Investment Insights

Our quarterly insight focuses on three key areas.

The first highlights that the current weak and volatile equity markets are sources of opportunity for our strategy. This is in contrast with many of our peers who are unable to harvest income from high volatility.

The second discusses how we have carefully rebalanced the portfolio, so it is positioned for excellent participation when markets recover. We believe it is now outright cheap, with 40% of our holdings offering exceptional value.

The third discusses why we are excited about the future. During the GFC, the only comparable period in the fifteen-year life of our strategy, performance showed that we were able to take advantage of uncertainty to find outstanding opportunities in stocks.

We intend to do the same for our investors during these difficult and uncertain times.

Monetising uncertainty

It seems a distant memory, but just six weeks ago US equity markets were at all-time highs. A breakdown in OPEC + and consequent sell-off in crude oil hit share prices in late February.

What followed was unprecedented, as investors redirected their focus onto the potential impact of the Coronavirus pandemic. It would be easy to run out of superlatives to describe recent moves across asset classes. Suffice to say that March included a 20% decline over a record sixteen trading days in the S&P 500, and a three-day rally of 18% matched only in intensity by the move in markets seen in 1933!

These data show that markets have not just been weak, but that they have also been volatile. Such characteristics have positive consequences for our portfolio. Below we concentrate on two of these: the increased opportunities to deploy cash, and secondly to harvest income.

Prior to the downturn our fundamental stock analysis concluded that there was a lack of attractive opportunities. Accordingly, the portfolio entered the recent sell-off with around 20% of assets in cash. Given current weakness now, the number of shares on offer at attractive levels has increased. By the end of the quarter we had put 6.5% more of the portfolio to work.

The heightened volatility offers advantages in the way we purchase stocks. Instead of directly buying a share, we sell a put option which commits us to buy the relevant share at a price we find attractive.

In this way we realise a differentiated source of income in the form of option premium. If we are assigned the stock, we own it and retain the premium. If we are not assigned the stock, we still retain the premium and have the flexibility to change the pricing parameters next time.

When markets are calm, the amount of income we generate has never been less than 7%. However, when there is a high degree of uncertainty and markets are rocky, the amount we generate rises sharply. In recent weeks, the portfolio received an average payment of 30% annualised on the 6.5% of capital it committed to equities. For receiving this payment we have agreed to buy shares at an average level 27% lower than the prevailing share prices.

These are returns seldom on offer. The result is that the portfolio generated over 2% in option premium in March. Investors will appreciate that, firstly, the premium is yet to flow through; and secondly, it arose without any attempt to 'time the market.'

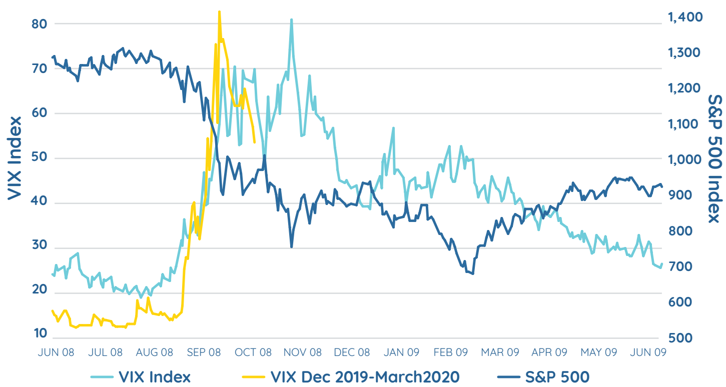
The level of uncertainty facing markets currently will take time to recede as the impact on economies, communities and businesses is unclear. Questions will have to be answered concerning the scale of the economic impact, the level of bankruptcies, the likely trajectory of a recovery, potential behavioural changes, and the effect on corporate profitability.

> *'In the last few weeks, the portfolio has received an average payment of 30% annualised on the 6.5% of capital it committed to equities. For this payment, we have agreed to buy shares at an average level 27% lower than the prevailing share prices.'*

Furthermore, the success or otherwise of efforts on health, fiscal and monetary fronts will not be evident for some time. In this context, volatility will remain high relative to the past - a regime the portfolio is built to benefit from. For example, the portfolio has been running for fifteen years and therefore had to negotiate the GFC, another period of tremendous uncertainty. Between October 2008 – April 2009 equity markets fell around 25% and the volatility was comparable to that of today. During this period the portfolio generated 13% of option premium, around 2% each month.

It is no coincidence that March 2020 was in line with this level.

Exhibit 1: Volatility now vs. the GFC



Backing value

Expensive momentum sectors have continued to outperform their cheaper peers. For example, the global 'Value' benchmarks fell 26% over the quarter, whereas the tech heavy, highly rated NASDAQ only fell 10%.

There is not an area of the market in which we would not invest if our criteria are met.

However, price discipline means we have been carefully reducing our exposure to market favourites such as utilities, consumer discretionary, staples and home and personal care.

By way of contrast, during the first three months of the year we have bought Schneider Electric, the leading supplier of equipment for electrification; Swiss Re, the world's best capitalised reinsurance company; Lear, the largest auto seat supplier; Kingfisher, Europe's largest hardware retailer; and CH Robinson Worldwide, a leading US freight and logistics company.

These companies are well capitalised, robust, and continue to grow about twice global GDP. They also stand at a % discount to the global index valuation level and at a 42% discount to the S&P 500.

Although some of our companies are not in vogue, we believe they position the portfolio for excellent market participation when prices recover. This belief has experience behind it.

During the GFC, not only did we generate a 13% return through our option premium from October 2008 – April 2009, but over the following three years we also delivered 15% more than investors who had simply put their money into the market.

Built for Now

Like everyone, the Coronavirus global disaster moves and worries us. We feel great compassion for those affected. However, from an investment point of view, we are excited about the future. There are, as we have said, parallels with the GFC in today's uncertain equity markets. We trust that our investors are encouraged that October 2008 subsequently saw the best rolling three-year period of absolute and relative performance in Talaria's history.

In many ways our process was built to take advantage of the uncertainty we now face. As we maintain good levels of liquidity, we can put cash to work on stocks that offer tremendous value. The unique way we implement our ideas means we can increase the income component of return. The discipline of our process means we go where there is value, rather than hiding in apparent safety.

However, we take nothing for granted, and our investors should be in no doubt that we are committed to delivering for them.

Talaria Asset Management
Level 14, 330 Collins Street
Melbourne, VIC, Australia 3000
+61 3 8676 0667
talariacapital.com.au
AFSL 333732

Important Information