Setanta European Equity Fund

Q1 2022

Fund Description

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

The Fund is an actively managed equity portfolio which holds c.30 stocks which are located in or active in Europe. The portfolio is managed in accordance with the Setanta investment philosophy. That is, the manager seeks to own good businesses for the long-term at prices below what they think they're worth, carefully considering each investment's risk profile.

The Fund is managed by the lead portfolio manager, who also looks to leverage off the experience and knowledge of his colleagues. The aim is to achieve a sensible level of diversification on a sector and geographic basis.

The investment objective of the Fund is to outperform the MSCI Europe index over the long term.

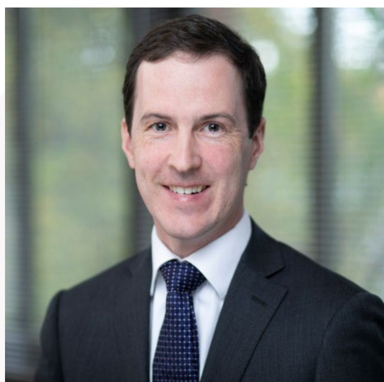
Fund Commentary

Until Russia's horrifying invasion of Ukraine, market developments were unfolding in a manner we had been expecting. The pandemic seemed to be entering a manageable, endemic phase. Consumer behaviour was normalising. Governments and Central Banks across the world were beginning to withdraw the enormous financial stimulus that had helped to define market price action since the spring of 2020

(Fund Commentary continued on Page 3)

Portfolio Manager

David Byrne, 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

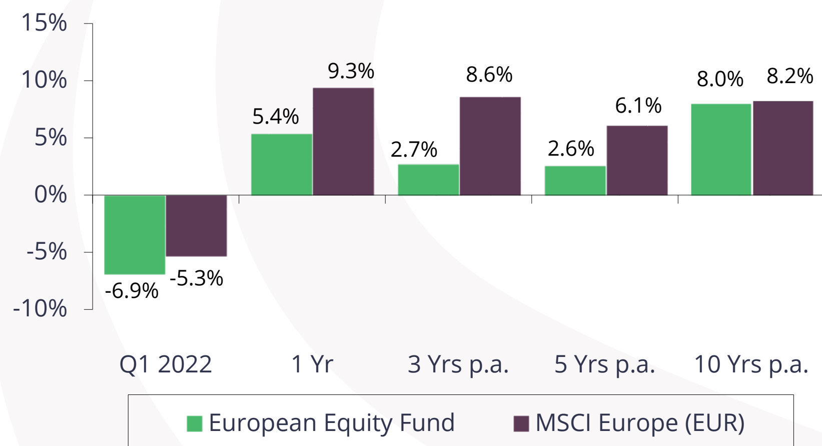
We consider scenarios rather than making forecasts

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 – 31.03.2022 (EUR)



Yearly Performance

Year %	2017	2018	2019	2020	2021
Fund	8.3	-7.3	21.5	-14.0	23.5
Benchmark	10.2	-10.6	26.0	-3.3	25.1

Performance Source: Setanta Asset Management Limited. The Fund returns stated are based on the movements in the unit prices of the ILA/CLI European Equity Fund [IEC7002] 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 Europe (EUR). **Holdings Source:** Setanta. Sector allocations based on invested portfolio only (excludes cash). **Fund Statistics Source:** Bloomberg.

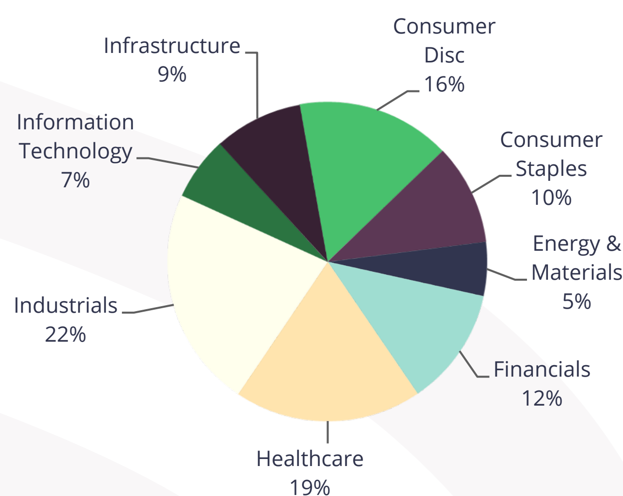
Top 10 Holdings

COMPANY	SECTOR	% OF FUND
DCC	INDUSTRIALS	6.8%
GPE BRUXELLES LAMBERT	FINANCIALS	6.1%
CRH	INDUSTRIALS	5.8%
DIAGEO	CONSUMER STAPLES	5.6%
GLAXOSMITHKLINE	HEALTHCARE	5.4%
SANOFI	HEALTHCARE	4.7%
NOVARTIS	HEALTHCARE	4.6%
LIBERTY GLOBAL PLC	CONSUMER DISCRETIONARY	4.3%
GEA GROUP	INDUSTRIALS	4.2%
ERICSSON	INFORMATION TECHNOLOGY	4.1%

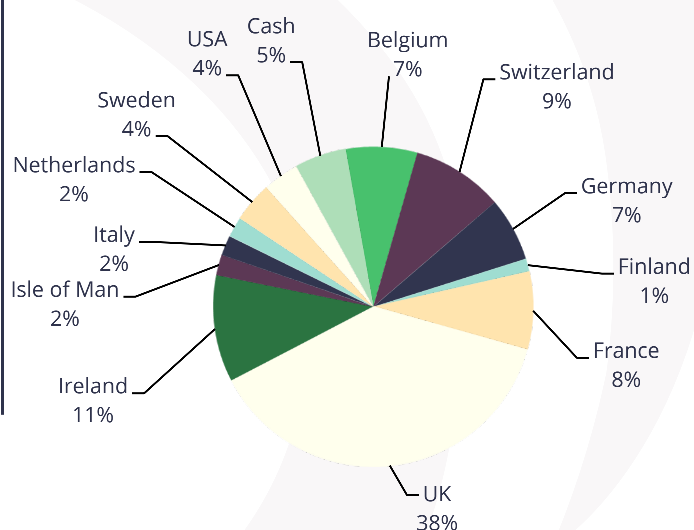
Fund Statistics

PRICE/BOOK	1.8
PRICE/EARNINGS RATIO (FY 1)	13.8
DIVIDEND YIELD %	2.6
AVERAGE MARKET CAP €BN	41.1
NO. OF HOLDINGS	30
ACTIVE SHARE RATIO %	88.0
DEBT/EQUITY %	61.2

Sector Distribution



Geographic Distribution



Commentary

Investor expectations were readjusting accordingly and the Setanta portfolio was regaining ground that had been lost during the two previous, extraordinary years. Putin's appalling actions have created a new round of uncertainties for markets. Barring additional catastrophic developments in the conflict, and critically, assuming the global economy can return to some form of normality, we think the longer-term prognosis for the portfolio will be little changed by these events, as unconscionable as they are. Nonetheless, while the companies in which the Setanta portfolio invests have only marginal direct exposure to the Ukraine-Russia region, there will be indirect impacts that could be painful in the nearer-term. Supply chains that were placed under severe strain during the past two years, and were beginning to normalise, are now being compromised again. Sanctions, port closures and transportation restrictions resulting from the invasion are compounding existing shortages, causing commodity prices to increase across the board. These stresses could hardly be coming at a more difficult time, with inflationary pressures already biting. The only saving grace is that Europe is now through winter.

Some examples of the new economic stresses:

- EU imports of natural gas from Russia account for almost 40% of consumption. Oil is closer to 25% of EU consumption and coal probably closer to 50%. Energy prices have increased substantially since supplies of oil were already struggling to keep pace after years of lower upstream investment across the industry.
- Higher petroleum prices are feeding into higher prices for derivatives such as chemicals and plastics.
- The Financial Times estimates that Russia and Ukraine supply close to one third of the world's wheat exports, a fifth of global corn trade and almost 80% of global sunflower oil production.
- Russia and Belarus produce 40% of the world's Potash (a critical input in fertilizer production). Fertilizer prices had already increased substantially due to high gas prices.
- Ukraine supplies 50% of the world's neon gas, which is a critical input for semiconductor production.
- Ukrainian companies are important producers of wiring harnesses, that are used to hold the electronic cables together in cars. Some European automobile manufacturers have already curtailed production because of shortages of these and other parts.
- Russia is a key producer of high-grade nickel which is used to produce stainless steel and batteries for electric vehicles
- Shortages of building materials, including bricks, pipes and slates, are emerging in Europe, due in part to the impact that high energy prices are exerting on producers. The cost of construction materials in Europe has already risen by more than 20% in the past year, with more to come.

These difficulties are of course accentuating the pressures on consumer budgets that were already coming under strain, thanks to inflation in prices of energy, basic materials, and food. The impact on retail prices will vary by region, depending on local market conditions, but futures prices for Wheat, Oil, Corn, and Copper have increased by approximately 80%, 70%, 40% and 20% respectively over the past year. We can therefore expect some impact on consumer spending in the coming quarters at least.

The longer-term risks are, however, more troubling. We are not geopolitical experts but clearly these military developments, and China's perceived support of Russia, have potentially very serious implications for the global economy; implications that extend well beyond near-term supply chain disruption. The modern economy has thrived through globalisation, and China has been central in that process. Not only has it become a critical manufacturing hub, but it has become a key market in itself for western goods. For some years, governments across Asia and the West have been increasingly uneasy with President Xi's growing projection of Chinese power. These recent developments have the potential to bring the world closer to a new type of cold war and an unravelling of the process of globalisation. This would have far-reaching consequences and it is difficult to know where investors could seek shelter in such a setting. Fortunately, such a scenario is not in the best interests of China or the West so our base case is that pragmatism will win out. Everyone should hope that it does.

Commentary

Given this backdrop, there was substantial rotation within the stock market during February and March. Share prices of companies in the mining, oil & gas, renewable energy and defense sectors have risen sharply since the invasion. We have very little invested in these sectors. The Setanta portfolio is heavily invested in companies exposed to manufacturing, general industry, finance and consumer spending and these sectors have under-performed materially since the war began. For example during February and March the Stoxx Europe 600 Basic Resources sector rose by c.17% in US$ terms with the Autos and Travel & Leisure sectors down by more than 10%.

Interest Rates

As inflation expectations rise across the world, bond yields have been following suit. The US Federal Reserve has begun to raise interest rates, and although the UK's Bank of England has implemented three quarter point hikes in recent months, Europe is generally in a different place to the US. The US economy is booming. Europe's isn't and it now faces threats from the war in Ukraine. Nevertheless ECB council members seem concerned about firmer inflation expectations taking hold and so it seems likely that Euro interest rates will increase from here. Consequently we've seen the German 10-year government bond yield rise to a towering 0.6%, having spent almost three years in negative territory.

As is well known, interest rates have been low and falling since the global financial crisis (depending on perspective, one could extend this reference period to twenty five years!). If we are now beginning a move into a new phase of meaningfully higher interest rates, what will the impact of this be on an economy that had become so used to cheap and readily available credit? The channel of greatest concern is probably the housing sector – how high would rates have to go to catalyse a severe demand retrenchment? The government channel also concerns us. Government debt levels are historically high almost everywhere, not least in places like Italy, France, Greece, Portugal and Spain.

Thus far, the stock market has largely taken rising bond yields in its stride but we are nervous. We continue to believe that well financed, good quality companies will prove to be better positioned than inferior companies that might look cheaper at first glance.

Ten Year German Government Bond Yield 1980 – 2022

Commentary

Key developments at portfolio companies

Ericsson

Shares in Ericsson fell very sharply during the quarter. The company disclosed some details of a 2019 investigation into the conduct of employees in Iraq between 2011 and 2018. The investigation, which involved external counsel, identified serious breaches of its code of ethics, including evidence of payments to unknown intermediaries and the use of alternate transport routes, at a time when ISIS controlled swathes of the country. Although Ericsson could not determine the ultimate recipients of these payments, it seems reasonable for us to infer that ISIS, or some similar organisation, may have received payments indirectly from Ericsson, perhaps to facilitate passage. As a result of the investigation, several employees departed and other disciplinary and corrective actions were implemented. Ericsson also terminated a number of third-party relationships.

What makes this episode particularly unpleasant is that Ericsson had already paid over $1 billion, having entered a Deferred Prosecution Agreement with the US Department of Justice in 2019, following allegations of corruption in five countries (Djibouti, China, Vietnam, Indonesia and Kuwait). Ironically, having already gone through this expensive and arduous process, we felt it was highly likely that all skeletons were already out of the closet, so this news came as a shock to us. It is our understanding that the company disclosed the Iraq investigation to the DOJ prior to the DPA, but the DOJ has now deemed that disclosure to be inadequate. It is unclear what steps are next, but a new review of some description, plus additional fines, appear likely. This update leaves a bitter taste in the mouth. We have decided to retain the position having considered some mitigating factors:

- Borje Ekholm was appointed as CEO in 2017 to lead a turnaround of the business. This turnaround included groupwide investment to improve compliance systems and processes. Clearly these things can take time to take full effect and we think it is likely that substantial progress has been made.
- Ericsson's technologies provide a competitive and credible alternative to those from Chinese operators, including Huawei and ZTE. The solutions from Chinese competitors come with material security concerns, and there are few alternatives besides Ericsson.
- Ericsson has lost in excess of $10 billion in market cap since the news broke, which we believe likely substantially exceeds the value of potential penalties.

Shares in *Ryanair*, *Melrose* and *Lancashire* all fell sharply after the Russian invasion.

Although *Ryanair* has an immaterial presence in Ukraine/Russia, investors' concerns would appear to centre on two points: (1) the potential for booking trends across Europe to decline as a result of the war; (2) the impact of higher fuel prices on its existing business.

Regarding (1), booking trends were recovering strongly as covid restrictions were lifted across the continent. These dipped during the first few weeks after the invasion but indications are that the trend has since reversed and bookings are growing again. Regarding (2) Ryanair is in a more favourable position than many, having hedged the bulk of its fuel needs for the next four quarters or so. We are already seeing weaker competitors seek to increase prices in response to rising fuel costs, which provides some market support. If fuel prices remain high into 2023 we expect a combination of higher prices and industry-wide capacity reductions to help to offset the burden on Ryanair. Ryanair has thrived in prior periods of higher oil prices and we continue to believe the company will be a long-term winner as a result of its strong Balance Sheet and industry leading cost structure.

Melrose is largely exposed to two key end markets. Automotive components and Aerospace (primarily civil) components. Underlying demand for new cars seems to have fully recovered to 2019 levels or higher. The difficulty has been that OEM production has been constrained by a shortage of components; primarily semiconductors. This problem was easing in recent months but the invasion throws a potential new spanner in the works given the scope for further supply-chain challenges. At this point Melrose management is hopeful that automotive customers can find alternative component sources but visibility remains limited at this juncture. We believe that the supply chain issues will eventually be resolved. Management has done a good job managing costs and cash flow over the past two years. The Balance Sheet has improved materially and the auto business is primed to see meaningful margin improvement when underlying demand can be fully realised. The aerospace division is a bit further behind, with demand for wide-body aircraft (long-haul) still lagging, but narrow body (short-haul) demand recovering. Management expects to have largely completed the aerospace division restructuring by the end of this year such that margins should have potential for substantial expansion as demand recovers over the next few years. In short, we still see significant value in the business.

Investor confidence in *Lancashire* has been low for some time, the result of elevated underwriting losses in recent years. It is perhaps unsurprising therefore that the market took a "shoot-first" approach to the evaluation of the likely impact of the war. The particular point of concern here is likely around the risk in the company's aviation book; especially the extent of potential losses incurred by aircraft leasing companies that have lessees in Russia and have insured the risk of loss with Lancashire. The situation is still in a state of flux and we don't yet know the outcome but it looks like the >20% decline in the share price is an over-reaction.

Aircraft leasing companies cancelled contracts with Russian airline operators in February/March and requested return of the aircraft. However it appears that Russian authorities have facilitated a re-registration of the aircraft in Russia (i.e. for now, it seems the aircraft have effectively been stolen). Russian aircraft are essentially prohibited from flying internationally and spare parts will not be provided by Airbus or Boeing. The local authorities are possibly planning to strip the pilfered aircraft to use as spare parts for domestic flights. This exposes Lancashire to potential losses since its clients may be unable to recover their assets. However there are numerous potential offsets here:

- Lancashire cancelled contracts via seven-day notice period in late February, without any apparent losses to that point. This does not mean the company is off the hook since the courts may decide that any loss was effectively incurred when the war began (i.e. prior to the cancellation date).
- EU sanctions prohibit insurance "for use in Russia" – it appears companies like Lancashire may not have to pay out, even if they were deemed liable, since sanctions seemingly voided the contracts
- If any loss from asset confiscation is deemed to have been derived from an action by the airline rather than the government, then the cover probably defaults to an all-risks policy rather than a war policy (Lancashire probably has modest exposure to the former)
- Russian airlines will claim they have been trying to make payment, albeit in roubles. This might make any loss the responsibility of the leasing company or the government
- Lancashire will have utilised reinsurance to offset a significant portion of losses that may be incurred.

Commentary

There are a lot of moving parts and given the uniqueness of the situation it is likely that the allocation of any losses will be argued in courts for years. Our belief is that this is a manageable risk and it is somewhat reassuring to see that some Lancashire managers have been buying shares in the open market recently. The market cap has fallen by close to $400 million. The stock has under-performed its peers meaningfully and trades at a material discount to those peers.

Shares in Sanofi outperformed. Although it announced disappointing results from a drug targeting breast cancer, it announced positive results for a clotting factor drug designed to treat Haemophilia. The company's 2021 fourth quarter results were also well received.

Shares in Bank of Ireland gained. The company reported good full year 2021 results with continued write-backs of loan loss provisions accrued in the early phase of the pandemic. Furthermore the backdrop of rising bond yields is generally supportive as it helps underpin net interest margins. We also saw ICS, one of the non-bank competitors in Irish mortgage market, increase its fixed rates. This is likely driven by rising wholesale funding costs and helps to underpin pricing in the mortgage market. Bank of Ireland, which benefits from a substantial customer deposit base, is better insulated from these funding cost pressures.

Transactions during the Quarter

There were no transactions during the quarter.

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