Setanta Global Equity Strategy (USD)
Q2 2023

Strategy Description

The **Global 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 a diversified, actively managed equity portfolio. As bottom-up fundamental value investors, our research process is designed to properly understand how each business functions and to consider risks pertinent to the business. Securities are chosen by a team of global sector specialists, targeting sensible diversification across industries, geographies and market capitalizations. We value each business, with the priority to pay a price that mitigates downside risk. We aim to make investments for the long-term, all the while considering the available opportunity set.

Strategy Commentary

Global equity markets produced a good positive return of 6.8% (MSCI World Net Total Return in USD) in Q2, leaving the benchmark around 15% ahead in the first six months of the year. The performance looks at odds with the tough global macro backdrop of a stubbornly high core inflation rate and rising interest rates. The mini-banking crisis of Q1 which claimed the corporate lives of Credit Suisse and Silicon Valley Bank is a distant memory. As I write this in early July, all appears (eerily?) calm. *(Strategy 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

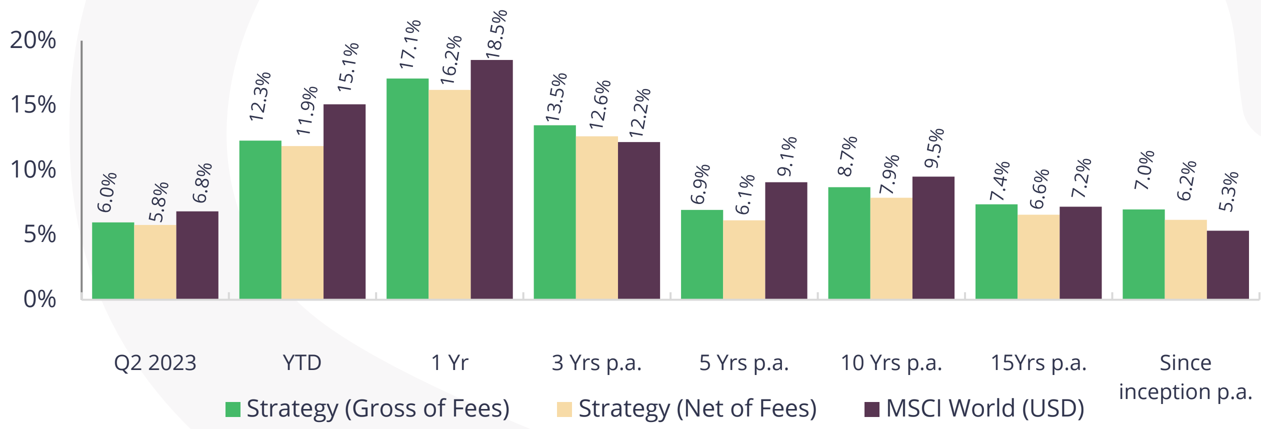
Businesses we own must have strong balance sheets

We make mistakes and always endeavour to learn from them

We will act with integrity in everything we do

Performance and Strategy data as at 30th June 2023

Strategy Performance (USD)



Yearly Performance (USD)

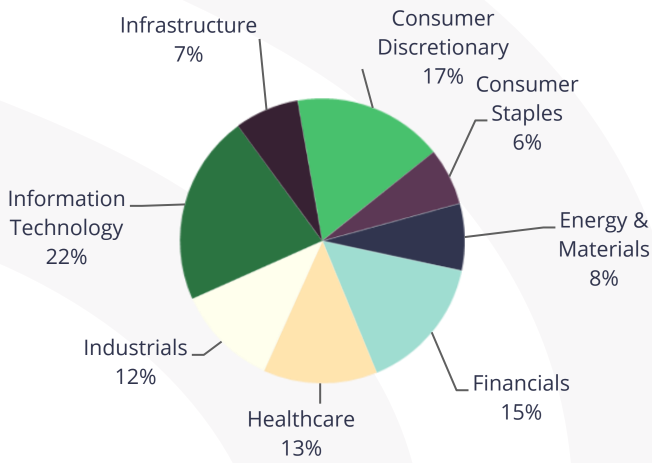
	2018	2019	2020	2021	2022
Strategy (Gross of Fees)	-8.5%	19.8%	5.4%	23.2%	-13.4%
Strategy (Net of Fees)	-9.1%	18.9%	4.6%	22.3%	-14.1%
MSCI World (USD)	-8.7%	27.7%	15.9%	21.8%	-18.1%

Performance Source: Setanta Asset Management Limited. The returns stated are based on the movements in the unit prices of the lead Euro portfolio of the Global Equity Strategy, which has been converted to USD at FX rate 1.091. 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: December 2000. **Benchmark:** MSCI World (USD).

Portfolio Valuation Statistics

PRICE/BOOK	2.4
PRICE/EARNINGS RATIO (FY 1)	17.1
DIVIDEND YIELD %	2.0
AVERAGE MARKET CAP $BN	149.1
NO. OF HOLDINGS	81
ACTIVE SHARE %	83.5
DEBT/EQUITY %	49.4

Sector Distribution

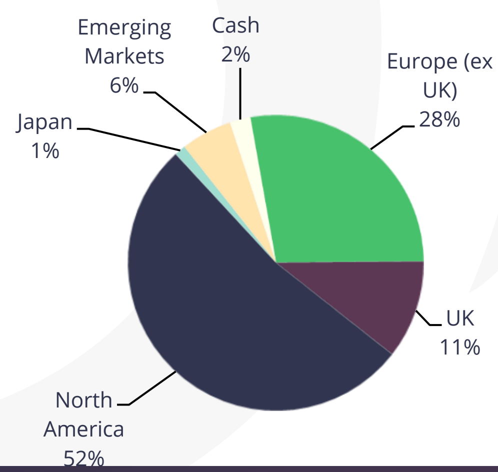


Top 10 Holdings

COMPANY	SECTOR	WEIGHT
MICROSOFT CORP	INFORMATION TECHNOLOGY	4.9%
BERKSHIRE HATHAWAY	FINANCIALS	3.8%
ORACLE CORP	INFORMATION TECHNOLOGY	3.6%
ALPHABET INC	CONSUMER DISCRETIONARY	2.8%
MCDONALD'S CORP	CONSUMER DISCRETIONARY	2.8%
COSTCO WHOLESALE	CONSUMER DISCRETIONARY	2.7%
BOOKING HOLDINGS	CONSUMER DISCRETIONARY	2.5%
SAMSUNG ELECTRONICS	INFORMATION TECHNOLOGY	2.5%
JOHNSON & JOHNSON	HEALTH CARE	2.2%
NIKE INC	CONSUMER DISCRETIONARY	2.2%

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

Geographic Distribution



Narrow group of stocks drive most of equity market gains

However you very likely know that is not the full story. A remarkable feature market in 2023 has been share price strength in a very small number of very large companies. To highlight, just seven out of over 1,500 stocks in the MSCI World – Apple, Microsoft, Nvidia, Amazon, Meta, Tesla and Alphabet, each up between 30% and 180% – accounted for almost 60% of the index's return in the year to end June. By contrast, the median stock in the benchmark was up just 4.7% over the same period. A common theme among these magnificent seven is they are perceived to be beneficiaries of Generative AI: large data algorithms such as ChatGPT that can generate content based on user prompts. Though it never brings us any pleasure to report strategy underperformance, the speed and narrowness of the "theme" explains why the portfolio only rose 10% in the first six months. In fact, we think in the circumstances it was a rather good outturn.

Equity markets are prone to bouts of hype and most of the time we don't bat an eyelid, but this feels different. When Bill Gates says that generative AI is one of the most revolutionary technologies he has ever seen, it should be taken seriously. The speed at which Generative AI has captured the attention of users / markets / investors over the past six months is staggering. It is the fastest consumer application in history and it's also rapidly capturing the attention of companies who are looking to use it to innovate, to speed up workflows and processes, to collaborate with humans to provide better outcomes and to provide faster and more comprehensive data processing. It took ChatGPT just two months to reach 100 million Monthly Active Users, compared to say TikTok which took nine months to reach a similar level or Instagram which took two-and-a-half years. According to IBM Global AI Index 35% of companies are now reporting to be using AI in their business and a further 42% are evaluating it.

While we are by no means AI experts, we have been thinking about the potential for AI for a while and we believe a number of existing holdings may ultimately benefit from the technology, some less obvious than others. For example Samsung Electronics, TSMC, S&P Global, Thermo Fisher, United Health, as well as the likes of Microsoft, Alphabet and Oracle. However AI is still in its infancy. The most critical stumbling block for investors is that we can't be sure how these models will ultimately work, which makes it extremely difficult to identify the implications of AI applications. The speed at which the technology is adopted is also very unclear, as is the regulatory environment which will govern it. As AI capabilities become integrated into the economy, it is conceivable that many companies will be displaced while others will be huge direct or indirect beneficiaries. We will be watching developments, feeling out which category each of our holdings are likely to fall into and whether changes are needed. As you know, our investment approach is to own quality companies at attractive prices, so anything that threatens the sustainability of that quality demands serious consideration.

In addition to Microsoft, Oracle and Alphabet, (up 15-29%, local prices), other notable portfolio performers during Q2 include Melrose Industries (+42%), following a capital markets day where management laid out a bullish outlook for the aerospace business, and Netflix which was up 28% as the market grows more confident it can execute its plan of a lower-cost ad-tier service. Among the detractors were Estée Lauder (-20%), Tencent (-13%), Nike (-10%). In all three cases the companies are experiencing some current difficulties, but we believe the valuations to be attractive and continue to believe their long-term investment cases are sound.

Portfolio activity

During the quarter there was a somewhat elevated level of portfolio activity as we added four new stocks (full positions in Ferguson and Nextera; starter positions in Sonova and PayPal) and sold out of three (Constellation Energy, Tesco, Euroapi). Also, Dowlais (auto parts manufacturer) made its way in via a spin from Melrose. Below we offer the investment rationale behind the decisions.

Ferguson – previously known as Wolseley – is a distributor of plumbing, heating and related products to professional tradesmen. Today Ferguson sells primarily in the US (national footprint), having exited its poorly positioned European operations over the last decade or so. The company has a balanced exposure to steady renovation / maintenance spending versus more volatile new build (60/40%), while there is near 50/50% split between sales to residential and non-residential end markets. Ferguson sits between highly fragmented supplier and customer bases and is usually the number 1 or 2 player, with typical market shares of 10-20% across its different divisions. Its scale results in greater bargaining power with suppliers (estimated ~3% price advantage over smaller competitors), an ability to reliably stock a wide number of products (very important for the customer), more resources to invest in technology / automation / omnichannel distribution (better efficiencies) and an ability to develop its own brand offering (twice the gross margin of non-own brand). The combination of these and other factors have enabled Ferguson to earn very attractive economics in the US historically and we estimate the group has the potential to earn a c.20% return on invested capital over the cycle. Management targets 7-12% p.a. revenue growth over the medium term, made up of market growth, pricing, market share gains and 1-3% from acquisitions. It also believes there is scope for modest margin expansion. The group's balance sheet is good order.

Near-term risks include the impact from higher interest rates / tightening credit conditions on general demand, a greater than expected reversal of pulled-forward demand from COVID and price deflation that could crimp margins by more than we expect. These may add volatility to near-term earnings but should not detract from the attractive longer-term opportunity. Ferguson accounted for 1.2% of the strategy at quarter end and was funded by partial sales of Johnson Controls and OI Glass.

Nextera Energy is a diversified US utility with a long track record of developing clean energy assets. It operates two main businesses: a regulated integrated utility in Florida (FPL), and Nextera Energy Resources (NEER) which is a mix of mostly unregulated businesses operating across the US and Canada. US regulated utilities may earn an allowed return on equity, with an ability to outperform this rate through efficiencies. Thanks to a strong operating performance, FPL has been able to match or outperform its regulator allowed 10.5% RoE over the last decade while growing operating assets at a mid- to high-single digit annual rate while maintaining high levels of service quality and affordability. Growth is helped by Florida's strong economy above-average population growth (more demand requires more generation assets and electricity grids).

NEER is one of the largest independent power producers in the US. It was launched around 30 years ago, beginning with wind assets and since then has added marketing and trading capabilities, transmission and gas infrastructure and has a strong position in the nascent battery and green hydrogen markets. We believe NEER has significant sustainable advantages, including its strong reputation with regulators; customer relationships that enables it to match its long-duration assets to demand (>90% of revenues contracted for an average 15 years); scale advantages such as in the procurement of generation equipment; and low finance costs. NEER has grown its capacity by 7% p.a. over the last 10 years.

The US, like elsewhere, has a significant need to overhaul its energy infrastructure. The Investment Reduction Act (IRA) provides very strong support for renewables investment. As a pre-eminent renewable asset developer and operator, Nextera has a clear capability to reinvest earnings at attractive rates of return. We believe the company can grow earnings and dividends by high single digit rate over a long period of time. Nextera's valuation is high relative to peers at c.25 PE, but we feel it is well deserved given the visibility of future growth and a best-in-class management team known for its execution and forward-thinking culture. Nextera was 1.2% of the strategy at quarter end.

Sonova Holding is a Swiss-based hearing aid company. Our healthcare portfolio manager Rowan Smith has followed Sonova and its peers with interest for about 20 years. There are just five hearing aid wholesale manufacturers globally (Sonova has a leading 25% share) and market shares have remained quite stable over time with no significant new entrants. We like that improvements in hearing aid technology tend to be incremental, not revolutionary e.g. smaller form factor, more adaptable to varying noise levels. Also hearing aid demand is very stable, partly because more than 50% of industry volume is replacement units. We think industry sales should grow above GDP, helped by demographics (hearing loss is closely correlated with age) and increased availability of products in underpenetrated parts of the world. Hearing aid wholesale manufacturing is extremely profitable, with good margins and low capital requirements.

In most markets hearing aids need to be prescribed by a trained professional. Customers go to a retail store to undergo a hearing test, be advised on a suitable product and have their hearing aid settings adjusted as required. In the past we were concerned to see hearing aid manufacturers enter into the retail space. This was a move to control the customer relationship and protect the brand but retail is a more fragmented / competitive business and we feared it could have a detrimental impact on group financial performance. However Sonova has managed this transition reasonably well even as retail has grown to around a quarter of profits.

On our conservative estimates, Sonova was trading on a PE of 25x at the time of purchase, with the potential to deliver a mid to high single digit annual total return. We have added a starter weight (0.5% of strategy at quarter end) and may increase this over time.

PayPal is a brand known to you all: a payments company makes it easier and safer to make digital transactions. It is a beneficiary of the secular growth in ecommerce and digital payments. PayPal is one of the few double-sided payment networks, sitting between consumers and merchants. Consumers us PayPal because it is free to use and widely accepted by merchants (who pay a transaction fee), which draws more users into the network. PayPal has an estimated 15% market share of global ecommerce payments, making it 3- to 5-times bigger than its closest competitor. Such scale gives the company tremendous advantages over competitors. This is reflected in the company's historic mid-to-high teens operating margin (Setanta calculated) and strong growth. As an asset light company, PayPal does not need much capital to grow, resulting in a high conversion of profits into cash flow, which the company has historically used to buy back stock and make acquisitions.

Commentary

PayPal became a COVID darling stock but as economies reopened and ecommerce trends stalled / reversed the shares gave back all its pandemic gains and more, prompting us to investigate a possible investment. Greater competition in payments has emerged in recent years, including from Apple / Google Pay and Buy Now Pay Later companies. However, we think PayPal still has a bright future with untapped potential to offer what rivals cannot. A changing mix shift is putting some pressure on group margins, but the company expects increased scale, efficiencies and new products will offset this in the coming years, driving profits upwards. With the stock trading at its lowest ever valuation (we estimate a low 20s PE at the time of investment) we decided to take a starter position (0.4% at quarter end) with a view to adding as we get more evidence that the company can continue to thrive in the face of competitive threats.

The most notable portfolio exit was **Constellation Energy** (0.9% weight in the strategy at end-March). Constellation Energy was a spin out from US utility Exelon, following its decision to split into two: the regulated assets remained with Exelon (which we continue to own) while the unrelated assets were put into Constellation Energy. Constellation has had a favourable wind behind it in the last couple of years. For one, the company's profit outlook was boosted by the rising cost of fossil fuels, which pushed up wholesale power prices while only modestly impacting its power generation costs given its large nuclear generation fleet. And secondly, whereas there was previously some uncertainty about the role for nuclear in the US power market, the aforementioned IRA bill explicitly supports it as a clean energy source of the future, materially increasing the company's reinvestment opportunities. Following a near doubling of its share price in just over a year, we decided to cash in and invest the proceeds in Nextera where we believe the prospects are better.

We first purchased British retailer **Tesco** in 2012 after a profit warning and a sell-off in the shares. At the time we thought these were temporary issues and that the company had structural competitive advantages, primarily scale and operating efficiencies. This was a misjudgement. A year later it emerged that Tesco had been inflating profits and had been unfairly squeezing suppliers. Under new management the company put in place fairer supplier payment agreements, exited international operations and cut prices to better compete with hard discounters that had emerged as a serious threat. The company's profit turnaround took a number of years and even longer for the market to recognise the progress made. We concluded some time ago that this was not a core long-term holding – UK retailing is too competitive – so this was a case of waiting for the market to offer us a fair exit price. We sold some shares in Q1 and competed the sale in Q2 at roughly the same price as we first purchased, but the opportunity cost over this period was substantial. The proceeds from the Tesco sale were added to existing holding Estée Lauder, which released weaker than expected profits for the quarter ended March. We believe the company is very high-quality, a market leader in the growing premium skincare market, where brand loyalty is high and margins are very attractive. The current difficulties are due to stocking and inventory management by customers in its key Chinese market, who have only recently emerged from an extended COVID lockdown.

Euroapi was also sold in Q2. We received shares in the company via a spin out from another portfolio holding, French pharmaceutical Sanofi. Euroapi is a relatively a small company and a miniscule holding for us. After some research we concluded this was not a stock we wanted to continue to own. The strategy ended the period with 81 holdings.

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