to €3.89 at year end. Over the course of 2019, the stock declined by over 30%. The problems the business has encountered have been numerous. Agricultural commodity prices have been generally low over the period of ownership which has pressured farmer incomes resulting in pricing pressure and customer spending constraints. The acquisitions strategy has produced poor results so far with Origin facing integration challenges in Poland and a breakdown of the competitive market structure in Ukraine. As a result of these challenges in Eastern Europe Origin has had to invest significant additional working capital and has yet to see a return on this investment. In the background there are various structural changes taking place with the supplier base consolidating and various industry agents, including Origin, investing in digital services with no clear monetisation strategy yet apparent. We have been terribly disappointed by the performance of the business and believe poor execution by management has been an underlying problem that must be addressed. We have made this view clear to the executive team and the board and are optimistic that there are self-help opportunities that can be implemented to improve Origin's results, namely a greater emphasis on cost reduction and a pause/curtailment of the acquisition strategy. Despite the clear degradation in our original investment thesis, we believe the stock is cheaply valued and if self-help measures are successfully implemented there is significant upside potential from current levels. Hence we are retaining the position.

Alfresa Holdings Corporation is the largest distributor of pharmaceuticals in Japan. Pharmacists and drug manufacturers rely heavily on Alfresa and its three main competitors to ensure that pharmaceuticals can be transported efficiently from factory to patient. We have been invested in Alfresa since Q3 2017. Our investment thesis at the time of purchase was that demand, whilst mature, is stable and predictable and that it is extremely difficult to see any serious threat to disintermediate this business since it is such a critical cog in the workings of a highly sensitive industry. So whilst growth is very slight, profitability and cash flows are strong and we felt there was little value attributed to the company's enormous holding of cash and financial investments. Since our initial investment the business has performed well, probably a bit better than we expected and the board has also completed a share buyback program, albeit a fairly modest one. We have had the opportunity to meet with the company's president, Kubo-san, twice and we believe the management team is doing a good job overall. However there was negative news late in 2019 when the Fair Trade Commission of Japan announced an investigation into accusations of collusion between multiple distributors on a contract with a large hospital scheme. Alfresa has announced it is cooperating with the investigation but unsurprisingly has provided no other details. We are surprised by this turn of events as these accusations don't fit with the history of competition in this industry, as we understood it. We will await further developments in this matter. In the meantime after a poor year in which the stock price fell by roughly 20%, lagging the market considerably in the process, we are content to remain investors in the company.

The fund has small positions in two Hong Kong listed companies, both of which have performed poorly this year. **Dah Sing Financial Holdings** owns 75% of Dah Sing Banking Group which operates approximately 70 banking branches, primarily in Hong Kong, but also a few in Macau and mainland China. The business has been successfully managed by the controlling Wong family for decades. Operating conditions for domestic banks had weakened as a result of low interest rates, which pressure net interest margins, and the ongoing Sino-US trade tensions. The more recent pro-democracy protests have further destabilised the economy. This latest development is particularly concerning as we have no real idea about how long this instability could persist, and how it might ultimately be resolved given the vastly different viewpoints of the Communist Party of China and the substantial pro-democracy contingent of the local population. This unrest is not to be dismissed. There has been a collapse in tourist numbers, consumer spending and the economy has officially fallen into recession.

However we feel there is a lot of bad news in the share price after it declined by close to 20% in 2019. The bank's capital position is robust and the stock is trading at less than half of its tangible book value. In light of this and the small position size (little more than 1% of the fund) we are happy to retain the investment.

Shares of **Great Eagle**, the Hong Kong listed Property Company that the fund has been invested in since 2015, fell approximately 20% in 2019. To refresh readers, Great Eagle owns office, hotel and retail properties in Hong Kong and also has international interests in the hotel business. The company has been well managed by the controlling Lo family for decades but the stock has been recently depressed as a result of the aforementioned negative macro developments in the domestic economy. Whilst nervous, we take comfort in the substantial discount to its asset value we believe the stock is trading at, as well as the modest position size (approximately 1.5% of the fund at year end). In total the fund has less than 3% of assets invested in Hong Kong stocks so we believe the portfolio's Hong Kong risk exposure is contained.

Portfolio Turnover

There were no new additions or disposals in the fourth quarter. Turnover this year has been low with just a single portfolio disposal, **Ultra Electronics**, and one new addition, **Alcon** (a spin from portfolio holding Novartis), this year.

Concluding thoughts

Whilst we do take comfort from the strong absolute returns produced in 2019, under-performing the benchmark at any time is disappointing because we take pride in our work. However we are determined to retain our investment discipline and we believe the 2019 performance deficit can absolutely be recovered in the future. We are always looking for opportunities to enhance the portfolio but this has proven very difficult because valuations are high across most pockets of the market. And in those rare instances where the valuation case seems more attractive, the business risks are often burdensome. These factors explain why turnover has been low this year, in spite of high portfolio returns.

We will of course continue to do our best to justify the faith our clients have placed in us.

Rowan Smith – Portfolio Manager

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