

Setanta Global Equity Fund (CAD)

Q2 2022

Fund Description

The **Global Equity Fund** ('the Fund') is managed by Setanta Asset Management Limited ("Setanta") and is a representative account of the Global Equity strategy. The Fund is an actively managed equity portfolio which holds c.80-100 global stocks. The portfolio is managed in accordance with the Setanta investment philosophy by a team of eight global sector specialists, overseen by two lead portfolio managers. The aim is to achieve a sensible level of diversification on a sector and geographic basis. Reflecting this, portfolio sector weights are generally set so as broadly similar to the sector weights in the benchmark. Within each sector, stocks are chosen through bottom-up analysis, based on investment merit. Rather than focusing on the historic level of volatility of an asset, the portfolio managers regard the probability of permanent impairment of capital as the most relevant measure of risk. In doing so, they seek to maximise downside protection by understanding the risks posed by the valuation, financial, and operational characteristics of the asset. The investment objective of the Fund is to outperform the MSCI World index over the long term.

Fund Commentary

Fund was -9.6% (CAD) in Q2, outperforming the benchmark -13.4% (CAD). For the year to date the fund was -15.1% to end June compared to the benchmark -18.8%. The fund's positive relative performance in a down market was pleasing to see. Due to the nature of the companies we tend to own – sensible valuation, attractive through-the-cycle economics, low financial debt, resilience in times of adversity – the fund had outperformed in nine of the ten worst down markets since its 1999 inception up until 2019.

(Fund Commentary continued on Page 3)

Portfolio Managers

David Coyne & Sean Kenzie, 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

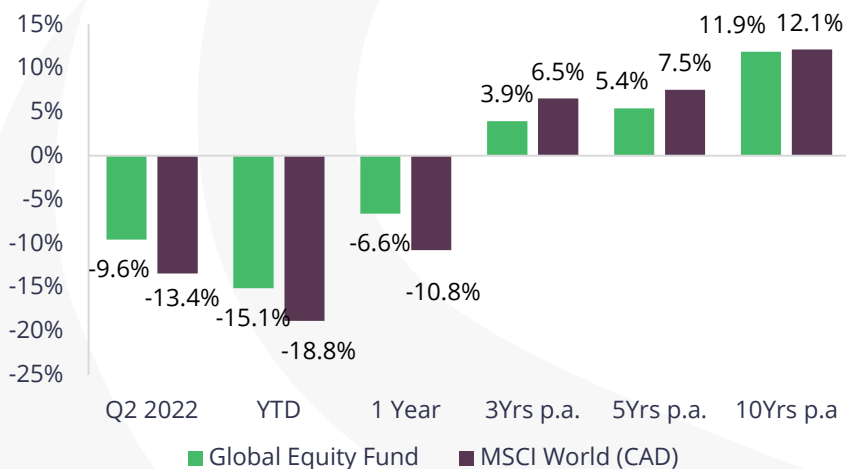
We consider scenarios rather than making forecasts

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 – 30.06.2022 (CAD)



Performance Source: Setanta Asset Management Limited. The Fund returns are based on the movements in the unit prices of the London Life Global Equity Fund (S034) 4.03SAM [IEC15001] 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 World (CAD). **Holdings Source:** Setanta. Sector allocations based on invested portfolio only (excludes cash). **Fund Statistics Source:** Bloomberg.

Top 10 Holdings

COMPANY	SECTOR	% OF FUND
MICROSOFT CORP	INFORMATION TECHNOLOGY	4.4%
BERKSHIRE HATHAWAY	FINANCIALS	3.3%
MCDONALD'S CORP	CONSUMER DISCRETIONARY	3.1%
ALPHABET INC	CONSUMER DISCRETIONARY	3.0%
JOHNSON & JOHNSON	HEALTHCARE	2.7%
COSTCO WHOLESALE	CONSUMER DISCRETIONARY	2.7%
ORACLE CORP	INFORMATION TECHNOLOGY	2.7%
SAMSUNG ELECTRONIC	INFORMATION TECHNOLOGY	2.2%
DCC ORD	INDUSTRIALS	2.0%
KEYSIGHT TECH	INFORMATION TECHNOLOGY	1.9%

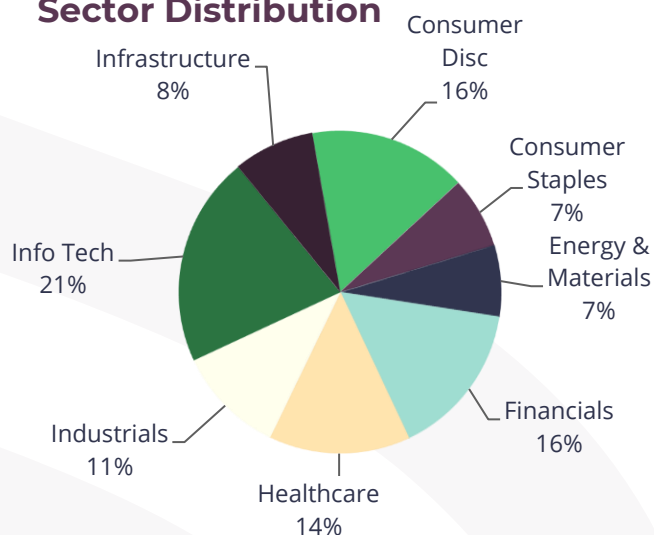
Yearly Performance

Year %	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Fund	16.1	2.3	0.1	13.4	38.5	15.3	15.8	9.7	15.8	-0.7	13.8	3.4	22.1
Benchmark	10.4	5.9	-3.2	13.3	35.2	14.4	18.9	3.8	14.4	-0.5	21.2	13.9	20.8

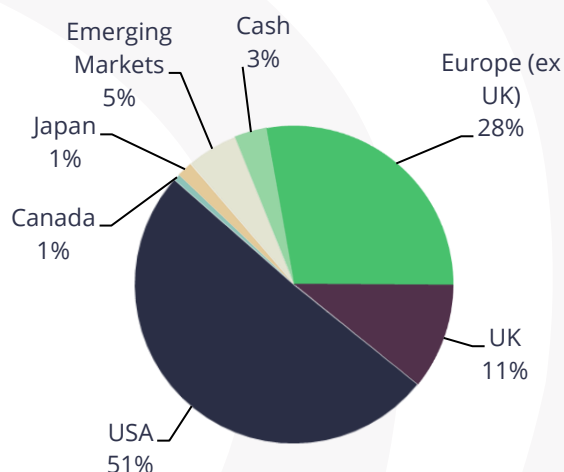
Fund Statistics

PRICE/BOOK	2.0
PRICE/EARNINGS RATIO (FY 1)	15.8
DIVIDEND YIELD %	1.9
AVERAGE MARKET CAP C\$BN	165.3
NO. OF HOLDINGS	81
ACTIVE SHARE %	83.4
DEBT/EQUITY %	47.8

Sector Distribution



Geographic Distribution



Commentary

This did not prove to be the case during the sharp COVID-induced market sell off in Q1 of 2020. The environment proved beneficial for a relatively small number of work-/entertain-/shop-from-home exposed companies, to which the fund was under-exposed, while at same time profitability in a number of our normally defensive stocks were battered by the government enforced lockdowns. We judged that these trends would at least partially reverse as economies reopened and that in many cases a major change in companies' intrinsic values was not justified. Moreover many "-from-home" stocks were valued highly even pre-pandemic and became significantly more expensive through 2020 and up to mid-2021. We concluded that our investment style was simply out of favour and that by-and-large we should stick to our tried and tested process. The last year has broadly proven out our view as many pandemic beneficiaries crashed back to earth and the fund outperformed in the last three quarterly periods by a cumulative ~9%. With the market falling double-digits in Q2:22, it was reassuring that the fund had 25 stocks (out of ~80) in positive territory.

Below is a summary of the top and bottom contributors to fund performance in the quarter.

Top 5 contributors	Period average weight	Total return (CAD)	Contribution to return
Melrose Industries	1.2%	15.2%	0.2%
McDonald's	2.9%	3.7%	0.1%
Johnson & Johnson	2.5%	4.1%	0.1%
O-I Glass	1.3%	9.7%	0.1%
Exxon Mobil	1.5%	8.2%	0.1%

Melrose gained strongly in the period, but this followed a weak performance in Q1 such that it was unchanged in the 6-month period. Recall that Melrose's model is to "Buy, Improve, Sell", typically acquiring industrial businesses, investing in them to make them more efficient, and then selling them at a profit. It has a long track record of achieving selling prices at multiples of the purchase price. The pandemic, followed by inventory and supply chain difficulties, have slowed management's ability to improve and sell. However, a recent Capital Markets Day focused on the operational progress management is making in its large Aerospace division, despite the macro headwinds. This bodes well for achieving a full price in the future when sales recover. Management also committed to buying back 8% of shares outstanding using the proceeds of a business sale in Q1.

McDonald's and **Johnson & Johnson** performed well in the quarter and year-to-date. These excellent companies have been held in the fund for 10 and 19 years respectively – and all have performed exceptionally well over their holding periods. Although they compete in very different industries, they exhibit similar characteristics: stable and predictable demand, high levels of customer trust, tough but rationale existing competitors with high barriers to entry that makes it hard for new companies to change the competitive landscape.

Commentary

O-I Glass, which makes glass bottles and jars for the food and beverage industry, has been another long-held stock (2011), but it's been a much tougher ride. Although three glass companies account for a significant majority of industry sales, glass is sold locally so global scale only accounts for so much. In addition the glass industry competes with aluminium cans and other forms of packaging. Also, glass plants are costly to run at the best of times so current high energy prices are not helpful, other things being equal. Specific to O-I, the company had a high annual expense of settling asbestos claims from the 1960s and 1970s, which has consumed around 40% of free cash flow over the last 10 years. Fortunately these factors are now turning more positively but the improvement has yet to be priced into the share price. O-I's asbestos exposure has been finally settled and current demand is far outstripping supply, both for glass and can manufacturers, which will allow O-I to pass on higher energy costs (and more) to its customers.

Bottom 5 contributors	Period average weight	Total return (CAD)	Contribution to return
Berkshire Hathaway	3.6%	-20.1%	-0.8%
Alphabet	3.1%	-19.1%	-0.6%
Microsoft	4.3%	-13.8%	-0.6%
Samsung Electronics	2.5%	-20.6%	-0.5%
Johnson Controls	2.0%	-24.0%	-0.5%

The largest negative contributor to fund performance in Q2 was **Berkshire Hathaway**. For more context, the stock was the fund's top positive contributor in the Q1 (+18%, USD) and we outlined many of Berkshire's extraordinary attributes in last quarter's commentary. Longer term, the macroeconomic worries of today will have very little impact the value of the conglomerate. However near-term profits may come under some pressure. This, plus marking-to-market the value of some of its quoted equity holdings (e.g. Apple, year-to-date -22%, USD), likely weighed on the share price. That's good news for long-term shareholders like us – the lower the share price, the greater the likelihood the company will carry out meaningful, value creating share buybacks.

Alphabet and **Microsoft** fell 17% and 11% (USD terms) respectively in Q2. Both stocks have performed exceptionally in recent years, both pre- and through-pandemic. They are sustainably benefiting from greater digital adoption, which has served to propel their profits to multiples of where they were just a few years ago. Microsoft's products and services are mostly sold to enterprises where we expect there to be continued strong and stable demand as corporates increasingly shift spending to the cloud. In the case of Alphabet, it makes most of its money on Google and YouTube and advertising, which is cyclical. Like Microsoft, Alphabet will likely continue to profit from a structural shift to digital consumption. However it is probable that at least some money from loss-making, cash-rich VC-backed start-ups has made its way into Alphabet's coffers in recent years – fintechs and cryptos are prime examples – so we might expect some of that to permanently fall away. On the other hand it is not clear to us that the market is valuing Alphabet on over-extended earnings (currently trading on ~20x last 12 months profits). We remain confident in the futures of both companies, but will continue to observe the unfolding environment.

Commentary

Samsung Electronics might be best known to some of you as the maker of phones, fridges and TVs, but the bulk of its profits comes from memory chips. The memory chip industry used to be the poster child of what a cyclical industry looked like, with wild profit swings and the odd bankruptcy. However over time rising cost of building new fabs forced weaker players to quit and consolidation ensued to the point where today memory is essentially a three-player market, with Samsung the largest. As a result supply is better controlled and profitability is far more stable for this critical component. A global shortage of chips over the last number of years (probably exacerbated by WFH) has been helpful for profits at Samsung and its peers. The share price year-to-date has fallen by around a quarter, perhaps reflecting some easing of the chip shortage and a general sell off in technology shares. We do not believe this is warranted – the stock's ~10x P/E is far too low for the growing profit stream that we foresee long into the future.

Johnson Controls was profiled in the last two fund reports, as one of the top performance contributors in 2021 and a detractor in Q1 – please revisit if interested in a fuller explanation of our investment case. There is nothing new to report from Q2. The stock has derated by six P/E multiple points year-to-date, even though the company is likely to deliver strong top line growth along with margin expansion in the coming years as it executes its digitisation strategy.

Portfolio activity

During Q2 we sold Origin Enterprises and JD Wetherspoon and bought Estée Lauder.

Origin Enterprises provides agronomy services and sells farm inputs in Ireland, the UK, Central & Eastern Europe and Brazil. Its agronomists, or “crop doctors”, provide tailored advice on input application thereby enabling farmers to maximise yield per hectare.

We first initiated a position in 2015, after the stock had fallen a third following a collapse in soft commodity prices. Since the company went public in 2007, earnings had doubled, the company had consistently generated a health return on invested capital, free cash flow conversion had been close to 100%, the company had returned substantial cash to shareholders, and all this with a conservatively managed balance sheet.

The investment case was built around the company ability to leverage its scale (c.40% share of the UK crop protection market), R&D capability (€ spend many times bigger than its nearest rivals), optimise the performance of its agronomists, and exploit the potentially massive opportunity in Central & Eastern Europe. We also believed that the longer-term themes of population growth coupled with supply constraints on arable land, environmental issues and climate change, would present a range of opportunities for Origin.

So where did it all go wrong? It was a combination of our misjudgement of the robustness of the business, management execution and mother nature.

On the first, we failed to appreciate how difficult it is to effect change in this industry. Farmers and agronomists can be set in their ways. For example, farmers are very reluctant to change their agronomists (one industry expert told us tongue-in-cheek that farmers and their agronomists have a closer relationship than many married couples). This makes it very difficult for the likes of Origin to grow acres under management. Furthermore, it is the agronomist who owns the relationship with the farmer, not the company, and this is reflected in their share of the economics of the business. Origin has been trying to change this industry dynamic through company branding and modifying the agronomist remuneration model to more performance-based but it has had little success.

Commentary

For similar reasons, we failed to appreciate how long it would take to agronomise Central & Eastern Europe and to educate farmers that applying a more expensive tailored approach would deliver a greater payback in terms of higher yields. While this seems like sensible business practices and a win-win for all parties involved, it is now clear to us that adoption will take a lot longer than we originally thought.

Second, we believe management over-promised and under-delivered on the execution of their strategy. Specifically, the capital allocation strategy failed to create value. The acquisitions in Central & Eastern Europe took too long to integrate and professionalise; they did not deliver results nor were they synergistic to the overall group. Management also failed to appreciate the competitive dynamics within these markets. As a result, the business suffered a material erosion in earnings and returns on capital. Finally, the business was further pressured by two of the worst weather years in recent memory (2016 and 2020), and the company took longer than expected to recover from these.

Throughout our holding period we actively engaged with the management team and the Board. We expressed our concerns with the capital allocation strategy, which we believed had contributed to a loss of investor confidence in the company. We recommended that the company cease allocating any further capital to acquisitions and return all free cash flow to shareholders. We understand these views were also shared by other shareholders. The Board eventually announced a share repurchase program. The share repurchase program and a more favourable industry backdrop led to a rise in the share price and we decided to exit our position.

We bought UK pub chain **JD Wetherspoon** in 2014. Its proposition is cheap-and-cheerful drink and (increasingly) food. It has scale advantages over its competition (typically smaller operators) and over time the company has done a good job of increasing profit per pub as well as growing its footprint. Pre-pandemic Wetherspoon was generating decent cash profits across the estate. However, the business requires a lot of capital investment as they own the freehold to most of the pubs. They state in their annual report that “debt levels of between 0 and 2 times EBITDA are a sensible long term benchmark”. The journey through the pandemic was a rough one. Even though the company raised capital twice (2020 and 2021, cumulatively increasing shares outstanding by 22%) the balance sheet was stretched and in fact was in breach of its loan covenants, requiring the company to get a waiver from the banks. On top of this, management restarted its freehold conversion program, which added to its debt pile. While the company's profitability may well rebound, there were too many red flags for us to remain shareholders. We began selling down the position during 2021 and we sold the remainder of our holding in Q2.

During 2Q we took a starter position in **Estée Lauder**. The company was founded in 1946 in New York and today is one of the world's leading cosmetics players with total sales of US\$17bn. The company operates at the premium end of the industry with a well-diversified portfolio of more than 25 prestige brands across the skin care, makeup, hair care and fragrances categories. The company has four \$1bn plus brands: flagship brand Estée Lauder, Clinique, M-A-C and La Mer. Some of its other well-known brands include Origins, Bobbi Brown, Aveda, and Jo Malone London.

Cosmetics is an extremely competitive industry. However, Estée Lauder has always managed to grow market share by focusing on the growing prestige skincare segment, where brand loyalty and pricing-power is highest. It also has a management team adept at identifying and allocating resources to future growth opportunities. The Lauder family controls the company and is now in the third generation of ownership but still maintains a long-term orientation and commitment to building brands to last, not over days or even years, but decades.



Commentary

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We had been monitoring the company for a number of years, but it was always too expensive. An opportunity came in the 2Q following a profit warning caused by the Covid lockdowns in China, where the company generates a third of sales. While we have limited visibility on when the country will fully reopen, we see these lockdown headwinds as transitory in nature.

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