Setanta Global Equity Strategy (USD)

Q3 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

Rising interest rates

A significant development during Q3 was the rise in long-term interest rates. As I write this, the 10-year US Treasury and 10-year German Government bond yields are 4.8% and 3% respectively, up from 3.5% and 1.9% at the beginning of 2023 and 0.5% and -0.6% at their lows around 2020. These benchmark rates are the lingua franca for investors of all stripes, ultimately determining how global assets are valued. Yields are up because inflation has remained high and investors fear that short term interest rates will remain higher for longer. *(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

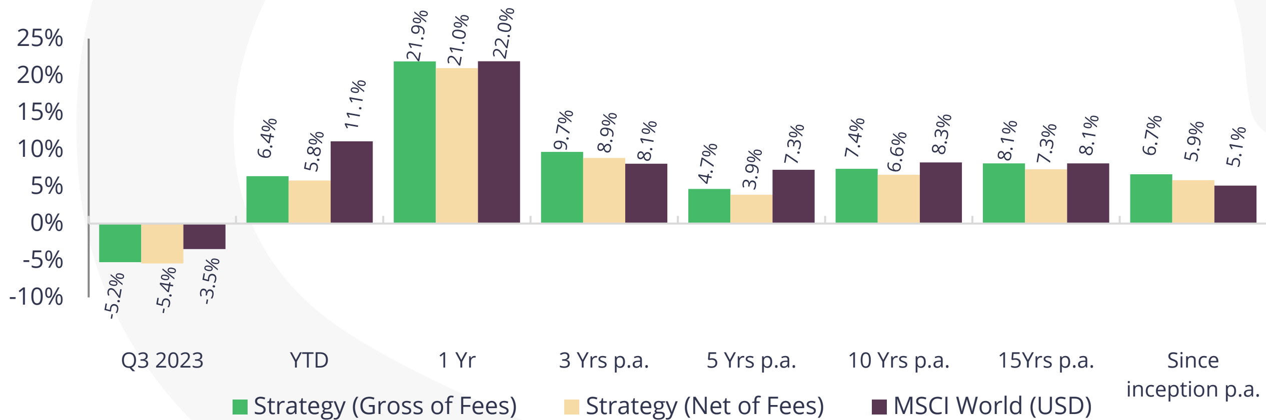
Businesses we own must have strong balance sheets

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 September 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%

Portfolio Valuation Statistics

PRICE/BOOK	2.2
PRICE/EARNINGS RATIO (FY 1)	15.4
DIVIDEND YIELD %	2.1
AVERAGE MARKET CAP $BN	147.8
NO. OF HOLDINGS	78
ACTIVE SHARE %	83.7
DEBT/EQUITY %	48.2

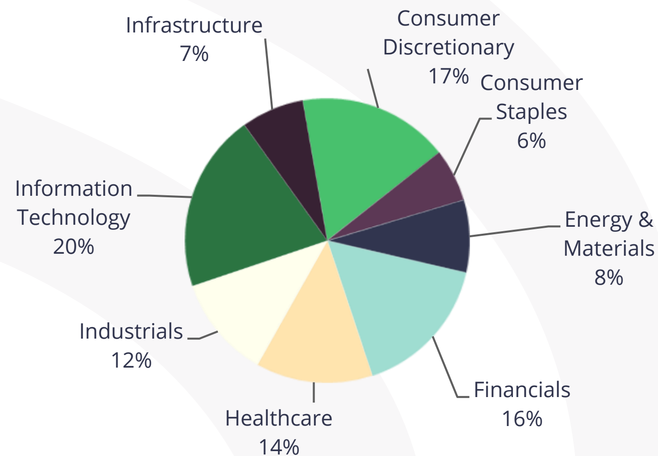
Top 10 Holdings

COMPANY	SECTOR	WEIGHT
MICROSOFT CORP	INFORMATION TECHNOLOGY	4.9%
BERKSHIRE HATHAWAY	FINANCIALS	4.1%
ORACLE CORP	INFORMATION TECHNOLOGY	3.4%
ALPHABET INC	CONSUMER DISCRETIONARY	3.2%
BOOKING HOLDINGS	CONSUMER DISCRETIONARY	3.0%
COSTCO WHOLESALE	CONSUMER DISCRETIONARY	2.9%
MCDONALD'S CORP	CONSUMER DISCRETIONARY	2.5%
SAMSUNG ELECTRONICS	INFORMATION TECHNOLOGY	2.5%
S&P GLOBAL	FINANCIALS	2.0%
NIKE INC	CONSUMER DISCRETIONARY	1.9%

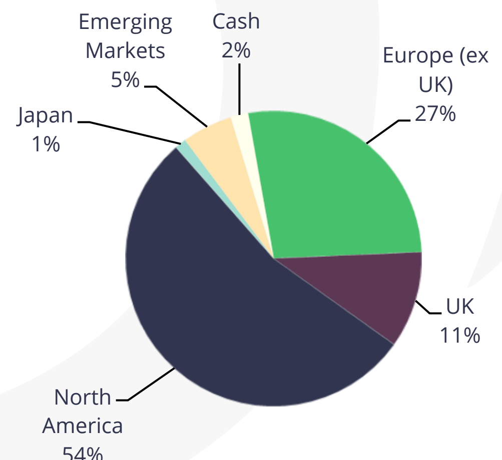
Holdings Source: Setanta. Sector allocations based on invested portfolio only (excludes cash), of the lead Euro account of the Global Equity Strategy. **Portfolio Valuation Statistics Source:** Bloomberg, based on the lead Euro account of the Global Equity Strategy, shown in USD.

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 1.0588. 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).

Sector Distribution



Geographic Distribution



SETANTA Asset Management

Commentary

One can say that interest rates have simply reverted back towards their long-term average. And yet it would be something of a minor miracle if interest rates could rise so far and so quickly and for there not to be some fall out, somewhere. Save for consumers cutting back on discretionary purchases (see below), to date there are few signs of economic strain. The big drivers – employment, house prices – continue to hold in well for now and financial markets are relatively calm.

The Setanta investment approach has always emphasised balance sheet strength as a protective shield for the equity holder and the current crop of strategy holdings is no different. To demonstrate, of the strategy's top 20 holdings (accounting for almost 50% of the strategy), ten have net cash on their balance sheets while we estimate a further six would be able to pay off all their debt within 3-4 years (calculated using an estimate of free cash flow i.e. after interest, tax and capex – not some EBITDA nonsense). Where debt levels are a bit higher like McDonalds and Oracle, the business quality is exceptional. We don't always get it right because things can come from leftfield, but it's a mindset that has helped protect performance in the past. Overall, we think our portfolio of holdings is in pretty good shape to navigate choppy waters should they emerge and we are ready to act if dislocations appear.

Performance review

In the third quarter the strategy trailed the benchmark (gross of fees) by 1.8%. Notable outperformers include energy stocks **HF Sinclair** (US refiner, +29% in local prices), **ENI** and **Exxon Mobil** (integrated oil companies, +18% and +11% in local prices respectively), all of which are beneficiaries of higher oil prices. Also strong in Q3 was **Charter Communications** (+20% in local prices). You may recall last year the company announced it was going to step up its investment in the business for the next few years, which would divert cash flows from share buybacks. The market reacted negatively to this despite assurances from management that the return on the investments was attractive, but this year investors have become more agreeable to the idea and the stock has regained some of its lost ground. **Booking Holdings**, the parent of Booking.com, was also strong, as the stock rose 14% (in local prices) in Q3 and over 50% (in local prices) in the year to end September. The company takes a percentage of the spend on hotel room nights booked on its platform and has particular strength in Europe. Consumers are choosing "experiences over things", which is good for the travel sector. The strong US dollar has also helped, boosting inbound tourism from the US into Europe. Booking expects to make record profits in 2023. We really like the business longer term, but there is a question mark over whether current demand will be sustained into 2024 because we have seen dampened demand across a number of consumer companies, as highlighted by a couple of the strategy's consumer staples holdings below. In light of this we are keeping an eye on Booking's valuation.

Among the underperformers was **Pernod Ricard**, the world's second largest producer of wines and spirits and owner of 240 brands including Jameson whiskey, Absolut vodka, Glenlivet scotch as well as its two eponymous aniseed liqueurs. The company reported good results in August but warned that the three months to September would be weak in the US and China. We were surprised that the stock reacted so negatively to this news (-21% in local prices in Q3). Management noted that China is experiencing general economic weakness, hitting sales of their premium cognac brand Martel. There has also been a slowdown in demand in the US which is leading to some industry destocking, while the best performing category in the US is tequila where Pernod has less exposure than peers. Aside from these near-term challenges, the company is in rude health and given its favourable valuation of ~16x earnings (5-year average 22x) we increased our position shortly after the quarter end.

Also under pressure was **Estee Lauder**. The company sells a range of beauty products but it makes most of its money in premium skincare, a particularly attractive segment of the broad consumer staples category. The company has a particularly strong position among Chinese consumers, which has helped grow group revenues by 6% p.a. over the last 25-30 years. This company snapshot splintered somewhat in the last year. China's re-emergence from Covid lockdowns has proven a challenge. Consumers probably overbought and / or reduced their usage of beauty products during Covid and retailers have had to adjust down their inventories. And in truth the company has not managed the situation as well as peer L'Oreal. During the quarter the Chinese government-imposed restrictions on daigou shoppers – individuals that purchase for profit goods outside of China on behalf of people living in China, to avoid duty / tax or to access supply. This move has delayed the recovery in Estee's travel retail division by a few quarters, contributing to a ~26% fall in the share price during the quarter. Importantly, there is nothing to suggest that EL has lost market share in China or that its products are less desirable. The longer-term picture is that consumption of beauty products in China is still very underpenetrated versus markets such as the Korea and Japan but right now there is a demand air pocket. Estee's valuation looks high (mid-30s PE) for the next 12 months, but assuming an operating margin of 15-16% (versus peak 20% and current 11%) then it's trading on ~25x. If the company can get back on a growth track we think the stock can recover and deliver attractive long term returns.

While there are specifics relating to Pernod and Estee Lauder, a recurring theme of a weakening consumer has emerged in recent months and quarters. Among the strategy's holdings we note Q3 share price weakness in **Nike** (footwear & apparel, -12% in local prices), **Richemont** (luxury goods, -24% in local prices), **Heineken** (premium beer, -10% in local prices) and **Kerry Group** (food ingredients, -11% in local prices). Each of these has attributes we seek out when investing – strong brands, good growth prospects and healthy balance sheets. We expect to remain shareholders over the medium to long term, but near-term results could be tricky.

Portfolio activity

Three stocks made their way out of the strategy during the quarter. There were no new stock additions and proceeds from the sales were spread across existing holdings.

The three sales were Groupe Bruxelles Lambert, Sandstorm Gold and Vodafone.

Groupe Bruxelles Lambert (GBL) was the most meaningful sale, having recently accounted for 1.3% of the strategy. The company is a family-controlled financial holding company. It has investments in a range of European public and private companies e.g. Pernod Ricard, SGS and adidas account for ~50% of current gross NAV. It can be thought of as an investment fund with very low operating costs, a low level of financial leverage and at the time of purchase in Q3 2015 it was trading at a ~25% discount to the fair value of its assets. We considered the likelihood of the NAV discount closing to be low (it had been this way for most of its history) but it struck us as a heads we win, tails we don't lose a lot scenario. It turned out to be the latter. In the 8 years we owned the stock the discount gradually widened to 35-40% but nevertheless still generated a passable mid-single digit annualised return. We had many conversations with the company about how they could narrow and perhaps even take advantage of the NAV discount. In fairness to management and the Board they simplified the company structure and increased share buybacks during our ownership period. However, we don't believe these actions went far enough and weren't optimistic that a major strategic change was forthcoming. In particular we questioned management's strategy of recycling more capital into private assets, whose valuations are inherently more subjective, rather than buying back their own stock in more substantial size.

In the end, we decided that our capital was better served elsewhere and topped up other financial holdings: S&P Global (ratings, financial data & analytics), Tryg (Scandinavian property / casualty insurer) and Bank Leumi (Israel's leading bank).

Sandstorm Gold is a gold royalty company. It acquires gold purchase agreements with companies that have advanced development projects or operating mines. It was first purchased for the strategy in 2013. At the time we had analysed the mining industry and didn't like what we saw. Mining companies are highly operationally leveraged, requiring huge amounts of capex with little visibility into the return likely to be generated. However we spotted what looked like an attractive niche: companies that provide financing to mining companies in return for receiving gold at a predetermined discounted price to market value. We liked that the royalty companies have a very low cost base (they typically employ just a handful of people) and are diversified across many projects (and so less dependent on the success or failure of any one mine). There are some excellent royalty companies out there, but unfortunately Sandstorm turned out to be a poor investment, declining modestly over 10 years in the midst of an equity bull market. In hindsight, Sandstorm in 2013 was subscale and in order to grow issued equity. Between 2013 and 2016 shares outstanding doubled – more than we expected – but at that point we received assurances from management that the company was sufficiently large and diversified and that dilutive equity issues were in the rear mirror. However in 2022 the company made two major acquisitions totalling $1.1bn, financed by a 50% increase in shares outstanding and by increasing financial leverage (a significant departure from its past). Having already harboured misgivings about their capital allocation (choosing which project to finance is key to success in this business), our exit was just a matter of when and not if. Sandstorm accounted for 0.6% of the strategy at year-end 2022. We cut back our holding over the course of 2023 and sold our final shares in July. The proceeds were invested into Ryanair and Ferguson.

Vodafone is a telecommunications provider, with key operations in Germany, the UK, Italy and Spain. It was also a long-term holding and in truth has been long earmarked for sale. The telecoms business is brutally competitive and requires high levels of capex every few years. Regulators in Europe have taken a particularly strong consumer-first approach, making it hard for operators like Vodafone to make an attractive return on investment. As with many value traps, there was always the prospect of better times ahead coupled with what seemed like terrible investor sentiment and a depressed share price. Over the years we saw consolidation as being helpful for future returns, only to see new competitors emerge (new licences issued). Some very profitable revenue sources disappeared, notably the ban on mobile roaming surcharges across the EU in 2017. The potential for operators to monetise sharply rising mobile data usage was ultimately competed away. Vodafone itself sold off assets over the years but proceeds have primarily gone towards debt reduction measures rather than into shareholders' pockets. Meanwhile the operating performance of remaining businesses has been under constant pressure and there are now fears that the company is not generating enough cash to cover its dividend. We should have sold out of Vodafone years ago, but at least we had the good sense to keep our exposure limited to ~0.5% of the strategy over the last 7-8 years and in a broader context the strategy was underweight telcos versus the benchmark. The proceeds raised were invested in Nextera.

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