Setanta EAFE Equity Fund (CAD)

Q2 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

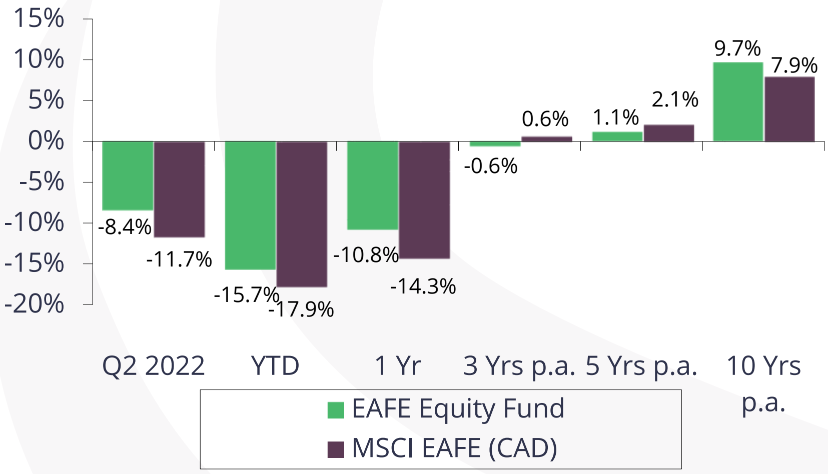
We consider scenarios rather than making forecasts

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 – 30.06.2022 (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] till 09.06.22 and LL EAFE Equity Fund 6.84 [IEC15004] thereafter 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.

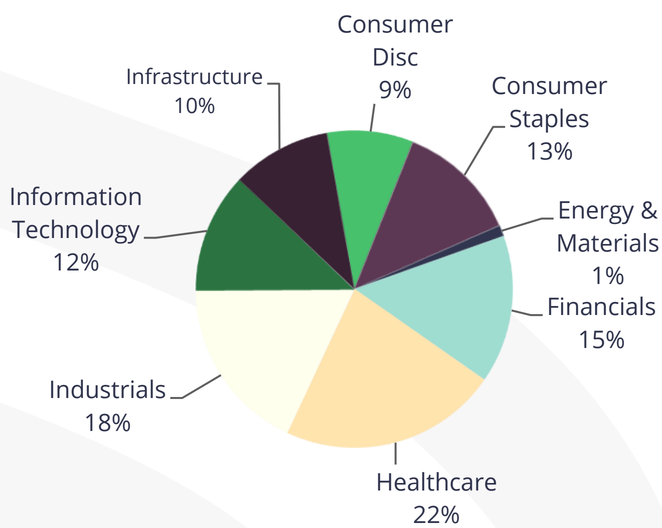
Top 10 Holdings

COMPANY	SECTOR	% OF FUND
ALCON AG	HEALTHCARE	4.9%
DCC	INDUSTRIALS	4.7%
GPE BRUXELLES LAMBERT	FINANCIALS	4.5%
DIAGEO	CONSUMER STAPLES	4.3%
GSK PLC	HEALTHCARE	4.2%
SAMSUNG ELECTRONIC	INFORMATION TECHNOLOGY	3.9%
THAI BEVERAGE	CONSUMER STAPLES	3.7%
SANOFI	HEALTHCARE	3.6%
ESSILORLUXOTTICA	CONSUMER DISCRETIONARY	3.5%
UNILEVER PLC	CONSUMER STAPLES	3.5%

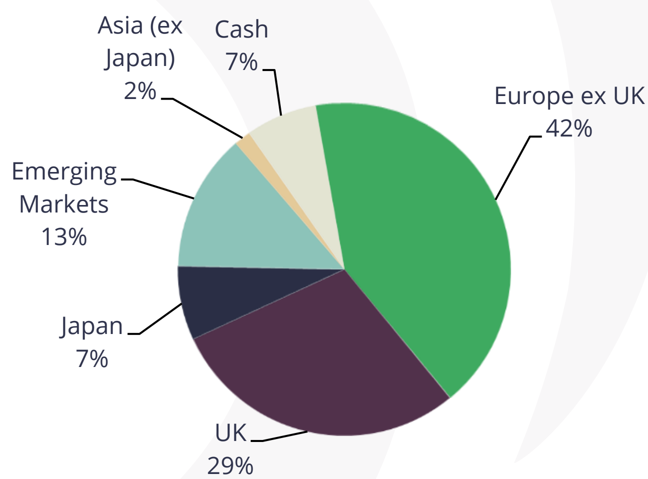
Fund Statistics

PRICE/BOOK	1.7
PRICE/EARNINGS RATIO (FY 1)	13.3
DIVIDEND YIELD %	2.9
AVERAGE MARKET CAP C$BN	80.2
NO. OF HOLDINGS	36
DEBT/EQUITY %	43.5
ACTIVE SHARE %	90.5

Sector Distribution



Geographic Distribution



SETANTA Asset Management

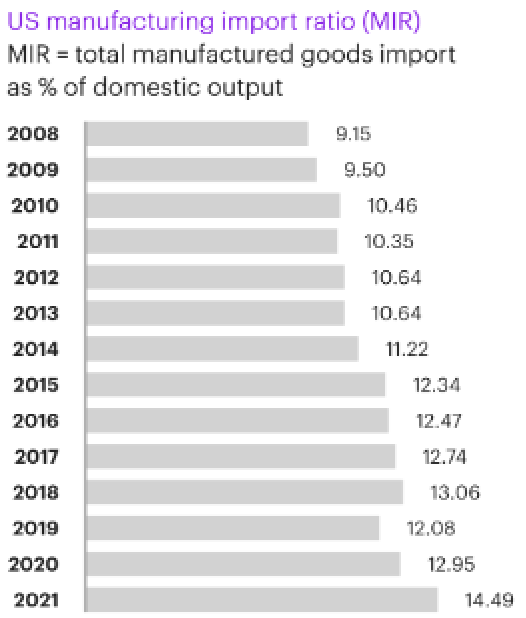
Fund Commentary

De-globalisation, Inflation and Corporate Profit Margins

In our Q3 2021 quarterly report we questioned the transitory nature of inflation and put forward some views on areas like trucking and energy to at least sow the seed that inflation may not be entirely transitory. This report is a continuation of sorts, focusing on the secular trend of de-globalisation, why it's gathering momentum and what it might mean for corporate profit margins and inflation over the medium to long term.

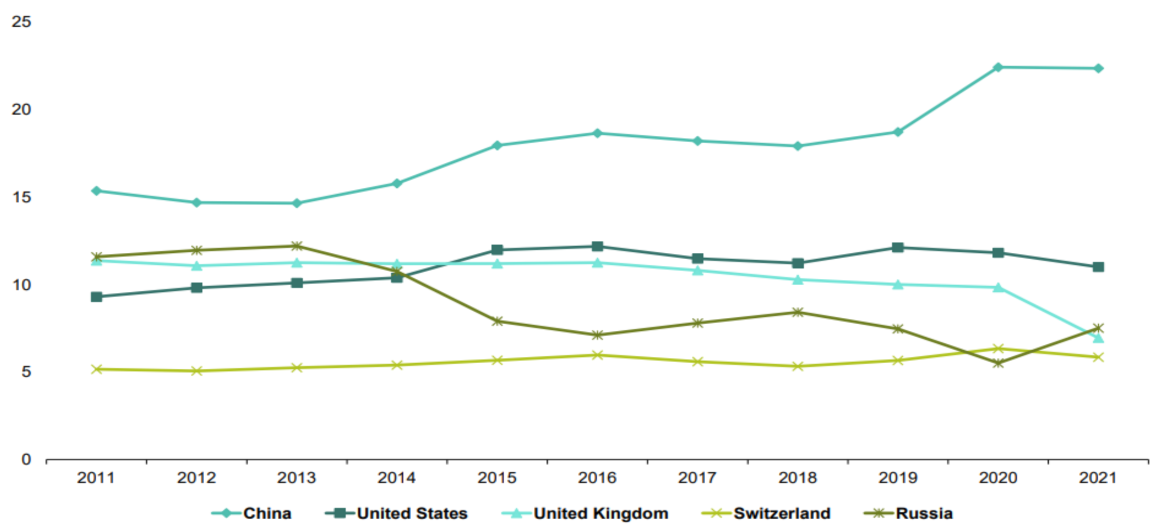
Over the past 4 decades, globalisation has been a dominant theme. The advent of container shipping in the 1970's helped change global trade and facilitated China becoming the factory of the world. Prior to the 1970's, production and consumption was largely local with transport costs over long distances uneconomical for most goods. The development of container shipping in the 1970's, better technology and communications, resulted in lower transport costs and increased efficiency of supply chains. This in addition to China with its low-cost labour and abundant resources facilitated the globalisation of trade and helped China become a manufacturing powerhouse as global corporates flocked to the country to avail of low production costs. To give an indication of the extent of the cost differential between East and West, in the early 2000's the ratio of average manufacturing wages in the US versus China stood at 20x. While it has narrowed considerably to 4x in 2019, China still commands a healthy competitive advantage when it comes to the production of physical goods for consumption on the world stage as well as helping ensure a benign global inflationary backdrop over the past several decades.

Kearney, a consulting company, using data from the US International Trade Commission, Bureau of Economic Analysis and their own data compile a US manufacturing import ratio (MIR) which shows the imports into the US from 14 Asian low-cost countries.



While the US has become more reliant on low-cost countries for imports, so too has Europe which has seen its imports from China increase by almost 50% over the past 10 years. Moving from 15% to 22% over the 2011-2021 time period.

Shares of EU imports of goods for main partners, 2011-2021, %



Source: Eurostat, Bernstein Analysis

The trend over the past 14 years has unquestionably been towards increased imports from China and other low-cost countries, however there is evidence that the tide is beginning to turn and globalisation as we know it may be coming to an end. The Covid pandemic has resulted in significant supply chain disruptions and that coupled with increased geo-political risks is resulting in a mindset shift from globalisation to de-globalisation.

A survey by the American Chamber of Commerce in China of 121 companies with operations in China showed that confidence in doing business in China continues to decline with over half of the respondents (52%) indicating they have already delayed or decreased investments in China since the most recent Covid lockdown. Also, Brian Ehrig, partner at consulting firm Kearney, wrote a report that found 78% of CEO's who have manufacturing operations in China have either already moved part of their operations to the US or plan to do so in the next 3 years as well as 92% of US executives expressing positive sentiments towards reshoring.

De-globalisation, near-shoring, or reshoring is being driven by both corporates and governments alike, with the US and Europe intent on reducing dependency on China while corporates are looking to pursue the best cost rather than the lowest cost and are weighing up cost against other factors like supply chain resiliency and sustainability.

Q2 2022 Commentary

Janet Yellen, US Treasure Secretary, has referred to de-globalisation as "friend-shoring", and the desire for the US to increase trade relationships with a group of partners where there are little concerns over geopolitical issues.

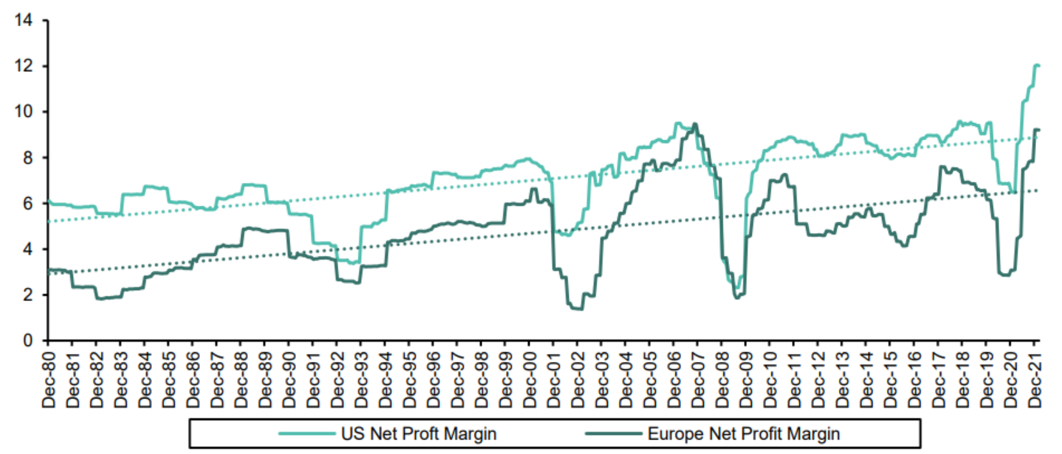
The intention is clear, the US wants to bring production either back to the US or to countries where they have a healthy relationship. They're passing legislation aimed at tackling competitiveness of US companies versus Chinese counterparts as well as creating new initiatives to dilute their dependency on China. The Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act is aimed at supporting US semiconductor manufacturing and includes $52bn in federal investments while the Senate has passed the United States Innovation and Competition Act (USICA) with the House passing the America COMPETES Act.
The Indo-Pacific Economic Framework (IPEF) will see Australia, India, Japan, South Korea, New Zealand as well as 7 other Southeast Asian countries join the US in order to counter China's influence in the region. According to the White House it will constitute 40% of global GDP with the absence of China very notable and shows a deep commitment by the US to become less reliant on the factory of the world.

It's very clear that western policy makers especially the US are pushing a de-globalisation strategy. Additionally, companies have also realised through the global pandemic that their supply chains are far from efficient with too much outside their control. Production delays due to persistent Covid lockdowns in China, bottlenecks in transport and logistics and rising freight costs have all led to corporate management teams re-evaluating their supply chains and looking for a more regional approach rather than over-reliance on China. The mindset shift from lowest cost to best cost production and from just-in-time to just-in-case inventory management are aimed at future proofing western world supply chains for the next decade.

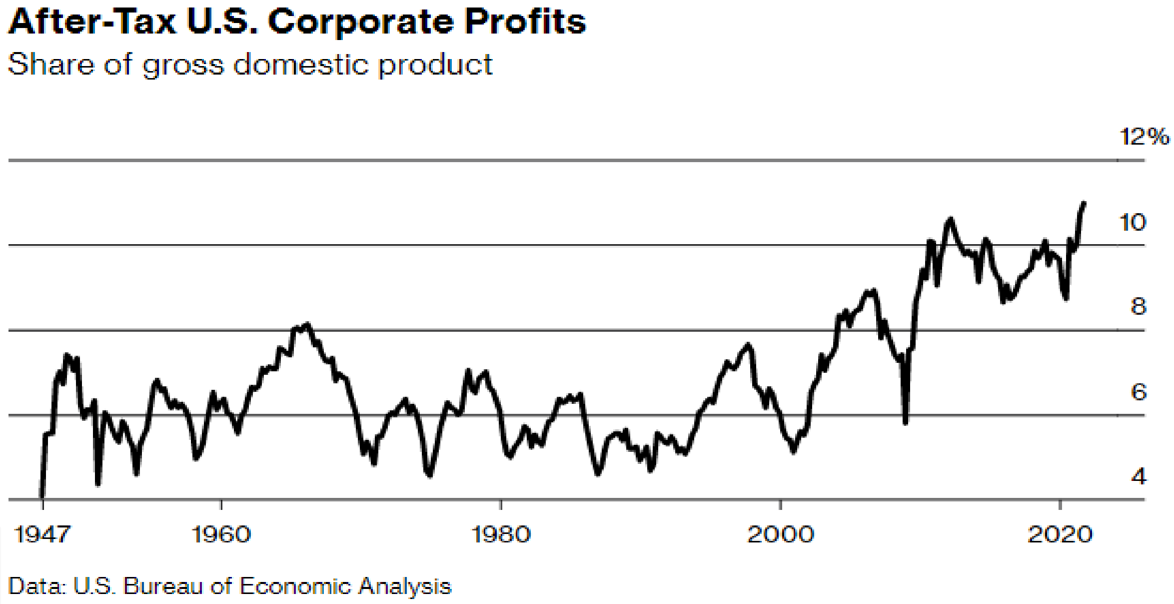
But at what cost? What will the cost of these legislative measures and corporate strategic changes be to corporates and consumers over the coming years?

Globalisation has been very favourable for corporate profit margins with margins in the US and Europe at historic highs and in the case of the US contributing the highest amount ever to GDP. US profit margins have almost doubled from 6% to just shy of 12% over the past 40 years while European profit margins have almost tripled from 3% to close to 9% over the same period.

US and European Net Profit Margins



Source: Source: Datastream, Bernstein analysis
The data series are the reported net profit margins published by datastream for their US and European equity market indices. The dotted line is the long term for the series.



Of course, technology and innovation have resulted in greater efficiency in the production of goods and have played a part in allowing corporates to earn higher margins but so too has globalisation and a shift towards de-globalisation must surely present downside risk to profit margins. Higher capital costs, higher labour costs and higher working capital costs will all present challenges for global corporates as they friend-shore.

To give an example of the challenges facing companies as they look to shift production from East to West, TSMC the world's largest and most profitable semiconductor manufacturer has a fab in Oregon for the past 25 years but has never been able to get it to the same level of profitability as their Taiwanese fabs. The CEO is quoted as saying that for the same chip the Oregon cost is 50% more than the Taiwan cost.

Semiconductors are the building blocks in a digitised and interconnected world, and if the US and Europe want to promote increased self-sufficiency in the production of semiconductors this will invariably come at a higher cost which will have to be borne by the producers of the end product thus impacting their margins or be passed on to the end consumer thus resulting in higher end market prices and inflationary pressures.

The Labour market also presents a challenge for de-globalisation and inflation. With an extremely tight labour market it is proving very difficult for US corporates to hire and the prospect of bringing more production back to the US will only exacerbate the tightness in the labour market all the time putting increased pressure on inflation.

The number of job openings is +64% since 2019 and this is being reflected in wages.

- Walmart have increased their starting range for truck drivers to $95,000 - $110,000 compared to an average salary for a Walmart truck driver of $87,500.
- Microsoft is doubling its salary budget and boosting stock compensation by 25% for many employees
- Apple is raising starting salaries for retail workers by 10% to $22 per hour

There's no doubt that Covid has made corporates and governments realise that global supply chains are fragile. De-globalisation may well be a longer-term trend or it may just be a short term response to the current supply chain woes. Only time will tell. While there are merits to de-globalisation, we also feel that there are significant risks and what concerns us most is the risk that corporate profit margins may come under pressure as well as more persistent upward pressure on inflation.

Our investment philosophy centres around conservatism and an aversion to risk. Today, as we invest our client's capital we are faced with the additional risks of de-globalisation and more importantly downward pressure on corporate profit margins and inflation. It's been a one-way street for many of these factors over the past several decades so it's important we take our time to understand how these factors may impact our existing investments as well as our investment universe. However, our investment philosophy also centres around investing in quality companies at good prices and we feel that quality companies with strong value propositions, franchise values, brand awareness, and strong management teams should be able to weather potential storms relatively better than other benchmark companies.

Q2 2022 Commentary

Transactions during Q2 2022

We initiated a new position in Ferguson PLC, the leading North American distributor of plumbing, heating and related products to professional tradesmen. It was formerly known as Wolseley until 2017 and has a dual listing in both the UK and US. Over the past 5 years under the stewardship of CEO, Kevin Murphy, the company underwent a strategic review with the focus now on the structurally attractive US market while exiting less attractive markets across Europe.

We believe Ferguson commands a market leading position in a very fragmented market, and that its scale (3.5m SKU's across 1,600 locations, located within 60 miles of 95% of the US population) coupled with bolt-on acquisitions of smaller competitors should give Ferguson a competitive advantage and facilitate outsized growth relative to its market over the medium to long term.

The market itself also presents a nice tailwind with 56% exposure to residential and within that, 60% RMI and 40% new build. Our research has led us to believe that there has been a persistent under-build of homes across the US with current housing starts similar to 1960's levels. On top of this, the housing stock is old, with the median US house now 41 years old. So, in a market which needs more new houses as well as greater refurbishment of the existing ageing stock we believe it presents a very positive picture for demand of plumbing products over the medium to long term.

We are also very impressed with the quality and experience of the management team. Both CEO, Kevin Murphy and CFO, Bill Brundage, while being relatively new to their respective positions are Ferguson veterans, Kevin Murphy is with the company since 1999 and Bill Brundage more than 17 years. They have experienced downturns in the past and know how to navigate them so even if we do see a downturn in the US housing market, we feel comfortable that the management team are well positioned to deal with it as well as taking advantage of opportunities that may present themselves if weaker companies begin to struggle.

This position was funded with cash as well as reducing our positions in some existing holdings.

As always, we are very grateful for the continued support of our clients.

Fergal Sarsfield,
Co-Lead Portfolio Manager

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IMPORTANT INFORMATION

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