Setanta Income Opportunities Fund

Q1 2023

Fund Description

The **Income Opportunities Fund** ('the Fund') is an actively managed portfolio primarily comprising global equities but with the flexibility to invest in assets which offer attractive income and reasonable value. These assets include fixed income, property (including REITs) and cash. The Fund is not constrained by limitations on the level of any given asset. In practice, the Fund has had its greatest weight in equities, reflecting the breadth of that market, Setanta's expertise in that area, and the option writing strategy employed by the Fund. Nevertheless, property, fixed income and cash have all played meaningful roles in past returns of the Fund, at times, comprising up to 50% of the Fund's assets. The portfolio is managed in accordance with the Setanta investment philosophy. That is, the managers seek to own good assets 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 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 employs an option writing strategy. This entails the sale of both call and put options in return for a cash premium, representing an income stream that boosts the underlying income yield of the Fund. This strategy is employed in a conservative fashion, as all options written are fully covered.

The Income Opportunities Fund has two investment objectives:

1. To generate an annual income yield at a target rate. This is declared at the start of each financial year.

2. To achieve capital appreciation over the long term.

Portfolio Managers

Richard Doyle, CFA; David Pastor, CFA; Caroline White, 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

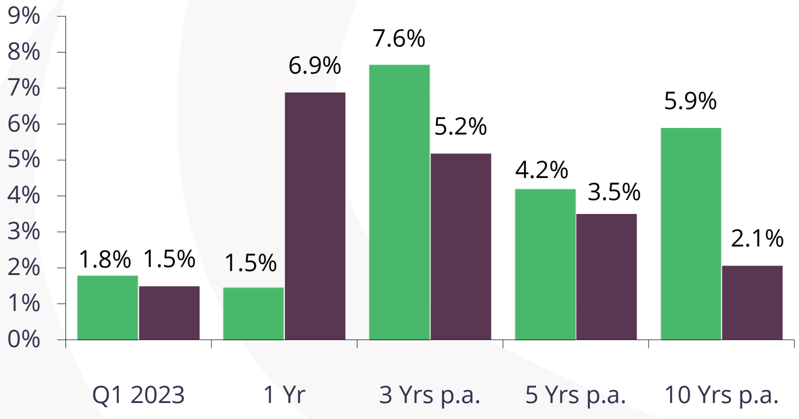
We consider scenarios rather than making forecasts

Businesses we own must have strong balance sheets

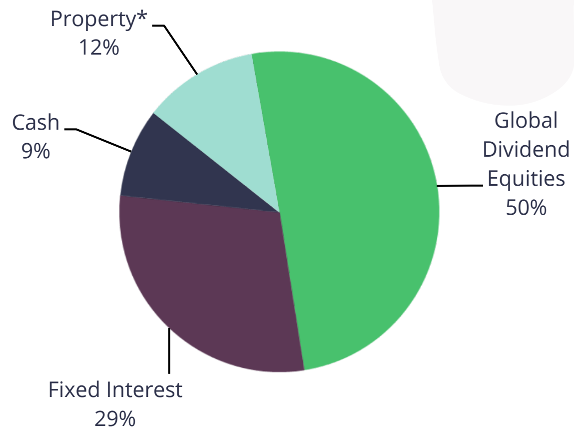
We make mistakes and always endeavour to learn from them

We will act with integrity in everything we do

Fund Performance – 31.03.2023 (EUR)



Asset Distribution



*includes 1.5% in IRES REIT

Yearly Performance

Year %	2018	2019	2020	2021	2022
Fund	-1.2	13.7	-5.6	11.9	-0.3
Benchmark	1.6	1.1	-0.3	5.0	9.6

Performance Source: Setanta Asset Management Limited. The Fund returns stated are based on the movements in the unit prices of the ILA/CLI Income Opportunities Fund [P-INC1] and are gross of management fees. The performance will be reduced by the impact of management fees paid, the amount of which varies. **Benchmark:** Eurostat Harmonised Index of Consumer Prices (EUR). Inception as at 30.09.11 **Holdings Source:** Setanta.

Top 10 Equity Holdings

COMPANY	SECTOR	% OF FUND
SANOFI EUR2	HEALTH CARE	2.4%
UNILEVER PLC	CONSUMER STAPLES	2.2%
PROCTER & GAMBLE	CONSUMER STAPLES	2.2%
AIR LIQUIDE(L')	ENERGY & MATERIALS	2.0%
NWS HOLDINGS	INDUSTRIALS	1.9%
MEDTRONIC PLC	HEALTH CARE	1.9%
SAMPO OYJ	FINANCIALS	1.8%
JOHNSON & JOHNSON	HEALTH CARE	1.8%
CRH ORD	INDUSTRIALS	1.7%
VISCOFAN SA	ENERGY & MATERIALS	1.7%

Historic Income

	Income Earned % of Fund Value
2011	6.2%
2012	5.6%
2013	5.5%
2014	4.8%
2015	5.5%
2016	4.7%
2017	4.1%
2018	3.9%
2019	4.2%
2020	3.9%
2021	4.1%
2022	4.4%

SVB Shutdown

On Thursday 9th of March last quarter, California-based SVB Financial Group, the holding company of Silicon Valley Bank, said it needed to raise $2bn of equity to cover losses in its bond portfolio. On the following day it was ordered to shut down. Here is an account of its demise courtesy of our colleague, David Coyne:

The root of SVB's woes was a decision in 2020 to buy a very large portfolio of fixed coupon, long duration bonds (a yield pick-up on shorter duration bonds). This was plainly a bad management decision, made possible by a watering down in 2017 of the post-Great Financial Crisis Dodd-Frank Act for banks of under $250bn in assets. The consequences of this original mistake took a few years to emerge. The US Federal Reserve began to increase interest rates in 2022 to combat inflation and SVB's long duration bonds fell in value by 17% or $15bn by year-end 2022, as disclosed in its 10-K annual report. On a fair value basis, the bank's equity was almost zero, but a well-meaning accounting convention allowed the bank to classify the bonds from 'Available-for-Sale' to 'Held-To-Maturity' (HTM), meaning that they would be valued at amortised cost, rather than their current market value. This enabled SVB to meet its regulatory capital requirements and gave it the appearance of being better capitalised than the reality. Investors and depositors largely carried on unaware or unconcerned.

There was a wrinkle, however. The vast majority of SVB's depositors were uninsured, so if any solvency or liquidity concerns were to emerge, depositors would run for the exits, which would force the bank to sell some of the HTM assets at prevailing market prices. The sale of even one of its HTM bonds would lead to a revaluation of a $90bn portfolio. You know what happened next: a $211bn asset bank disappeared as a going concern.

Despite government reassurances and interventions, SVB's collapse caused the Banking 'Fear-O-Meter' to spike, leading to deposits being pulled from a host of other regional banks in the US. For much the same reasons, New York's Signature Bank failed a few days later while First Republic Bank (assets $212bn) was teetering on the edge at the time of writing. SVB and Signature – somehow deemed by lawmakers too-small-to-be-fully-regulated – had a whopping $320 billion of assets between them. For context, this is the equivalent of Ireland's two large lenders, Bank of Ireland and AIB. Bigger news was to follow in Europe when confidence drained from Switzerland's Credit Suisse ($580bn in assets) and over a weekend it was frog-marched into an arranged wedding with UBS (a marriage both banks had shunned for decades). Confidence in banking remains brittle and further contagion cannot be ruled out.

From early March to the end of the quarter, US banks and European banks fell 15% and 12% respectively; US regional banks were particularly affected, falling 30%[1].

Setanta's Approach to Banks

Our long-held approach to investing in banks is one of extreme caution, based on an understanding that things can go wrong quickly. The 'challenge' with banks is that they are complex and, by nature, highly levered. This means that problems can be hard to identify and, by the time they are identified, the bank's leverage means that it might be too late. An investor in banks has always to be 'switched on'; these are certainly not 'sleep-at-night' stocks.

[1] As measured by S&P500 Banks Industry subset (SPXBK), Euro Stoxx 50 Banks (SX7E), and S&P500 Regional Banks Index (S5RBNK) respectively.

However, we don't think it makes sense to rule them out of bounds. They do have unique advantages. They have the privilege of taking in deposits, which can be loaned out at higher rates, and if depositors panic and want their money back in a hurry, banks can depend on a lot of liquidity support so long as they've been prudent on the asset side of the balance sheet. Banks are critical to the smooth functioning of modern economies. The necessary, but not always sufficient, attributes of a good investment in the bank sector are a relatively simple business model; stable and rational competition; conservative and competent management that prioritises its balance sheet at all times, and government policies and regulations that try to prevent excesses.

We believe that the Income Opportunities Fund ('The Fund') by and large, reflect these characteristics. We can confirm that the Fund did not, and does not have exposure, whether through equities or bonds to any of the troubled banks discussed in the first section of this piece. Within the equity portion of the fund, the Fund has typically had a low weighting in banks, while in bonds, we aim to limit exposure to banks in which a Setanta fund holds equity. The Fund holds equity in three stocks, which are, in order of position size: Bangkok Bank (Thailand); Handelsbanken (Sweden); and Toronto Dominion (Canada). It also holds a small position in a **Bank of Ireland** bond, due to mature in Q3 of this year. Bank of Ireland is an equity holding of Setanta in other funds.

Global Dividend Fund – Bank Holdings

Bangkok Bank is one of Thailand's big three banks, serving a population of around 70m people. We took our position in the stock at a substantial discount to book value during a period of COVID-related weakness in Q2 2020. The bank has a conservative culture, reflecting the presence of a family as a key shareholder; its tenure on the board stretches back beyond the Asian Financial Crisis of the late 1990s, which engulfed Thailand. While Bangkok Bank has a modest presence outside Thailand, its key focus is providing everyday banking services in Thailand, where it serves a resilient, and entrepreneurial, economy. It typically aims for modest loan growth, consistent in our view, with prudent loan growth. Bangkok Bank has a particularly high ratio of tangible capital to total assets ratio as well as region-leading liquidity, both of which are relevant in times of turmoil. We previously noted that having faced headwinds during an extended COVID lockdown, the bank is now benefitting from the tailwinds of a reopened economy and rising interest rates (which have lagged those of the US and Eurozone).

We have written before about the distinctive business model of Swedish bank, **Handelsbanken**. This includes: making lending decisions locally (rather than centrally as at many other banks), so that its managers are well-informed in taking risk; incentivising managers on return on equity, rather than on lending growth; and the fact that most of its employees have a substantial part of their retirement wealth invested in Handelsbanken shares. Over the course of history, Handelsbanken has reported low, if not negligible, loan losses, evidence, we believe that its unique approach works. This record positions Handelsbanken as one of the most prudent banks in the world. Nevertheless, it maintains, at nearly 20%, one of the highest capital ratios (Core Tier 1 Equity) amongst European banks. Handelsbanken has been a Fund holding for more than 15 years.

Last year, as outlined in our Q3 commentary we acquired **Toronto Dominion** ('TD') Bank. As a brief reminder, Toronto Dominion is one of the five main banks domiciled in Canada, from where it earns the bulk of its profits. It is also one of the largest banks in USA, reflective of the fragmented nature of US banking and the ability of TD to reinvest profits from Canada into the USA. It is well-diversified, both on the asset and liability side. TD's capital ratios are well in excess of the regulatory required (e.g. Core Equity Tier 1 ratio of 15.5% vs 10.5%); additionally, as a systemically-important bank, TD's capital reflects unrealised losses (and gains) on its bond holdings.

This capital strength means that it should be able to absorb the type of losses that banks can suffer, whether arising from property lending, corporate lending, or, indeed, any arms-length investments. Nevertheless, in light of the recent events in the sector, and the inherent riskiness of banks, we continue to challenge the investment cases of it, Handelsbanken and Bangkok Bank.

Fund Performance

The Fund rose just under 2% over the quarter. There was, generally speaking, a degree of rotation in which stocks that had lagged in recent quarters, led in this quarter (and vice versa). For example, we noted in last quarter's commentary that TSM, a Taiwan-based manufacturer of logic semiconductors was one of the main detractors from the Fund's performance over the past year, despite exceptionally strong profit growth. Over the past quarter, TSM has reflected some of that strength in posting a total return of 23%. CRH, added to the fund last year, was the largest contributor to the Fund's performance. During the quarter, it provided generally positive guidance on the coming year as well as announcing an increased share repurchase programme. It also announced its intention to move its primary share listing to the New York Stock Exchange from London, while retaining its headquarters in Ireland. While this should make no difference to the stock's valuation, we note that CRH is principally a US-oriented business, while valuations placed on building material companies listed in the US have typically been higher than those listed on European stock exchanges.

Bond markets weren't immune to the turmoil in the banking sector. Having priced in disappointingly persistent high inflation readings early in the quarter, investors had to contend with the added uncertainty of financial instability and potential policy response, as Central Banks walked a fine line between quelling inflation and ensuring trust in the financial system. Credit spreads inched higher as selected segments of the corporate bond market sold down, led lower by Real Estate, and Banks bonds. Nevertheless, our one bank bond holding, Bank of Ireland 1.375% August 2023, was largely unaffected, as it nears redemption.

**All figures relating to stock and index performance are in Euro terms, unless otherwise stated; those relating to fund performance are also gross of fees, unless otherwise stated. This commentary relates to the lead Setanta Income Opportunities Fund, IEC 7602.*

Richard Doyle, CFA, David Pastor, CFA, & Caroline White, CFA
Co-Lead Portfolio Managers

Contact Details:

Setanta Asset Management Limited,
Beresford Court,
Beresford Place, Dublin 1, Ireland.

Brendan Moran, Tel: + 353 1 612 4962
Email: brendan.moran@setanta-asset.com
www.setanta-asset.com

IMPORTANT INFORMATION

The Income Opportunities Fund is managed by Setanta Asset Management Limited and is a representative account of the Income Opportunities strategy. The performance shown is the performance of a representative account (ILA/CLI Income Opportunities Fund [P-INC1]). For this life assurance product, investors should refer to the relevant policy conditions available through Irish Life and via www.irishlife.ie. The strategy is also available on a segregated basis or a UCITS mutual Fund via Beresford Funds ICAV. Current and prospective clients should not assume identical performance results to those shown would have been achieved for their account if it was invested in the strategy during the period. Clients of the firm may receive different performance than the representative account. Client performance may differ due to factors such as timing of investment(s), timing of withdrawal(s), client-mandated investment restrictions and the portfolio not being fully replicated for new accounts or new flows. Investors should consider the investment objectives, risks, charges and expenses carefully before investing. The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities. See 'WARNING' and IMPORTANT INFORMATION' below.

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