# TALARIA PROCESS = GENUINE DIVERSIFICATION BENEFITS

**Traditional asset allocation approaches face extreme challenges to balance the risk / reward trade-off on behalf of clients.**

**Below we step through the challenges facing asset allocators in attempting to achieve maximum benefit per unit of risk using traditional asset class strategies. We also demonstrate why strategies that are truly differentiated are the key to delivering risk / return outcomes for clients.**

**Introduction:**

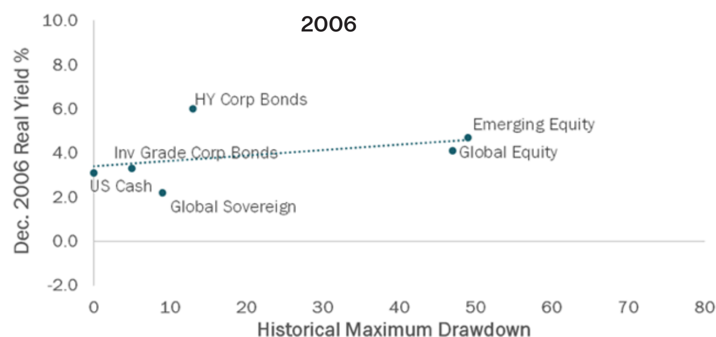
** Traditional portfolio diversification doesn't work today. Specifically, blending cash / bonds / equities doesn't generate anywhere near the historical return for the risk taken.

** Assuming an inflation+4% target return, on a like for like basis 2017's diversified portfolio today has a negative (rather than a positive in 2006) drawdown expectation. …you're almost as likely to get a negative return as a positive return p.a. of equal magnitude.

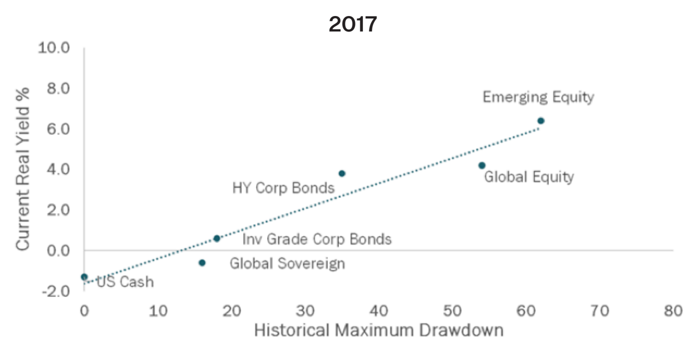
** Looking for truly differentiated strategies within asset classes rather than thinking across asset classes is the key to finding diversification given current cross asset valuations.

** <u>Our process seeks to halve the level of risk</u> AND <u>doubles the potential absolute return vs. global equities over a cycle</u> - providing an opportunity for diversification in overall portfolios. For example blending our strategy into the theoretical diversified portfolio below increases the target return by 0.9% p.a AND reduces the drawdown risk by around 40%.

The steepening of the lines of best fit in the two charts below show how the benefits of diversification are much lower compared to a decade ago. I have included below the charts a simplistic asset allocation assuming the requirement to generate a minimum 4%+ real return p.a and the capital at risk assuming a one in seven year drawdown to demonstrate this lower benefit. Notable is in 2006 – the worst outcome on the "portfolio" was an implied 2.6% p.a real return over a 7 year time horizon.




| Asset | Real Yield | % Allocation | Max Drawdown |
|---|---|---|---|
| US Cash | 3.1% | 33% | 0% |
| Investment Grade Corporate Bonds | 3.3% | 33% | 5% |
| High Yield Corporate Bonds | 6.0% | 33% | 13% |
| Expected Portfolio Return (p.a.) | 4.1% | | +2.6% |




| Asset | Real Yield | % Allocation | Max Drawdown |
|---|---|---|---|
| Defensive Equities | 4.1% | 33% | 35% |
| High Yield Corporate Bonds | 3.8% | 33% | 35% |
| Emerging Market Equities | 6.4% | 33% | 62% |
| Expected Portfolio Return (p.a.) | 4.8% | | -4.3% |

****Note we have generously assumed the real earnings yield on equities to equate to the real yield of equities*

With the current real yields on offer in cash, sovereign bonds and investment grade corporate debt the outlook for a traditional 60 / 40 asset mix is such that the "old rule of thumb model" is broken.

Our strategy – that incorporates agreeing to buy the equities we want to own, at a price typically 3-5% lower and on average 6 weeks in advance - increases the 7 year real return outlook, and reduces the risk of losses.

Since inception twelve years ago and excluding unencumbered cash, around 30% of the Fund has been in cash backing the commitment to buy the companies we fundamentally want to own. This 30% typically has never earnt less than 13% real so generates a 4.1% real return uplift all else equal. There is no free lunch obviously - the opportunity cost of the $30 not directly exposed to equity markets is 1.2% per annum. Summing these gives an overall uplift to the real yield on our global portfolio of 290bsp pa.

Despite the return uplift, the lower direct equity market exposure reduces overall risk - by around 25% than simply being exposed to the market.

Diversifications aim is simply to increase returns per unit of risk. The above chart demonstrates how our strategy over a cycle increases returns and reduces risk - the diversification benefits are obvious.

Replacing the Global Equity allocation with Wingate Asset Management (now Talaria) in the 2017 "portfolio" above, results in an increase in returns of 90 basis points per annum and reduces overall drawdown risk by around 160 basis points.

**Diversification Benefits Of Including WAM In The Portfolio**

| Asset | Real Yield | % Allocation | Max Drawdown |
|---|---|---|---|
| Global Equities | 4.1% | 33% | 54% |
| High Yield Corporate Bonds | 3.8% | 33% | 35% |
| Emerging Market Equities | 6.4% | 33% | 62% |
| Expected Portfolio Return (p.a.) | 4.8% | | -4.3% |
| **Asset** | **Real Yield** | **% Allocation** | **Max Drawdown** |
| Wingate Asset Management | 7.0% | 33% | 42% |
| HY Corp Bonds | 3.8% | 33% | 35% |
| Emerging Market Equities | 6.4% | 33% | 62% |
| Expected Portfolio Return (p.a.) | 5.7% | | -2.7% |
| Diversification Benefit (p.a.) | +0.9% | | +1.6% |

Our process of explicitly expecting to be paid to take market risk - results in a potential return of $60 per $100 vs a potential loss of $13 over a seven year period assuming a static return uplift in the event of a drawdown (which has not been the case historically and nor do we see as likely going forward).

This compares to Global Equities in general offering a prospective $32 return on $100 and a $26 loss so over a 7 year period on this basis for half the level of risk you double the potential absolute return.

An additional benefit of our process is it gives greater certainty around our overall portfolio outcomes given we know the minimum return in advance of the 30% of capital guaranteeing our purchase commitments. From a diversification point of view this lowers the volatility of returns.

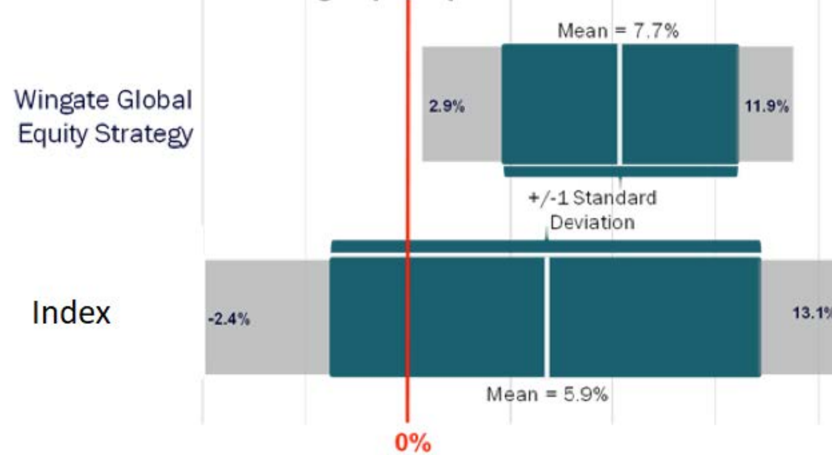
As the table below shows – it would be possible to diversify into a portfolio with around half the level of risk and still generate the same 4.8% return as the 2017 "portfolio".

| Asset | Real Yield | % Allocation | Max Drawdown |
|---|---|---|---|
| Global Equities | 4.2% | 33% | 54% |
| High Yield Corporate Bonds | 3.8% | 33% | 35% |
| Emerging Market Equities | 6.4% | 33% | 62% |
| Expected Portfolio Return (p.a.) | 4.8% | | -4.3% |

**Diversification Still Possible**

| Asset | Real Yield | % Allocation | Max Drawdown |
|---|---|---|---|
| Wingate Asset Management | 7.0% | 25% | 42% |
| Emerging Market Equities | 6.4% | 25% | 62% |
| HY Corp Bonds | 3.8% | 35% | 35% |
| Investment Grade Credit | 0.6% | 15% | 18% |
| Expected Portfolio Return (p.a.) | 4.8% | | -2.1% |

**All this adds up to a global equity strategy that has a positive skew in terms of returns, a higher mean and a greater level of certainty..**




## Performance: Expected Outcome In Various Market Conditions

| Rolling 3 Year p.a. Market Environment | < 0 % p.a. Absolute | 0% - 10% p.a. Absolute | > 10% p.a. Absolute |
|---|---|---|---|
| Volatility < 15 | − / + | + / + | + / − |
| Volatility 15 - 20 | − / + | + / + | + / − |
| Volatility > 20% | ~ / + | + / + | + / ~ |

As it stands today – the key to diversification is finding truly differentiated strategies within asset classes, not looking across asset classes.

Important Information

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