TALARIA

Thought Piece
12 March 2018

PORTFOLIO VALUATION AND CONFIDENCE IN THE FUTURE

Deputy CIO Hugh Selby-Smith provides an update on the valuation of our portfolio of companies and shares insights into the confidence of our investment team about the outlook for returns.

If media is to be believed attention spans are shortening. Taking this as fact I have summarised the body of text and elaborate on each item separately below.

- Our portfolio invests in businesses that tend to be more profitable, use less leverage, trade at cheaper prices, pay more dividends and retain more earnings to reinvest at higher rates than the broader market.

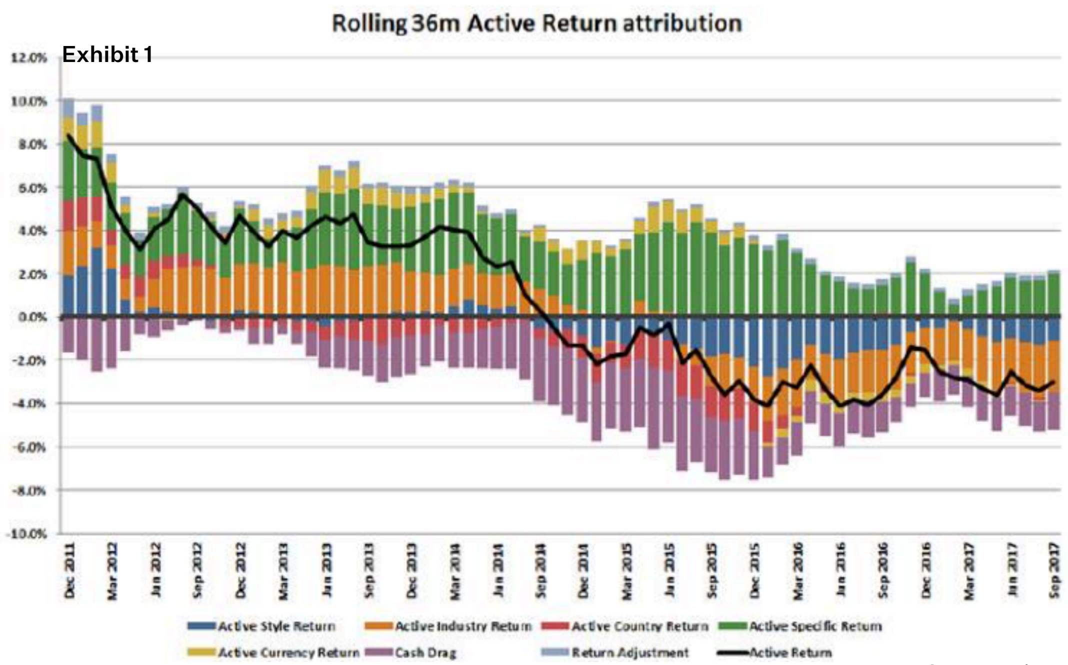
1) Higher volatility = more option premium for our strategy
2) Our process has consistently generated a positive rolling 3 year contribution to returns from stock selection
3) The P&L of our portfolio shows our companies are more profitable; pay higher absolute dividends and retain more absolute earnings than the index
4) A look at the balance sheet of our companies shows less leverage and more equity than the index companies
5) This results in our portfolio having better returns on capital and higher returns on equity than the market
6) By any valuation measure our portfolio is more favourably valued than the index
7) The truly exciting thing: We have more absolute dollars available for reinvestment at higher rates than the market.

1) Higher volatility = more option premium for our strategy:

We have been asked a lot recently about the regime change in Volatility and its effect on our portfolio opportunity set and returns. As exciting as it is it's also very simple. For every 5 point move in the VIX - we would expect to earn an additional 1.25% return assuming our 13 year average level of cash backing our options. Given rising Volatility increases the opportunity set – we also benefit by being able to deploy more capital at better contracted rates of return. So today we are earning an annualised 2.5% more in the portfolio compared to January 1st due to the increase in volatility

2) Our process has consistently generated a positive rolling 3 year contribution to returns from stock selection:

Compared to #1 above, what we haven't been asked much about recently is the portfolio itself – on which we feel very excited. It's worth noting - as Exhibit 1 below highlights - that we have had positive, active stock specific return (aka "stock picking alpha") every quarter on a rolling 3 year basis for the last 10 years as shown by the Green portion of the bars. Cash and lack of exposure to Info Tech have been the major detractors to active return as shown by the Orange and Purple portions of the bars.
The performance of our process and competence in analysing and investing in companies has and remains strong.



Source: Talaria

3) The P&L of our portfolio shows our companies are more profitable; pay higher absolute dividends and retain more absolute earnings than the index:

An analysis of what we own today – vs. the wider market - may be of interest and useful. The table below shows a comparative income statement of our portfolio vs. the broader market.

Income Statement	Talaria Portfolio	Market
Sales	100	100
EBIT	17.8	11.9
Net Income	13.8	10.6
Dividends	6.3	4.0
Retained Earnings	7.5	6.6

Source: Talaria, Bloomberg

While this information alone is not helpful in making investment decisions one can see that our businesses possess a higher margin structure than the amalgamation of businesses which make up the equity market index from where we derive our opportunity set.

Two businesses may have significantly different margin structures - as WPP and McKesson our two largest positions do – but each business has a double digit return on invested capital making margin structure comparisons against each other next to irrelevant. To look at a margin and say a business is good or bad makes no sense without looking at capital employed. This requires consideration of balance sheet and leverage ratios.

4) A look at the balance sheet of our companies shows less leverage and more equity than the index companies:

Balance Sheet	Talaria	Market
Equity (Book Value)	70.9	71.0
Debt	64.0	101.8
Cash	35.9	65.6
Net Debt	28.2	36.2
Total Capital (Equity + Debt)	99.1	107.2

Leverage Ratios	Talaria	Market
Debt / Equity	90%	143%
Net Debt / Equity	40%	51%
Net Debt / Total Capital	28%	34%

Source: Talaria, Bloomberg

At the index level, debt has replaced equity in recent years. Debt balances now exceed equity, with Debt / Equity at the index level measuring 143%. Net debt makes up nearly 35% of total capital for the index. Debt to equity ratios in our portfolio are 53% lower than in the wider market index. Our companies are less leveraged, and the benefit can be seen when analysing what really matters for investors – profit (cash profit at that). Again it's important to stress it's not the absolute level of a profit margin or gross margin – it's how much earnings power exists on the capital invested in a business.

5) This results in our portfolio having better returns on capital and higher returns on equity than the market:

Profitability Ratios	Talaria	Market
EBIT / Total Capital	18%	11%
Return on Equity	19%	15%
Return on Total Capital	14%	10%

Source: Talaria, Bloomberg

For the index in general, equity is most likely understated, as some assets are carried at historic and depreciated cost – shrinking book value relative to inflated earnings power – in other cases write-offs and write-downs have reduced asset and correspondent equity values.

With numerous others, share repurchases at increasing premiums to book value drive book value increasingly lower. So it's possible to argue that economic book value is understated to produce a higher return on equity than should perhaps be the case.

It's easy to see the large disparity between the returns on equity and on net capital that exist at the index level due to the use of net debt in the capital structure. The return would be even lower without offsetting debt with cash. The 25% lower return on Equity at the index level vs. our portfolio, turns in to a 40% lower return when looking at total capital. That our companies earn over 40% more on their invested capital than the wider market we think is a huge advantage.

6) By any valuation measure our portfolio is more favourably valued than the index:

Let's put price and valuation into the mix, for what are a collection of less levered and more profitable businesses.

Key Valuation Figures	Talaria	Market
Price	100	100
Price / Sales	0.9	1.7
Price / Book Value	1.9	2.4
Price / Earnings	13.5	19.6
Price / Free Cash Flow	14.6	20.5
Earnings Yield	7.4%	5.1%
Dividend Yield	3.2%	2.3%
Retained Earnings Yield	4.2%	2.7%
Free Cash Flow Yield	6.9%	4.9%
Net Income / Free Cash Flow	108%	105%
Dividend Payout Ratio	43.1%	46.1%
Enterprise Value / EBIT	13.3	17.4

Source: Talaria, Bloomberg

Our stocks trade at 0.9x sales vs a new record level for the index of 1.7x – and for that we have businesses which produce much more profit per dollar of sales. That translates into a P/E of 13.5x vs 19.6x – leaving the index around 45% more expensive and 25% more expensive on a book basis despite a lower return on equity.

The inverse of the P/E is the earnings yield. Our earnings yield is 7.4% which given the market's PE of 19.6 means we have 45% more profitability for each dollar invested at today's prices.

$1 million invested in either the index or our portfolio generates the following earnings, which are then either distributed as dividends or retained and invested by the company.

	Talaria	Market	Difference
Dollars Invested	$1,000,000	$1,000,000	
Earnings	$74,345	$50,965	$23,380
Dividends Received	$32,043	$23,472	$8,570
Earnings Retained	$42,302	$27,493	$14,810

Source: Talaria, Bloomberg

Our businesses generate a full 2.3% higher earnings yield which is derived solely based on prices relative to earnings. Each $1 million invested has an additional $23,380 profits working for our benefit. Because our earnings are so much greater, despite a lower payout ratio we receive a full 33% more dividends in absolute dollar terms BUT CRUCIALLY we have over 50% more absolute dollars being retained and invested for our benefit – a huge $14,810 more than the amount retained by the index.

7) The truly exciting thing: We have more absolute dollars available for reinvestment at higher rates than the market:

Now the truly exciting thing: The $42,302 being retained for us as shareholders is being invested at an unleveraged 13.9% return on capital. The index has a smaller absolute amount at a 40% lower return of 8.4% headline. But the dirty secret of the market is that its 2.7% retained earnings yield has been spent not re-investing in the business but buying back stock - and any purchase above 10.1x P/E is "Invested" at below a 9.9% return on capital. In effect most repurchases are destroying capital for shareholders.

In 2011 – the $300bn of share repurchases retired about 3% of the outstanding equity base of the S&P…with purchases amounting to $500bn in 2017 around 2% of the equity base was retired. What at some point was great for shareholders – is now costing them money.

Broadly speaking we don't own companies with aggressive accounting (CVS we are watching!!), we don't own companies that write down assets to boost returns on equity and capital, and we don't own companies buying shares at prices we would NEVER pay. We don't own businesses with huge pension fund liabilities that have little chance to earn enough on their plan assets to fund plan liabilities. We don't own business generally based on "pro-forma" or adjusted earnings.

Whilst our companies did grow around 2% slower than the index (ex-commodities) last year they did grow in absolute terms at around 3% top line – and we had $42,000 per $1 million working for us vs. the market having $27,000 working for it.

In theory Investors initially receive the earnings yield as their return assuming they are not over earning (index – discuss!!) – so the price paid is crucial to that equation. We are starting at 7.4% today. Long term returns however will move towards the return on capital as results will trend to the return on capital and on the reinvested capital of the business.

On this basis – I feel strongly that our ten-year track record of never having a negative contribution from stock selection on the quarterly 3 year rolling basis is well positioned to remain intact. Why?? Because of nothing more than the price we have paid initially for businesses – and their ability to retain and reinvest earnings.

Cheaper businesses, with lower leverage, which are more profitable. It's a good place to start to grow real wealth over time.

Important Information

Wholesale Units in the Talaria Global Equity Fund (the Fund) are issued by Australian Unity Funds Management Limited ABN 60 071 497 115, AFS Licence No. 234454. Talaria Asset Management Pty Ltd ABN 67 130 534 342, AFS Licence No, 333732 is the investment manager and distributor of the Fund. References to "we" means Talaria Asset Management Pty Ltd, the investment manager. The information in this document is general information only and is not based on the objectives, financial situation or needs of any particular investor. In deciding whether to acquire, hold or dispose of the product you should obtain a copy of the current Product Disclosure Statement (PDS) for the Fund and consider whether the product is appropriate for you. A copy of the PDS is available at australianunity.com.au/wealth or by calling Australian Unity Wealth Investor Services team on 13 29 39. Investment decisions should not be made upon the basis of the Fund's past performance or distribution rate, or any ratings given by a rating agency, since each of these can vary. In addition, ratings need to be understood in the context of the full report issued by the rating agency itself. The information provided in the document is current at the time of publication.