## Eureka Report's Alan Kohler recently spoke with Talaria CIO Chad Padowitz on all things Talaria, including our unique process for generating a differentiated source of income.

Chad Padowitz is the Chief Investment Officer of Talaria Asset Management, which used to be called Wingate, got about $500 million under management and it's got some very interesting investment methods. It's a global investor, a value investor, but they generate quite a lot of income tending to be 7 per cent plus income, not franked of course because it's all global, but 7 per cent plus income based on the way they use the options and derivatives markets to buy their shares so it's quite interesting, well worth having a listen to this or a read of the transcript.

**Chad, Talaria Asset Management used to be called Wingate, was that a management buyout and when did it happen?**

Yes, it was. The business has been going for 15 years, Wingate Asset Management – about 18 months ago we did a management buyout and changed the name to Talaria. It's the same business, the same underlying clients and employees, we merely changed the ownership structure to more align the business with its clients.

**Right, and so it's now owned by the staff, is that right?**

Yeah, there's three principals of which I'm one and I've got two partners, Hugh Selby-Smith and Jamie Mead, which we own the majority stake in the business with Wingate maintaining a minority stake.

**Right, and how much do you have under management?**

We're a little over $500 million and we only run the one fund so we only have effectively one product, we think because it's the best way to manage money so we only do one thing and that's basically doubled in the last two and half years.

Are you saying your performance improved after the management buyout?

The commercial imprint, yes, we invested into distribution branding, basically client engagement and that's obviously had a significant impact in our investment flows.

**What about your performance?**

Yeah, well our performance we have got a 15 year track record and that's been very good and it's met the objectives that we have had and I can talk to those, and that's been maintained since inception and certainly in the most recent, since the MBO as well.

**What are your objectives? I note that you seem to emphasise income so is it an income fund?**

Our objective is to compart real wealth over time and that is so that basically over a rolling three-year periods to have more money over time. We certainly expect to beat other asset classes and comparative market returns over a full market cycle but we are not benchmark aware in the more shorter term. We see income as an important component of return so we do not focus on generating income. We do generate it as part of the process but we see income as an important component of return and obviously our process allows us to generate a very high amount of income which disproportionately in the current environment is very attractive.

**Why is that, what about your process that generates income?**

The manner in which we buy shares – we are a long-only global equity fund, the manner in which we buy shares, we sell put options, cash back put options as a means of entering into positions we want to own for the long term. That generates a premium, that premium is impacted by market volatility such that higher volatility leads to higher income so that income which historically has been around 7 per cent a year as a component of return would generate about 7 per cent in income. Currently, that's running closer to 10 per cent a year because volatility is very elevated.

**Explain to us what you mean by a cash back put option, exactly what does that entail?**

So as I said we are a long-only bottom-up fundamental investor in equities so assuming we want to buy a share and we think the share is worth $120 and it's trading at $100, rather than buy the share directly we will sell a put option at say $95 for two months out which effectively gives the buyer of that option the right to give us the shares at $95, so we're a buyer at $95 when it's trading at $100 so that gives you a 5 per cent buffer. We will also get paid a premium for agreeing to buy it and that premium would be for instance $2 or $3 a share and that annualises at around 20 per cent return.

That's the income we generate. Importantly if we want to buy this share at $100, $1 million worth, we'll have $1 million in the bank, that's where the cash backed is. There is no derivative or option or margin risk or leverage of any nature, this is just a means of buying the shares you want to buy but getting paid for it along the way at a lower risk weight.

**It doesn't seem like long term ownership; it seems a bit less long term than that.**

This is the means of getting the share. Once we own the share our average holding period is about three years. This is merely a means of getting the share so once we get the share and it drops below say $95 in that example unless something has changed, we will own that until it goes to $120 depending on the fundamentals of the company, or at a higher level.

**You only end up owning the share if it drops below the put option price?**

That's right, because we want to always get paid for taking market risk. Every time you're a participant in the market you're taking a risk and it is part of our philosophy that you actually get paid for taking risk and it's currently more like 20 per cent to 30 per cent annualised return, is a very high return for taking equity market risk.

**That's very interesting, I hadn't heard of that being done before. Is that something you invented yourself?**

Invent is a very strong word. The option market has been around for a long time and it's actually becoming more and more well known and the volumes are going up as well. Certainly, the tools have been around and have just become more well known of late but it is fair to say there haven't been too many funds that combine a bottom-up fundamental view with getting paid for taking that view.

The integration is quite unique, there would be others that do it but not many that we're aware of but yes we did start the process about 15 years ago so effectively it's about getting two sources of return, the shares you own which we talked about, plus the income you get from agreeing to buy them and that gives you the better chance of earning a compounding return over time.

**It seems to me that what your method involves is getting a double discount, your price estimate is below your estimated value but you're also buying at a discount to the current price.**

Yes, and we're getting a premium for that as well. Yes, you are right, there's multiple levels of lowering risk and getting paid for that. The opportunity cost on the other side which is obviously in that environment if the share skyrockets up immediately, we don't own the share, we've just got the premium. We think over time the combination of getting the shares you get plus the high level of return compensates for that but yes you are absolutely right, there's multiple levels of lowering risk.

The other thing that's notable is your total return on virtually every timeframe is virtually made up entirely of income and the growth proportion is negative so on the three years growth is minus 0.308, income 8.26, total return 5.18 and that's kind of the same all over the place. How come in your method you result in getting negative capital growth which is made up for by the income? Is that deliberate or is it you're just buying the wrong stocks?

How that's calculated, that income side does incorporate it. The option premium actually is sometimes part of the cost base when you get exercised so those numbers you quote, they do conflate a couple of moving pieces together. The bottom line is the total return is what matters and we think income as a component of total returns are a very important number but no, it's not about – every share we get paid a premium on is a stock selection so it's a bit like insurance, if you insure a bad asset it's a bad investment, if you insure a bad stock or you run option on the wrong stock it's a bad stock.

To earn and keep the premium is actually a source of stock selection if that makes sense. Because if the share I gave an example of dropped to $60 well then that would completely more than compensate for any income generated. I think you've got to look at the total return, income just happens to be a very big proportion but it goes through different periods so if you look at like '09 or '10, more discrete periods, growth part was substantially higher than income because obviously the strength of the equity market and our stock selection post the GFC or if you look at 2016, so there's different periods where the growth is more important than the income but we actually look at it as an investor, in a dollar how much you get out is what matters, how you break that up we actually think is less relevant and not as important.

**What's your benchmark? On your website, you're not actually comparing your total return to any benchmark.**

Yeah, the investors we seek to get into... as I said are people that are looking for a longer – to actually three broad outcomes, and these outcomes aren't really benchmark aware. Those outcomes are keeping mostly up, less of the down, generating a high level of income as component of return and lower volatility. As you would expect we do expect over time through the market cycle to outperform and certainly since inception we have outperformed. I was the first one who invested into the fund and I am significantly ahead of the MSCI world since that time.

That is a benchmark we expect through cycle to outperform but it is not in any way how we manage the money and certainly we think in a market that drops 20 per cent we don't think minus 15 per cent is a success.

**Fair enough.**

We are absolutely looking to generate a positive return in rolling three year periods and substantially – well, in every single rolling three year negative performance period we have substantially added value since inception.

**Maybe I'm wrong about this but just while I was talking to you I looked at the MSCI total return index, the last five years 6.55 per cent compound and your return over five years is 3.92 per cent so what am I missing there?**

As I said through market cycle the last five years has been a very strong market that's been driven by growth and the FAANGs, the Facebooks, Amazons, Google, and we are a value fund, I don't think I might have mentioned that so we are certainly in the more value end of things which to be fair has been a more challenged part of the equity market. It is one we think is starting to turn. It's also been one with very low volatility. If you look at an environment where the market favours one sector or group over another, which it certainly hasn't, in quite extreme as well as a very low level of volatility which impacts our income generator or makes up a lower level those are the sort of outcomes you'd get.

If you look at sort of since inception, the 15 years, that is greater, but in any environment where you look at – in an environment where value stocks do better in a highly volatile environment we would do much better as well so if you look at 09 to 2011 or 12 or 13 it just depends on what periods you're looking at, Alan.

**I haven't calculated the three years, you said every three-year rolling period you've outperformed the MSCI, is that…**

No, I didn't say that, no, I said every rolling three year period where the market was negative.

**I see.**

Yeah, so one of our key objectives is not to lose money, we think that's just a very important thing. When the market does go down we think it's very important obviously in the first instance to go down less but certainly to make money and in environments where the market itself didn't give you what you hoped it would we have substantiated value. Now, in environments where the markets have been strong we do have an opportunity cost because we only have on average around 60 per cent market exposure from a risk point of view which does lead to a very strong market. We would likely underperform that but as I said that's not our objective.

**What do you mean by a 60 per cent market exposure, do you mean that you've got 40 per cent cash all the time?**

No, what that means is we have a combination of how because we cash back the options as I mentioned we will have at any point in time say 50 per cent in shares we actually own and if those shares go up or down we would, like any other long-only fund, then we would have say for instance 30 per cent of money in cash, that's agreeing to buy shares so we're getting paid for it by that process I told you about but it actually is at a far lower risk because if you agree to buy something at say $90 and is trading at $100 that definitely has lower risk than if you just owned it at 100.

We calculate that we use the world delta adjusted exposure but it's really just mathematical calculation of what the market risk is and when we take into account that risk plus the equities we own it gets to around a 60 per cent number but importantly at least 80 per cent at any point in time minimum is always earning a return whether it's in shares directly or getting paid this option premium and that gap between the 80 per cent and the 60 per cent is actually what drives that because we're getting a very high return on the cash back and options, it actually drives that compounding a talked about but it's not 100 per cent so in a strong market we can tend to underperform certainly in a strong market driven by where growth shares are driving that.

**You call yourself a value investor, what do you mean by that, what distinguishes you from a growth investor?**

We won't buy a share that has to justify a high and sustainable growth rate to justify its current valuation so when we look at equities we look at their current earnings and we look at the sustainable level of their earnings and the cash flow that generates. We obviously then assess the sustainability of that, the sustainability of the margins and we look at that as how we value the company. We don't say they're earning X dollars and if they can grow 10 per cent, 15 per cent or 20 per cent YOY for five years, it's still cheap, we don't do that. We don't pay for high growth rates.

**Right, okay. Take us through some of your top holdings, I noticed your top holding is Prudential.**

Yeah, that's one of them.

**Tell us why you bought that.**

Prudential is the largest life insurance company in the US. It's also a trillion-dollar asset management company. We like the business of life insurance, insurance generally. That is a company that historically has traded around about 1 times book value and book value tends to be one of the more appropriate ways of valuing high financial asset type businesses like insurance and even banks. This is a business that trades at around one times book value historically, the share price has dropped to around 60 cents on the dollar, 60 cents of book value because financials are just not a sector that the market likes but Prudential is a double A-rated company, they haven't cut their dividend as opposed to most other financial services companies or banks and so on, cut the dividends, they have not.

They are generating a dividend of around 8 per cent a year. Their PE if you want to look at that is around 6 times so this is a company that is doing absolutely fine in the current environment, is not overly impacted by COVID and related risks around that yet you can buy that at 60 cents in the dollar and get around an 8 per cent dividend yield. Now, that's a share that if it just goes back to book value again which is about $100 a share, so it's trading at around 60, that alone is about a 50 per cent return. These are some of the advantages you have when you are a value investor and environments like this show up. That's why we like that company.

Other holdings that we have in the financial space while we're touching that is Swiss Re, it's not a similar company but it's in the same kind of sector. It's a reinsurance company, they were a triple A-rated company, also haven't cut their dividend, they have a 9 per cent dividend which they just paid. They are also trading at around 65 to 70 cents in the dollar and historically trade at around 100 to 110 cents in the dollar and that's another example of an opportunity we have at the moment. Some other examples we have – we have one of the larger global brewers, Japan-based Asahi breweries, they are the one that just bought Carlton and United in Australia just a few weeks ago because it's in Japan and Japan is a market that equity investors have tended to disregard of late or for quite some time actually, we're buying that on 10 or 11 times earnings where their peers trade at generally 15 to 20 times.

**What are the stocks you're waiting to buy because you've got put options out on them?**

So, we have got some put options on for instance LaFarge Holcim as an example, that is one of the largest cement concrete type businesses, Swiss based and very globally diversified. That is an industry which is basically fixed asset intensive, would benefit from non-residential construction and so on. That is trading at what we think is a very strong balance sheet that one is undervalued in and of itself but would also benefit in any recovery, certainly led by fiscal expansion which we think is happening around the world which will ultimately lead to greater spending on infrastructure and things like that but in and of itself on the current earnings that is a very attractive price.

Another company, Sodexo, as an example. They are a French-based catering and voucher and event management business. They have obviously been impacted by work from home and a lot of other things that are happening at the moment but that's a company that used to trade around 100 euros, it's trading around 60 because of these issues but we don't see them as being long term sustainable problems and we see the current environment is one where we can pick up those shares at an attractive price. Interestingly because the volatility is high once Sodexo which is trading at around 62 Euro, we're agreeing to buy it at 54 so at quite a substantial discount and we're getting paid approximately 20 per cent annualised return on that. That just gives you some idea of the…

**But you might not end up buying it.**

We might not but we're happy to get paid a 20 per cent return by just agreeing to buy it.

**I see.**

That's the thing, the opportunity cost isn't much when you're getting 20 per cent.

**Just looking at your top 10 holdings you're investing in many markets, US, UK, Germany, Switzerland, Japan, France, your universe is so big how do you filter them? How do you come up with the smaller universe from which to choose, what are your filters?**

The funds we use are screened which we try to filter what's several thousand companies down to basically a couple of hundred. We look at a different range of factors that cover governance which is how companies spend their money and allocate capital, profitability which is things like return on capital, return on equity and valuation and that would obviously be whether it's enterprise yields to EBIT or earnings. We look at three different broad spectrums which leads to seven discrete filters and the idea generation is those that rank within the top 10 per cent.

We are geographically and sector-neutral so that means at every month – just say auto companies in Japan, the top 10 per cent will show up there, media companies in the UK, the top 10 per cent will show up there. It doesn't choose regions or sectors, it just chooses the top 10 per cent and that's where the analysts – there's six of us on the analyst team, that's where we go down into the focus more individually on that far smaller list to look for opportunities.

**What's your fee?**

We charge 1.15 per cent, no performance fee.

**No performance fee, right. Is there a buy/sell spread as well?**

Yes, there is, I think it's 0.2.

**Do you have a minimum investment amount?**

Our client base is quite broad based, institutional, wholesale and retail, I think $5,000 we could take as a minimum.

**Right, and only on a platform or directly?**

You could buy directly, you could download the PDS on our website or we're on the vast majority of platforms as well.

**What are your distributions or what have they been and how often do you pay them?**

We pay distributions quarterly and that's underpinned by the income we generate. They have tended to be around 7 per cent to 8 per cent a year for the last 10 years and in fact, we increased our distribution driven by the high levels of option premium generally. We increased our last quarter distribution by about 13 per cent because the income we're generating is quite significant and we're going to be paying our next end of financial year distribution next week or two weeks from now, and that's going to be very high as well.

**How high?**

We haven't fully for the final number so I can't be specific but a number of around 7.5 per cent to 8 per cent, that's the historical distribution rate on the annual basis and that you should not expect that to be lowered at the moment and given how high income generation is happening at the moment we feel very confident in the long term sustainability of our income generation and the distribution is going to be well supported which has obviously been very advantageous for a lot of our clients who have seen dividends cut and other sources of fixed income yields compress elsewhere.

**You're saying it's sustainable because the income flows from your put option method of buying.**

That's right, and at the moment we used to generate 6 per cent to 7 per cent of option premium a year, it's now running at around 10 per cent to 12 per cent. The income generation which underpins distribution is actually a lot higher now than it has been for the last seven or eight years which one, certainly will help our future performance but it will also underpin the distribution that we're able to make.

**Is the distribution amount generally independent of what happens in the market? Say the market corrects now by 20 per cent or 30 per cent for some reason because there's a second wave of COVID 19. Would you still be paying 7 per cent plus distributions?**

There are obviously a few things that go into the distribution but yes, the vast majority of it is impacted by the option premium we generate. As it so happens the more volatile the markets – the market did drop 20 per cent as you said, it's likely volatility would actually go up notwithstanding it's already quite high. In a higher volatile environment, we actually generate more income. I think it's fair to say that is a very high probability that our income generation and distribution will not be affected by the market activity.

**That's very interesting, Chad. Thank you very much.**

No problems. Thanks, Alan.

**That was Chad Padowitz, Chief Investment Officer and Founder of Talaria Asset Management.**

*Source: Eureka Report*