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Too much of a good thing?

- the bias towards Irish Equities

Irish pension funds are no different to pension funds in many countries in showing a strong bias towards domestic equities. In fact, compared to many countries Irish funds are quite diversified. However, as the Irish market is tiny in a world context (c. 0.4% of the MSCI World Index) the question is on what basis can Irish equity weightings of 18-19% be justified within Balanced/Managed funds?

Before answering that question it is worth trying to assess how these levels were reached; so let us examine "top down" as the likely rationale. Yes the strength of the Irish economy, the quality of the leading companies and valuations could well have encouraged Managers to be strongly overweight - BUT 45 times the World Index? In a market with large sectoral skews and stock specific risks?

"bottom-up" process could deliver a 45 times overweighting. As for 'legacy', the days of Exchange Control are long gone (1989), and the winding down of Irish equity content was well underway 10 years ago. Is it all about currency? Well, Eurozone markets (ex Ireland) account for 19% of the MSCI World Index and Irish managed funds were only slightly overweighted having 23% of their total equities (on average) in those markets at June 30, 2006 (Source: Mercer Pooled Survey). If 15% of Balanced/Managed assets were switched from Irish to Eurozone equities, the latter would not even be double-weighted.

It would appear that there must be another explanation and the answer would appear to lie in the behaviour of Managers, as the following graph illustrates:

- 32%* of the ISEQ is AIB and BOI
- 45%* of the ISEQ is financials
- the top 5 stocks represent 60%* of the ISEQ

*As of September 29, 2006.
Source: Davy Weekly Book

Large concentrations in the largest stocks are not unique to Ireland; however, there are few markets in which almost a third of the market is accounted for by 2 stocks which have a historic correlation of **0.93** (AIB and BOI over the 10 years to 31/8/06 - Source: Setanta Asset Management).

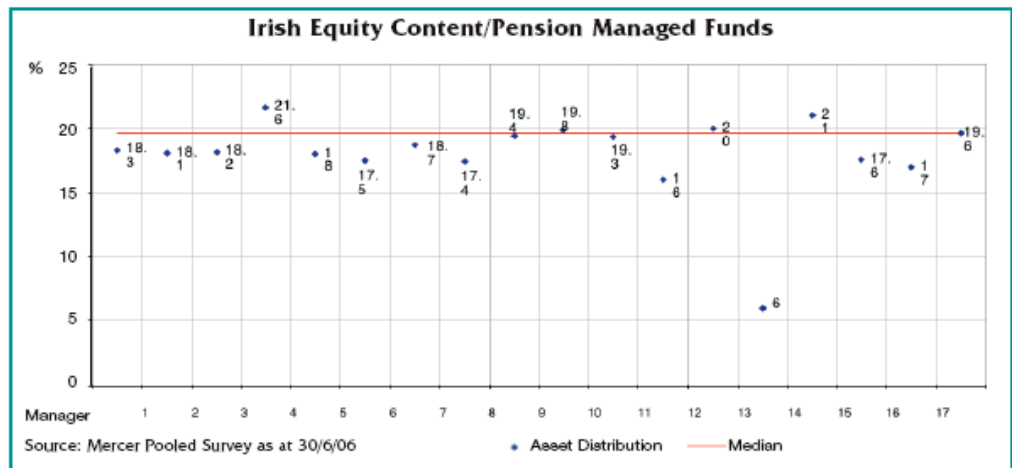
It is not as if the investment opportunity in Ireland (while very good) was so unique as to warrant huge overweightings - Spain (c. 5 times bigger) has produced comparable returns to Ireland over the past 3 and 5 years but few, if any, Irish managers have been even market-weighted. Canada has been c. 3% per annum better over the last 5 years (in € and CAD) but Managers have been significantly underweight.

	% of MSCI World Index	3yr Return (% p.a.)	5yr Return (% p.a.)
Ireland	0.4	23.5	9.6
Spain	2.2	22.9	10.8
Canada	3.9	22.2	12.4

Source: Bloomberg/Total Return (ln €) to 31/8/06

So was it "bottom-up"? - an assessment that AIB and BOI were the two most attractive bank investment propositions in the world (by a wide margin) is clearly not correct - they performed exceedingly well but so did many others (the index of Japanese banks rose by **37% p.a.** over the last 3 years).

Whatever about individual stocks being adjudged better value on a case-by-case basis it is inconceivable that any



If the Irish equity weightings were decisions taken independently, the probability of **15 of 18** pension managed funds arriving at levels within 2% of the average is absolutely remote. This is all the more remarkable an outcome given the massive overweighting of Ireland relative to its size.

The facts therefore confirm that most Managers in Ireland determine the Irish equity content of Managed/Balanced funds on neither a 'top down' or 'bottom-up' basis - **weightings are in most cases derived from or very substantially informed by the general level of Irish equities in comparable funds.**

When the property boom currently fuelling the economy slows down, ceases or goes into reverse, it will be interesting to see how quickly allocations to Irish equities are reversed, and whether Irish or overseas investors are quicker on the trigger.

However the future unfolds, the current commitment to Irish equities must be viewed as high in the context of the size of the market, the sectoral and stock specific skews within the market and the scale and variety of opportunity elsewhere.

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