Setanta EAFE Equity Strategy (USD)
December 2022

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.

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

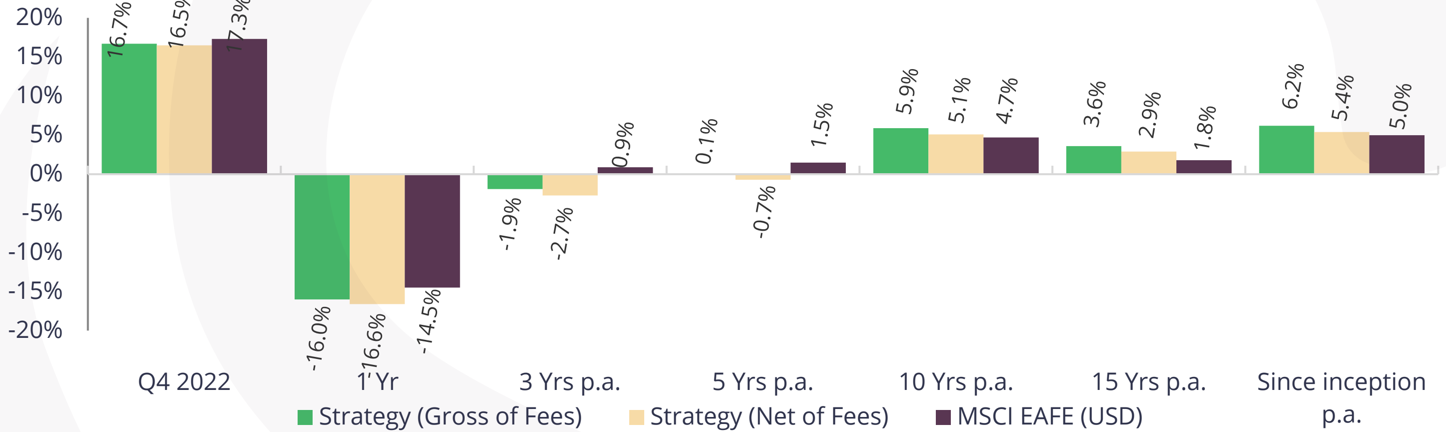
We will act with integrity in everything we do

Portfolio Managers

Rowan Smith; Fergal Sarsfield, CFA, Conor Walshe & Tony O'Sullivan

Performance and Strategy data as at 31st December 2022

Strategy Performance (USD)



Yearly Performance (USD)

	2018	2019	2020	2021	2022
Strategy (Gross of Fees)	-10.7%	19.1%	-0.2%	12.5%	-16.0%
Strategy (Net of Fees)	-11.4%	18.2%	-0.9%	11.6%	-16.6%
MSCI EAFE (USD)	-13.8%	22.0%	7.8%	11.3%	-14.5%

Portfolio Valuation Statistics

PRICE/BOOK	1.5
PRICE/EARNINGS RATIO (FY 1)	13.9
DIVIDEND YIELD %	2.9
AVERAGE MARKET CAP $BN	63.1
NO. OF HOLDINGS	35
DEBT/EQUITY %	51.3
ACTIVE SHARE %	92.4

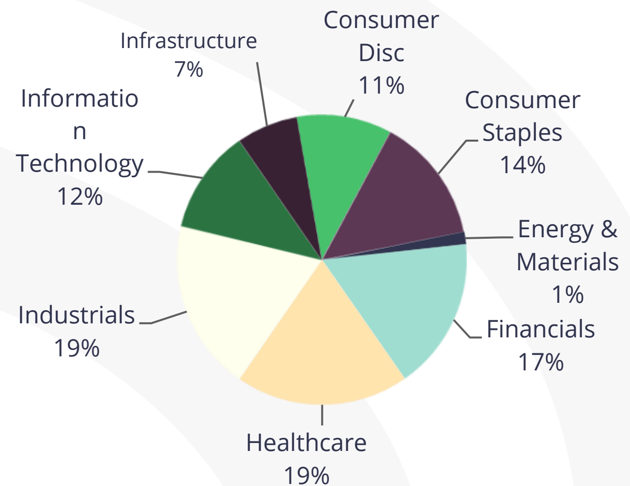
Top 10 Holdings

COMPANY	SECTOR	WEIGHT
DIAGEO	CONSUMER STAPLES	4.6%
ESSILORLUXOTTICA	CONSUMER DISCRETIONARY	4.4%
GPE BRUXELLES LAM.	FINANCIALS	4.3%
BANK OF IRELAND	FINANCIALS	4.3%
THAI BEVERAGE	CONSUMER STAPLES	4.2%
SAMSUNG ELECTRONICS	INFORMATION TECHNOLOGY	4.1%
UNILEVER PLC	CONSUMER STAPLES	4.0%
ALCON AG	HEALTHCARE	3.9%
DCC	INDUSTRIALS	3.9%
NOVARTIS	HEALTHCARE	3.7%

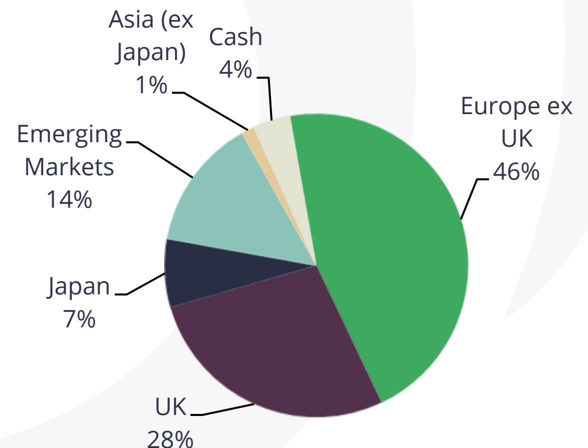
Holdings Source: Setanta. Sector allocations based on invested portfolio only (excludes cash), of the lead CAD account of the EAFE Equity Strategy. **Portfolio Valuation Statistics Source:** Bloomberg, based on the lead CAD account of the EAFE Equity Strategy, shown in USD.

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 was CLA CA Managed EAFE Portfolio SF035 [IEC11007] till 09.06.22 and LL EAFE Equity Strategy 6.84 [IEC15004] thereafter, which has been converted to USD at FX rate 0.73803. 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).

Sector Distribution



Geographic Distribution



SETANTA Asset Management

Strategy Commentary

The curtain has been drawn on an another utterly extraordinary year. As we referenced last quarter, this recent period has been the most bizarre of our careers; the Dot Com Bubble and the Global Financial Crisis are no match for the remarkable developments of the past three years. The process of moving through, and beyond, a global pandemic, with the myriad macro and micro upheavals this catalysed, was exceptional enough. The war in Europe, and the inflation and geopolitical tensions it amplified, has multiplied these complexities and the disruption to business has been perhaps unparalleled in the modern era.

The Setanta portfolio did not fare very well against this backdrop in 2022. We are disappointed and surprised by this because historically the portfolio has tended to out-perform during periods of market anxiety. Stepping back, the vast bulk of the under-performance can be attributed to the strategy's underweight position in Energy and Mining stocks, which out-performed substantially over the year. This is not something we could complain about since we have generally been beneficiaries over the years from being underweight these kinds of businesses. The general difficulty we find is that the economics of these industries have proven to be unpredictable and longer-term profitability has been mediocre, so we have not found it easy to identify attractive holdings from these sectors.

Another detractor from performance, albeit hard to quantify, is that the strategy is probably overweight businesses with direct or indirect exposure to the consumer, which has not been the place to be in 2022. Although earnings reports have generally been fairly resilient thus far, prices of many such stocks have come under pressure in anticipation of a deterioration in spending patterns in the coming quarters. These concerns are valid but as always, we try to look beyond the peaks and troughs because we don't think either represents a sensible base from which to value businesses.

The Setanta strategy is concentrated with a high active share which means relative performance can be volatile. If Mr Market gets on board with the strategy's exposures, out-performance can be dramatic, as we have seen in the past. However, this works in reverse, as evidenced by more recent under-performance. Our sense is that macro driven cash flows have amplified this recent volatility and the strategy's under-performance. We will always try to identify learnings from our experiences, but we continue to believe that our investment approach is sound, and we see good value in the portfolio today which makes us feel optimistic about its prospects for the coming years.

Macro

We don't usually write about "macro". That's not because we're not interested. Macro observations can inform our world view, which in turn can influence our decision making. For example, we believe the social and geopolitical developments of recent years are likely to encourage more western manufacturers to pursue some degree of production re-shoring in the future. We see CRH and Ferguson as being potential beneficiaries of this trend. On the other hand, we are concerned about the implications of higher energy prices for European industry. There's a risk that various European manufacturers may become less competitive in international markets if European energy prices stay elevated for years. This concern will inform our analysis of European industrial companies.

However, we don't believe we can effectively translate our observations on geopolitics, the current inflation problem, or the trajectory of interest rates - all of which are understandably hot topics - into meaningful portfolio actions. These kinds of problems are multi-layered, extremely dynamic and exceptionally complex. It isn't clear to us today that there are obvious mispricings related to these matters. Should we ultimately have extreme economic outcomes attributable to these factors, either positive or negative, these will look obvious in hindsight. However, we don't believe the outcomes are obvious today.

Strategy Commentary

We do believe the leaders of the world's major economies understand that everyone benefits from international trade. History also shows us that the global economy is extremely adaptable. So, we believe our effort is better spent on analysing the economic building blocks of industries and businesses that interest us. This approach reflects our experience, but we admit to taking a leaf out of the Berkshire Hathaway book here.

At the 1998 Berkshire Hathaway shareholder meeting, Warren Buffett was asked about macroeconomic trends that would develop over the subsequent decade. To paraphrase his reply:

"We don't think about that. It's unknowable. If we started focusing on those issues, we would miss a lot of big things. We think about things that are both important and knowable"

Buffett went on to elaborate that Coca Cola listed in 1919 at $40 per share and fell to $19 within the first year due to various operating problems. Not only that, but (paraphrasing him again):

"…if you had had perfect foresight at that time, you would have seen the great depression staring you in the face, World War 2, atomic bombs, and the social order being questioned. You could always find a reason to postpone the purchase of Coca Cola shares. But these were not the important things to see – the important thing to see was that Coca Cola would eventually sell one billion servings per day…. the share today (dividends reinvested) is worth well over five million dollars."

We are not claiming to have a 1920s version of Coca Cola in the portfolio, but we completely understand where Buffett is coming from. Many investors will convince themselves that they can bob and weave, duck and dive around the vicissitudes of the economy and the whims of the market. We believe the substantial majority will not only fail but will crystalise losses and incur incremental transaction costs in the process. This is not to say that the economy is not changeable, and these changes are to be ignored. However, a business is worth 20-plus years of cash flow, so the longer-term trend in profit is what will ultimately matter. The global economy over the longer-term has proven to be highly adaptable and resilient. During our careers we have heard many doomsday predictions made during the Asian Financial Crisis, the LTCM debacle, Dot Com Bubble, the Global Financial Crisis, Europe's Sovereign Debt Crisis and more recently, during the Covid Pandemic. All have proven to be misplaced. We're in the camp that believes today's difficulties will be overcome and we continue to try to focus on things we think are important and can have a credible view on.

Key Contributors and Detractors in 2022

Adidas

The strategy initiated a modest position in Adidas in 2020 with a plan to increase the position at lower price levels. We continued to add to the position as the price fell during 2022. The investment case was based on the following observations:

- Adidas is an extremely strong global sporting goods brand, and the company has excellent development and commercial capabilities that position it to benefit from growth in consumer spending in the future
- Adidas and Nike have a combined >40% of the global athletic footwear market and both have historically been meaningful market share gainers
- The product is not durable: it wears out and needs to be replaced which means downcycles should not last for extended periods

Strategy Commentary

- Management had exited under-performing parts of the business (Taylormade Golf, Reebok) facilitating greater focus on the more profitable Adidas brand
- Above average growth prospects enabled by trends such as healthier living, emerging market growth and the effects of the professionalisation of women's sports
- Opportunity to meaningfully increase profitability by shifting more volume to the still developing Ecommerce channel, thereby claiming more of the industry profit pool

However to state that the investment case has not worked thus far would be an understatement, with the stock down by close to 50% in 2022. Almost everything that could go wrong thus far has, including:

- Adidas's substantial business in China has suffered a dramatic decline as a result of consumer boycotts in reaction to the Xinjiang cotton controversy (i.e., the reluctance of Western brands, including Adidas, to source cotton produced in the region in light of human rights concerns) and the effect of the zero covid policy, with the rolling lockdowns it entailed
- The current inventory glut across the industry supply chain because of over-ordering by major brands across the industry just before the inflation spike had begun to crimp consumer budgets
- The sudden termination of the Yeezy product line, developed in partnership with Kanye West. It transpired that this line was significantly more profitable than investors had believed to be the case
- Poor management execution on various fronts, including ineffective leadership in China which resulted in inferior product promotion and positioning.

So the nature of the challenges the company has suddenly had to face have been a combination of external and internal. We have been happy to see the CEO replaced by Bjorn Gulden, who it appears did a terrific job as CEO of Puma over the previous decade. We do expect to see a substantial decline in earnings over the next year or so as excess inventory is worked off and as the new CEO repositions the business accordingly, but we are confident that the longer-term drivers remain intact. During the two years prior to the pandemic, 2018 and 2019, the company's average annual net profit was €1.8 billion, equating to €10.0 earnings per share. It won't happen overnight but we expect Adidas to eventually surpass this level of earnings, which makes 2022's closing share price of €127 look attractive to us.

DCC

A longstanding holding, DCC is a marketing and distribution business servicing clients in Europe and beyond across three verticals: energy, technology and healthcare. The healthcare business primarily supplies a wide range of products and services to providers including hospitals and general practitioners. It also provides contract manufacturing and ancillary services to various health and beauty brands. The technology business provides distribution and marketing services to global technology brands. The energy business, which accounts for around two thirds of group profits, primarily supplies fuel oils and liquified petroleum gas to commercial, industrial, and residential customers across Europe, the US and Asia.

The business has a terrific track record of internally funded cash flow growth, underpinned by adaptability to changing market conditions. The shape of the group has shifted over the years as management allocated capital to the most attractive businesses. For example, DCC once operated in the waste treatment, recycling and food industries but disposed of these businesses, in turn bulking up in more attractive pockets of its Healthcare, Energy and Technology segments, all the while maintaining excellent cash flow and high returns on capital. This adaptability continues to this day with management expanding the technology and healthcare businesses and, within energy, expanding into greener energy offerings including biofuels, biogas, EV charging, solar and heat pump service offerings.

Strategy Commentary

Aside from some recent, fairly minor bumps that have impacted supply chains and demand trends throughout the IT and Healthcare industries, financial results have remained strong in recent years. The stock however has derated substantially and after a sharp decline in 2022 now trades on under 10 times earnings. It seems that the market has no confidence in management 's plan to transition the energy business to incorporate “greener” solutions. We believe the market has this all wrong, providing us with an excellent opportunity. Many of DCC's traditional gas and fuel customers are off grid and will likely be dependent on traditional fuels for many years. Meanwhile DCC is already beginning to enjoy high returns on new services that it can now offer because of the energy transition. These include EV charging on their forecourts; providing biofuels where supply is available; arranging solar and heat pump installation for their customers. We believe the energy business will transition slowly and DCC will have time to adapt, with multiple opportunities for shots on goal, while still generating excellent cash flow through this journey. The stock seems extremely cheap to us.

Ericsson
The share price of Ericsson, the Swedish company that provides equipment and software to mobile telecom operators across the world, fell sharply during the year. There were two key reasons for the weakness:

- Allegations of employee misconduct in Iraq including evidence of payments to unknown intermediaries at a time when ISIS controlled swathes of the country (see our first quarter report for more details).
- Disappointing interim financial results in 2022 because of inflationary pressures and emerging spending weakness among telecom network operators, including the especially profitable US customers.

Ericsson has an ostensibly very strong market position with key competitor Huawei somewhat handicapped by geopolitical overhangs and Nokia having struggled to match Ericsson’s development capabilities. Furthermore, we think the aforementioned compliance issues will be resolved and the stock looks very cheap, trading on around ten times the earnings it produced in recent years. Nonetheless we are concerned by the recent deterioration in the business. While we have decided to retain the position for the moment, we are watching developments closely and may decide to exit if our comfort level falls further.

Bank of Ireland
Shares in Bank of Ireland rose almost 80% during the year as it continued to post strong results. The Irish economy is performing well, credit costs remain well behaved, and the company is a beneficiary of rising interest rates, which help net interest margins to expand. In contrast these higher rates are putting pressure on wholesale-funded competitors and two other large competitors have exited the market in recent times (Ulster Bank and KBC). Despite the significant share price increase, the stock continued to trade below book value.

Lancashire
Shares in the specialty insurance company sold off sharply during February/March 2022 after Russia’s invasion of Ukraine aroused concerns that insurers’ aviation books would be significantly impaired by claims made by clients on foot of Russia’s re-registration of foreign-owned aircraft. While uncertainty around this issue remains, today it appears likely that losses will be considerably more modest than the worst-case scenarios feared back in the spring. Furthermore, we have continued to see a hardening of market pricing. Encouragingly, the rise in interest rates is keeping supply of fresh industry capital at a minimum, which increases the likelihood that pricing will remain higher for longer. Lancashire has increased its premium base meaningfully in order to capitalise on this very attractive pricing and we think a substantial increase in profits is in the offing. Given this backdrop, investor confidence has increased, and the stock rose substantially from its lows, ending up in excess of 20% for the year.

Strategy Commentary

Thai Beverage

This stock performed well on the year. The company is the largest producer of alcoholic beverages (both beer and spirits) in Thailand and has a controlling stake in the number two Beer producer in Vietnam (Sabeco). The group performed resiliently during the pandemic, despite restrictions in both countries. The reopening process in both countries has been somewhat slow but the business in Vietnam is now firing strongly. Thailand should begin to follow with almost all restrictions now removed and tourists returning. The company has been successfully raising prices to offset materials and packaging cost increases and recent full year profits grew nicely ahead of expectations. We continue to believe that the company's market position in the key business lines is very strong.

Sanofi, GSK and Haleon

As we discussed in the third quarter report, all three of the aforementioned stocks sold off to varying degrees in the Autumn because of concerns about potential exposure to litigation risk in the US. Specifically, each of these companies (in addition to other companies not held in the portfolio) could be liable for payments to plaintiffs who claim that heartburn drug Zantac caused their cancers. What was very strange about these developments is that this matter was known about for some time and yet panic ensued in August after a report with no new information was issued by a sell side analyst, highlighting just how skittish the market has been in recent times. Our view is, and has been that, for various reasons, the ultimate costs would be manageable and that the market reaction was excessive. Since then, we have seen some positive developments, most notable of which was that the judge overseeing the main branch of the litigation (in Florida) has thrown the case out, essentially on the basis that the claims are without merit. This does not resolve the matter but gives additional comfort to our view and in turn, the stocks have recovered much of the ground that was lost in August/September 2022.

Transactions

There were no full disposals from or new additions to the portfolio during the fourth quarter. As a reminder, during the year four stocks exited the portfolio (Proximus, Origin Enterprises, Smiths Group and Melrose Industries) and three joined the portfolio (Haleon PLC, the Consumer Health spin from GSK that we had been awaiting for some time, Tencent and Ferguson PLC). Please see our recent commentaries for further details on these additions and disposals. One of the biggest challenges we face remains that, although there have been deratings, high quality stocks continue to trade at lofty valuations today. Nonetheless we have been working on a number of interesting ideas that could make their way into the portfolio in 2023.

In summary, we have been disappointed by the strategy's under-performance over the past few years. We always try to learn from our experiences, good and bad. We continue to believe that our process is fundamentally sound and see good value in the portfolio today. We thank you for your support and hope that your patience will be rewarded in the coming years.

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Co-Lead Portfolio Manager

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