

# Setanta EAFE Equity Strategy (USD)

June 2021

## Strategy Description

The **EAFE Equity Strategy** ('the Strategy') is managed by Setanta Asset Management Limited ("Setanta"). The Strategy is available to US Investors on a separate account basis.

The Strategy is an actively managed equity portfolio, with a long-term investment horizon. Our aim is to invest in EAFE (Europe, Asia and Far East) companies that are trading below their intrinsic value. Our investment process seeks to invest in companies that exhibit a combination of low financial risk, low operational risk and low valuation risk.

We believe that if we can invest in companies that possess these characteristics then we can reduce the risk of a permanent loss of capital and enhance our chances of outperforming our benchmark over the long term. The investment objective of the Strategy is to outperform the MSCI EAFE index over the long term.

## Strategy Commentary

Equity markets continued their advance in the second quarter of 2021. While Q1 saw a trend towards "value" outperforming "growth" and cyclicals outperforming defensives, we witnessed something of a reversal in favour of growth names later in Q2. The market remained quite firmly in "risk-on" mode. A clear illustration of this is junk bond yields, which have been falling to record lows.

*(Strategy 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

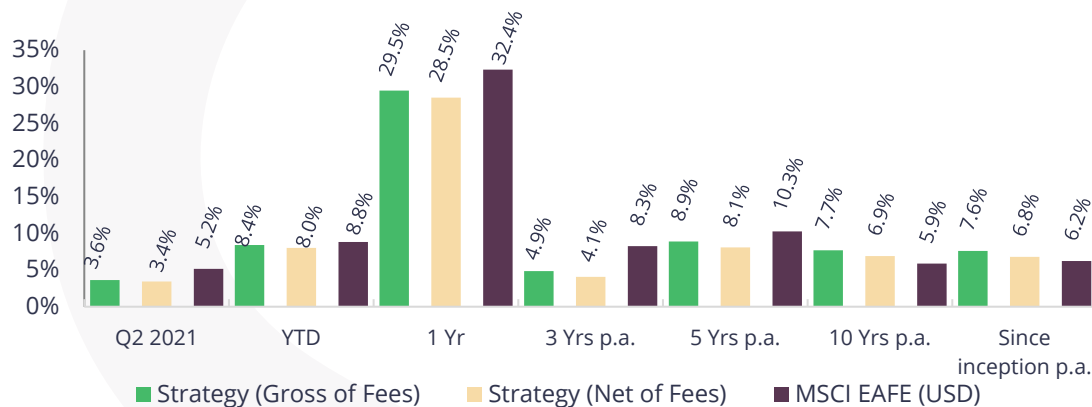
Businesses we own must have strong balance sheets

We make mistakes and always endeavour to learn from them

We will act with integrity in everything we do

# Performance and Strategy data as at 30<sup>th</sup> June 2021

## Strategy Performance (USD)



## Yearly Performance (USD)

	2016	2017	2018	2019	2020
Strategy (Gross of Fees)	10.8%	24.9%	-10.7%	19.1%	-0.2%
Strategy (Net of Fees)	10.0%	24.0%	-11.4%	18.2%	-0.9%
MSCI EAFE (USD)	1.0%	25.0%	-13.8%	22.0%	7.8%

**Performance Source:** Setanta Asset Management Limited. The returns stated are based on the movements in the unit prices of the lead CAD portfolio of the EAFE Equity Strategy, which has been converted to USD at FX rate 0.8075587. The gross performance will be reduced by the impact of management fees paid, the amount of which varies. Net of Fees performance is calculated based on an AMC of 0.75%, which is based on a minimum portfolio size of USD25m. Inception date: January 2004. **Benchmark:** MSCI EAFE (USD).

## Portfolio Valuation Statistics

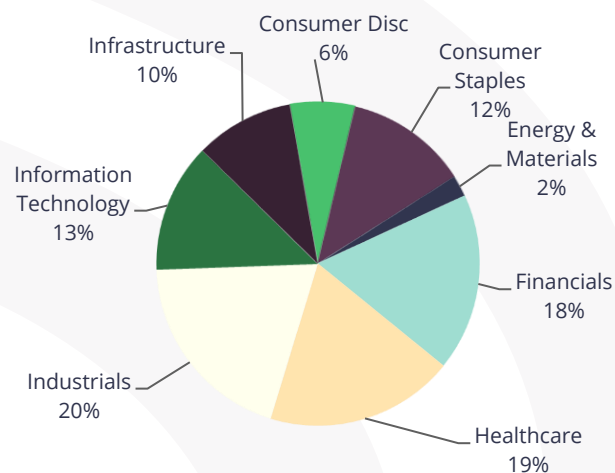
PRICE/BOOK	1.8
PRICE/EARNINGS RATIO (FY 1)	15.1
DIVIDEND YIELD %	2.2
AVERAGE MARKET CAP \$BN	63.3
NO. OF HOLDINGS	36
DEBT/EQUITY %	50.3
ACTIVE SHARE %	92.0

## Top 10 Holdings

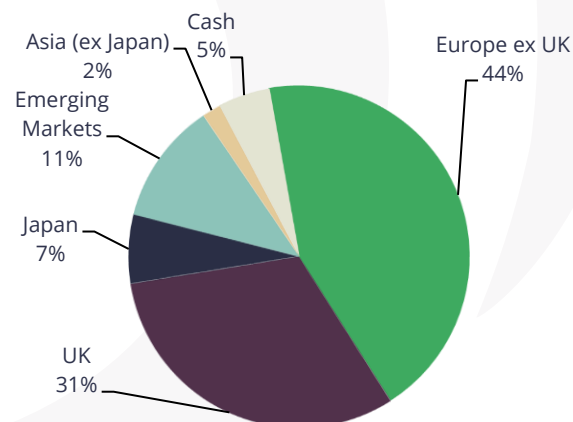
COMPANY	SECTOR	WEIGHT
GPE BRUXELLES LAMBERT	FINANCIALS	6.9%
DCC	INDUSTRIALS	5.3%
SAMSUNG ELECTRONIC	INFORMATION TECHNOLOGY	5.0%
LSL PROPERTY SERVICES	INFRASTRUCTURE	4.5%
ALCON AG	HEALTHCARE	4.1%
DIAGEO	CONSUMER STAPLES	4.0%
UNILEVER PLC	CONSUMER STAPLES	3.9%
GLAXOSMITHKLINE	HEALTHCARE	3.5%
RYANAIR	INDUSTRIALS	3.5%
ERICSSON	INFORMATION TECHNOLOGY	3.4%

**Holdings Source:** Setanta. Sector allocations based on invested portfolio only (excludes cash), of the lead CAD account of the EAFE Equity Strategy. **Portfolio Valuation Statistics Source:** Bloomberg, based on the lead CAD account of the EAFE Equity Strategy, shown in USD.

## Sector Distribution



## Geographic Distribution



## Barclays US Corporate High Yield Bond Index Yield to Worst, 2000-2021



Source: Bloomberg

What makes these levels even more striking is the concurrent degradation in credit standards. As Grant's Daily notes; "so-called covenant-lite structures featured in 85.2% of total loans outstanding in May, per S&P's LCD unit, up from about 66% five years ago and just 17% in 2007". Credit valuations at record highs in spite of record low credit protection. We think this backdrop is instructive about the pricing of risk more generally in financial markets.

Against this backdrop, the Setanta EAFE Equity Strategy lagged the MSCI EAFE Index in the first six months of the year. It has been frustrating that our strategy has been firmly out of favour during the past eighteen months in particular. It doesn't seem to us to be justified by fundamentals. The highly unusual nature of the pandemic induced recession in 2020 adversely impacted many holdings that had historically proven to be reasonably shock resistant. Now that these businesses are recovering, other more cyclical companies have been surmised to be greater beneficiaries of 2021's huge rebound in demand and bottleneck induced industrial price inflation. The coincident backdrop of valuation multiple inflation is also proving to be something of a headwind for our style. With a concentrated portfolio and active share in excess of 90%, a portfolio such as ours can easily lose a lot of ground against a benchmark quite quickly when some of its positions are out of favour. The converse is also true: the portfolio can gain a lot of ground quickly. We don't feel the need to change our approach and we hope that our patience, and yours, will be rewarded.

In the following paragraphs, we look at the some of the main stock drivers of the strategy's performance in the first half of 2021.

Shares in **Alfresa**, the Japanese drug distributor, suffered significant selling pressure following its deletion from the MSCI World Index in May 2021. As Japan's index weighting has fallen the circa thirty smallest holdings, including Alfresa, were deleted by MSCI. The company suffered a sharp fall in profits in the year to March 2021. The Covid-19 pandemic has led to fewer visits to hospitals and GPs leading to fewer prescriptions.





# Commentary

Pharmacies and hospitals have demanded greater price discounts to share the pain. Marketing allowance income was also negatively impacted as Alfresa's sales reps were restricted in visiting customers. Meanwhile, the investigation into collusion by the main wholesalers has rumbled on providing an ESG overhang. While it will take time, we believe profits have significant recovery potential. There is huge potential value to be unlocked from the cash and investments sitting on the company's balance sheet. All told, we believe the stock is cheap, very out-of-favour and offers considerable scope for things to improve.

Shares in **Thai Beverage** have been weak in recent months. The company's dominant position in the domestic spirits industry, which has large off-premise exposure, has helped to insulate profits through the pandemic. However, the rollout of vaccines has been slow in both Thailand and Vietnam which is constraining its beer business in particular. Thai Beverage had been planning to spin out a stake in its beer businesses into a separate company to be listed in Singapore. Management decided to postpone this plan in light of the volatile market conditions; a decision which seems to have depressed sentiment towards the shares. The stock continues to look undervalued.

In our Q1 report, we touched on the share price weakness in **Lancashire**, the specialist insurance company. To recap, last summer the company raised equity capital to fund an expansion in business, on foot of firming pricing across the industry. This backdrop remains favourable and we think results could be very strong for the next few years. However, Lancashire's discipline in the face of the weak pricing environment of previous years meant that the company made little money from 2017 – 2020 so the stock remains a "show-me" story. We continue to see the potential for a re-rating as results begin to improve this year.

**Melrose** was also a drag on performance in the six months to June. It boasts an excellent track record in acquiring under-performing industrial / manufacturing businesses, improving them and then selling at a higher valuation. However, its aerospace (in particular) and automotive exposure as well as financial leverage have weighed heavily on the share price since the pandemic's onset. Management has done a very good job with cost cutting and cash preservation. The H2 2020 profit performance and recent trading update were very reassuring and the company is on course for meaningful recovery over the coming years. Profit margin targets for 2023 for the Automotive and Powder Metallurgy businesses have been retained while the goal for Aerospace has only been slightly lowered. The sale of the Nortek Air Management business for £2.6 billion has placed the balance sheet in a much stronger position and provides further evidence of management's ability to execute on its Buy, Sell, Improve model and deliver significant value creation for shareholders.

**DCC**, the distributor of fuel, healthcare and technology products, enjoyed a share price bounce in the first half. The company delivered an excellent 7% growth in operating profit (3% organic) in the year to March 2021 despite some Covid-19 related headwinds for elements of its business. Cash conversion was very strong and there was an upturn in Return on Capital Employed. A number of acquisitions, a source of significant value creation in the past, were completed in the past year. Investors seem somewhat concerned about the sustainability of the energy businesses. We think the fuel transition will take many years to play out and believe the management team, which has proven adept at adapting to changing circumstances, is fully capable of successfully managing the business through this period. Significant M&A optionality still exists given the strong balance sheet. The stock valuation remains very attractive in our view.

**Diageo's** shares benefited from a strong trading update for the year to June 2021, forecasting organic operating growth of at least 14% year-on-year. The underlying demand tailwinds of premiumisation and spirits taking share from beer and wine remain intact.



# Commentary

The company has enjoyed particularly strong performance in the North American market where consumer demand has been very resilient. Europe has seen strong execution in the off-trade while the on-trade benefits from partial re-opening. Continued recovery is coming through in Africa, Asia Pacific and Latin America.

Shares in **Swatch** and **EssilorLuxottica** continued to recover on expectations that business demand is in the process of normalising.

## Transactions

During the second quarter, we received cash in exchange for shares held in **Coca Cola Amatil** after its takeover by Coca Cola European Partners was completed.

We added a position in **Taiwan Semiconductor** (TSMC) to the portfolio. TSMC is a company we have followed for many years. The company is a semiconductor foundry; it does not design semiconductors, rather it manufactures the chips on behalf of its vast client base. It has long been the dominant foundry, but its position of strength has gone to another level since the semiconductor market has moved to sub 10 nanometer nodes. After a series of industry exits, there is only one viable competitor for these smaller nodes, and it is not optimised for third party production. TSMC boasts an estimated 60%+ foundry market share by value. There is a long growth runway ahead in our view. 5G mobile technology, internet of things, autonomous driving, cloud computing and artificial intelligence all require increases in computation performance in an energy efficient manner. Capital intensity represents a significant barrier to entry, but the largest barrier is the engineering expertise required. The company is investing heavily, and we believe it can stay ahead of the competition. The P/E multiple we are paying of over 25x can be justified by the earnings growth outlook.

We also initiated a position in a Japanese healthcare company but have not completed our purchase at this juncture. We look forward to speaking about this investment in due course.

## Concluding Remarks

On this side of the Atlantic, we are currently enjoying the European soccer championships. It is now 45 years since one of the most famous moments in the tournament's history. The 1976 final between West Germany and Czechoslovakia (the former now part of a unified Germany, the latter subsequently split into two countries) went to a penalty shoot-out to decide the winner. The chance fell to Antonin Panenka to seal the victory for Czechoslovakia. Conventional wisdom was that penalties should be struck to the corner of the net to evade the goalkeeper's reach. Panenka had other ideas and had been practising a new technique in training for some time. He ran up at pace but then chipped the ball very gently towards the centre of the goal. The German goalkeeper Sepp Maier, anticipating a shot low to his left, had already dived out of the way and the trophy was Czechoslovakia's. Soccer writer Ben Lyttleton commented on the subject. "Czechoslovakia was a Communist country, so doing something so creative and spontaneous, which felt impulsive and impudent was really counter to what the country's ethos was about. I spoke to Panenka about what would have happened if he'd missed that penalty. He said he spoke to some politicians afterwards and they said he would have spent 30 years underground, working in the mines". Panenka trusted in his practised technique to go against prevailing attitudes and this style of penalty kick bears his name to this day.



# Commentary

At Setanta, risk aversion is one of the key pillars of our approach. Our first thought when making an investment is what can go wrong. This feels like it runs against the prevailing speculative mood in markets over much of the last 15 months. There is a sense that investors are being complacent and not seeking compensation for risks that in reality are still present. We are remaining consistent in our approach and not letting current market attitudes to risk infect our thinking. We continue to believe that above average quality companies bought at a fair price and held for the long term can deliver excellent investment results.

***Rowan Smith – Portfolio Manager***





## Contact Details:

Setanta Asset Management Limited,  
Beresford Court,  
Beresford Place,  
Dublin 1,  
Ireland.

Alan Hickey, Tel: + 353 1 612 4903  
Email: [Alan.Hickey@setanta-asset.com](mailto:Alan.Hickey@setanta-asset.com)  
[www.setanta-asset.com](http://www.setanta-asset.com)

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The EAFE Equity Strategy is managed by Setanta Asset Management Limited. The performance shown is the performance of the lead CAD portfolio of the EAFE Equity Strategy. This account has the longest performance track record. The strategy is available on a separate account basis to institutional investors however current and prospective clients should not assume identical performance results to those shown would have been achieved for their account if it was invested in the strategy during the period. Clients of the firm may receive different performance than the representative account. Client performance may differ due to factors such as timing of investment(s), timing of withdrawal(s), client-mandated investment restrictions and the portfolio not being fully replicated for new accounts or new flows. Investors should consider the investment objectives, risks, charges and expenses carefully before investing. See 'WARNING' and IMPORTANT INFORMATION' sections below.

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