Setanta EAFE Equity Fund (CAD)

Q1 2022

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.30-50 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.

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

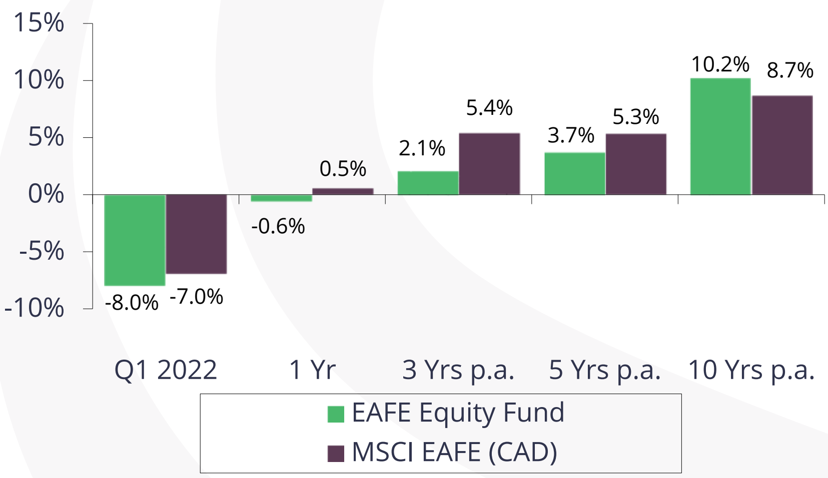
We consider scenarios rather than making forecasts

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 – 31.03.2022 (CAD)



Yearly Performance

Year %	2017	2018	2019	2020	2021
Fund	16.7	-2.7	13.1	-1.9	11.5
Benchmark	16.8	-6.0	15.8	5.9	10.3

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.

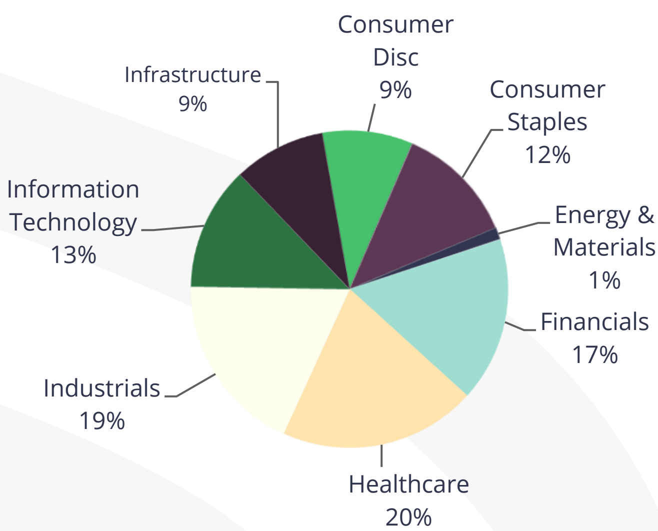
Top 10 Holdings

COMPANY	SECTOR	% OF FUND
GPE BRUXELLES LAMBERT	FINANCIALS	5.4%
DCC	INDUSTRIALS	5.2%
ALCON AG	HEALTHCARE	4.9%
DIAGEO	CONSUMER STAPLES	4.6%
SAMSUNG ELECTRONIC	INFORMATION TECHNOLOGY	4.5%
LSL PROPERTY	INFRASTRUCTURE	4.0%
ESSILORLUXOTTICA	CONSUMER DISCRETIONARY	3.9%
THAI BEVERAGE	CONSUMER STAPLES	3.8%
GLAXOSMITHKLINE	HEALTHCARE	3.7%
BANK OF IRELAND	FINANCIALS	3.6%

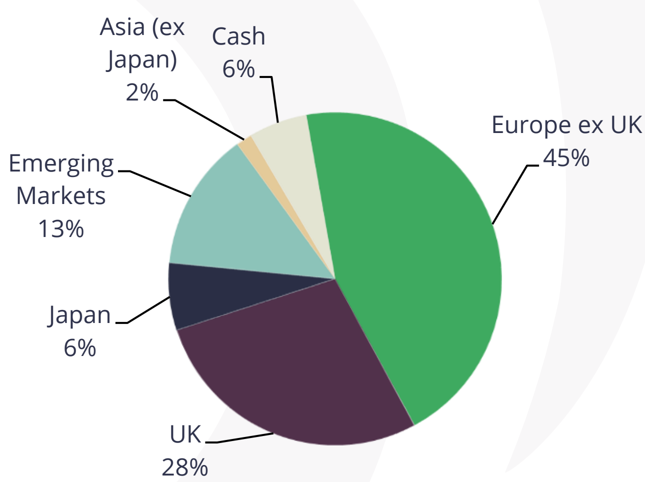
Fund Statistics

PRICE/BOOK	1.8
PRICE/EARNINGS RATIO (FY 1)	13.6
DIVIDEND YIELD %	2.6
AVERAGE MARKET CAP C$BN	93.7
NO. OF HOLDINGS	34
DEBT/EQUITY %	38.8
ACTIVE SHARE %	91.6

Sector Distribution



Geographic Distribution



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. 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.

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 defence 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%. Furthermore, it seems the closer a company's proximity to the affected region, the greater its share price under-performance. The Setanta portfolio is overweight Europe and underweight Japan and Australia. These sector and geographic skews explain the vast bulk of the portfolio's under-performance since the invasion. Portfolio and benchmark returns were also somewhat depressed by further, modest softness in the Euro as well as weakness in the Yen.

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

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. 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 no material 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.

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 KDDI performed well, possibly reflecting some investor views that spend on telecom services should be more inflation resistant than many other categories. Also the share repurchase program was increased slightly, which perhaps further boosted sentiment somewhat. Shares in Alfresa, the Japanese drug distribution business, recovered some of 2021's losses with the valuation having ended 2021 at very depressed levels. Shares in Thai Beverage outperformed as optimism grew about a recovery in demand, with pandemic restrictions easing in Thailand and Vietnam.

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

We exited Smiths Group PLC and Proximus.

The investment in Smiths Group didn't work out quite as well we'd hoped. Despite seemingly good market positions across a range of industries, business growth was below our expectations and we had already reduced our position. The board recently appointed a new CEO but we are worried that the desired improvements might be harder to realise than he hopes.

Proximus is the leading telecommunications company in Belgium. The regulatory backdrop across the continent has been consistently unsupportive of these businesses, despite political rhetoric around the need for investments in communication technologies. We are concerned that the company faces a prolonged period of investment and we don't have the confidence that it will be allowed to earn commensurately. Reflecting these concerns the position was small for some time, but we felt it was time to close the book on the investment in Proximus.

Tencent

The aforementioned disposals funded a new, modest position in Tencent. Fergal describes the company as a combination of Facebook, Nintendo, Shopify, Netflix, Spotify, Paypal and Azure, with a substantial venture capital business on the side.

Tencent's WeChat app, used by over 1.2 billion consumers, has been described as "the operating system of China". WeChat, originally a messaging app, has been the platform on to which additional services have been bolted. These include music, video, gaming and payments. Use of WeChat and ancillary applications accounts for over one third of time spent on the internet by Chinese consumers. It's common for companies to have WeChat Official accounts instead of websites and for Government agencies to use WeChat as a medium of communication.

The huge WeChat installed base acts as a significant competitive advantage by lowering customer acquisition costs, and raising the odds of success for new products. Tencent is estimated to have 50% of the mobile gaming market and >70% of the music streaming market in China. WeChat Pay is the second largest payments platform in China, in what is essentially a duopoly, with Alipay (roughly 40% and 55% market share respectively). Tencent operates a substantial cloud business, which is currently loss-making, but we believe could prove to be very valuable. The cloud business is central to Tencent's push into the enterprise sector. It provides a range of cloud solutions, as well as applications like Tencent Meetings (similar to Zoom), WeCom (enterprise CRM), Tencent Docs (Excel equivalent), in a SaaS based business model to corporates, and this creates the potential for a long runway of growth.

Tencent also has a substantial investment portfolio. We believe it has stakes in over 1,000 digital companies; predominantly Chinese, but also other international businesses. While around 80% of the value of its current investment portfolio is in listed companies, much of the future value may lie in the hundreds of private companies Tencent is nurturing and helping to grow. At current prices the portfolio accounts for perhaps 40% of the company's market cap.

We believe the WeChat network is exceptionally strong, and extremely valuable. However there are risks. Tencent, like essentially all Chinese foreign listed companies, uses a Variable Interest Entity (VIE) listing structure to bypass foreign ownership restrictions. This means that foreign shareholders have no legal claim on the assets of Tencent but rather own a company with a contractual arrangement to receive cash flows from the operating company. We have been studying Chinese VIE arrangements for years and today we see the risk around the structure as reasonably low. We believe the Chinese government has essentially endorsed the structures for companies with an existing listing. More generally we believe the Chinese Government has seen the benefits that overseas listings have brought to the digitalisation of the economy and we believe that companies such as Tencent, that operate alongside government objectives for national development, will be allowed to prosper. Nonetheless, while we have weighed these risks against the opportunities for the business, the risks are unusual and admittedly, hard to quantify. We believe these risks are at least partly reflected in the share price and we have further reflected these through the relatively modest position size, with Tencent accounting for c.2% of the portfolio.

When we made the investment in Tencent the stock was c.40% below its 2021 high. We never expect to pick the bottom, but always hope the bottom is not too far away. These hopes were ill-founded with Tencent share price continuing to fall sharply. The shares are now trading c.50% below the 2021 high. News flow for China exposed companies has been poor recently. Economic growth is slowing, in part the result of the zero covid policy, with lockdowns being reintroduced, most recently in manufacturing hub, Shenzhen and financial centre, Shanghai. The rising cost of energy, of which China is a substantial importer, is another source of economic pressure. There are now concerns about whether Western sanctions could be targeted at sections of the economy in response to China's perceived support of the Putin regime. The threat of delisting Chinese companies from US exchanges has been building too. The Holding Foreign Companies Accountable Act facilitates delisting from a US exchange of any company whose auditor does not facilitate a US audit inspection. This legislation is essentially targeting Chinese companies listed in the US. This threat is very real since the Chinese government to this point has not enabled the required access to audit papers. With a primary listing in Hong Kong, this does not fundamentally impact Tencent but the headlines are amplifying already depressed sentiment. However, we see significant upside potential for Tencent over the longer term.

We would like to thank all of our clients for their continued support.

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Co-Lead Portfolio Manager.

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