Talaria Global Equity Fund Currency Hedged (Managed Fund)

Quarterly Update September 2023

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Signatory of:

Investment Insights

When writing the investment insights section, as we have said before, we sometimes feel we should be dressed in a cowl and holding a scythe. Whilst the grim reaper image is extreme, we do think global equity markets are facing serious, complex challenges.

This would be less of a problem if these challenges were reflected in share prices, but a good appetite for risk this year leaves many looking expensive. Investors seem to think the light at the end of the tunnel is not an oncoming train, which is surprising given the odds.

As we run through valuations and the economic cycle, we find the balance of probabilities remains heavily in favour of a meaningful slowdown and low long-term returns to equities.

The world's most important index, the S&P 500, is on a Shiller PE of 31x. It has only been more expensive 5% of the time in 140 years of history. Down at a micro level, it is difficult for value investors like us to find new ideas, not just in the US but globally. With shares pricing in a soft or no landing, how much money is a conventional investor in cash equities going to make with this as the starting point?

Moreover, the soft-landing looks increasingly unlikely. For reasons that are well known and with libraries of books on the perils of prediction, we do not forecast, and we pay little attention to the forecasting profession. Instead, we attach a lot of weight to historic precedent, particularly the relationship between economic data sets.

The effect and timing of interest rate changes on leading, coincident, and lagging indicators are well established and provide powerful signals. As we discuss in the first section below, these signals are flashing red with blaring horns and big lit-up arrows pointing to large letters spelling recession.

If valuations and the cycle are the immediate challenges, there are others that may not manifest as setbacks soon, but they loom over us as huge shadow throwing shapes. The one we focus on this quarter is the debt problem, leaving liquidity, opacity, concentration, the proliferation of non-bank financial intermediaries and other risks for different days.

Most economies that matter are running high debt levels, the close comparison generally referred to is with the state of things after World War II. It is hard to find the right word to describe this situation, but staggering is a reasonable start.

With interest rates rising, the risk is that debt to GDP levels see the numerator go up as the denominator falls. In the public and private sector, debt service ratios count as they measure the proportion of income taken up in paying interest costs. In several countries, they are at points that have historically caused problems.

It seems inevitable that governments will pursue various avenues to reduce debt including financial repression. This is a benign sounding catch-all for far from benign mechanisms to transfer wealth from saver to borrower, the key borrower in this instance being the government.

Financial repression is not a theoretical approach to debt liquidation; it was in place around the world in developed as well as developing economies from 1945 to around 1980. Older Australians will remember the negative real returns after the war and then in the 1970s from various government sponsored bonds.

China, just to keep us on our toes, has a different sort of debt predicament. While the rest of the world battles inflation, China is fighting debt deflation, a vast misallocation of capital and the trials of trying to transition from an investment driven to a consumption driven economy. Who knows if or when there will be a renminbi devaluation, but the maths says that something has to give.

The good news is that interest on cash means investors have a decent starting point for capital preservation and targeted returns. In equities, given the growth outlook, income should be a priority. The buffer and returns from value should also become increasingly attractive. Equity assets with less downside and less volatility than the market are attractive. They will make holding on during selloffs or even leaning into weakness easier propositions whilst still providing upside.

1. I hear the train a comin', it's rolling round the bend

In our last quarterly we said that some investors, wrongly in our view, interpret the strength of the S&P 500 as a signal that there will be no economic downturn. If anything, three months later our conviction is only greater that it is odds on that what's coming down the track is a locomotive named recession.

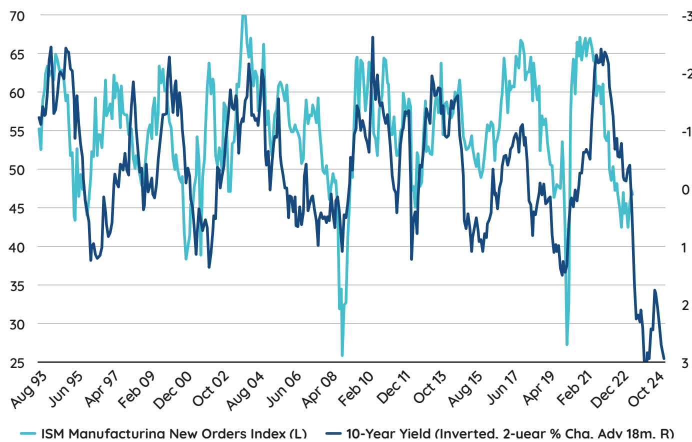
Focusing mainly on the US:

- Since World War II, the Fed has tightened interest rates thirteen times. Chairman Powell is not wrong when he says there have been three times when a recession did not follow. But it does not take an Einstein to work out what happened the other ten times.
- Since World War II, when the CPI has been over 5% a recession has always followed. Therefore, by definition, the three instances of soft-landing cited by Chairman Powell were not preceded by inflation above that level. CPI this cycle has been well above 5%.
- Yield curve inversion has been a strong predictor of recessions and their duration. The 10-year - 3-month yield curve has now been inverted for over a year.
- The Fed's own model of the probability of recession is at a forty year high.
- The pace of tightening under Greenspan and Bernanke was deliberately moderate, giving the economy time to adjust. The latest tightening is the fastest since the Great Inflation and of a greater magnitude.

- As evidenced by the Senior Loan Officer Opinion Survey, banks have been aggressively tightening lending standards. This leads to slowdowns in credit. It is unusual for banks to tighten lending standards this early, with unemployment as low as it is.
- The economy is already weak. Industrial production, retail sales and forward earnings' growth are all around zero compared to where they were at the start of the Fed tightening. These levels are also low relative to where they would usually be at this point in the tightening cycle.
- Those that take comfort from the low unemployment rate, might also recognise that this is generally the case late in a tightening cycle.
- Given that other developed economies are facing similar challenges, they cannot be expected to help stave off economic weakness.
- China has its own problems and offers no lifeline.

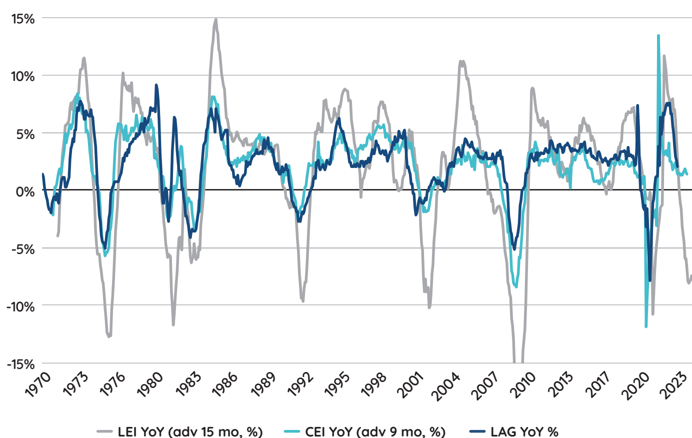
In addition to the points above, at the heart of the probabilities in favour of a slowdown are the established historic relationships between various economic measures. The starting gun is fired by a change in official interest rates and then, after different periods of time, leading, coincident, and lagging indicators respond.

ISM Manufacturing New Orders index vs 10-year yield



Source: Bloomberg

ISM Manufacturing LEI, CEI and LAG



Source: Bloomberg

2. A serious debt challenge

We cannot know with certainty that the picture we paint of the economic cycle will prove accurate. But we do have a good idea of what is happening and we can talk probabilistically, arriving at a sense of the odds. Other difficulties are harder to pin down, but in the end they may prove to be more consequential.

The issue we choose to focus on in what follows is the serious global debt challenge amid recent signs that investors are increasingly focusing on this too.

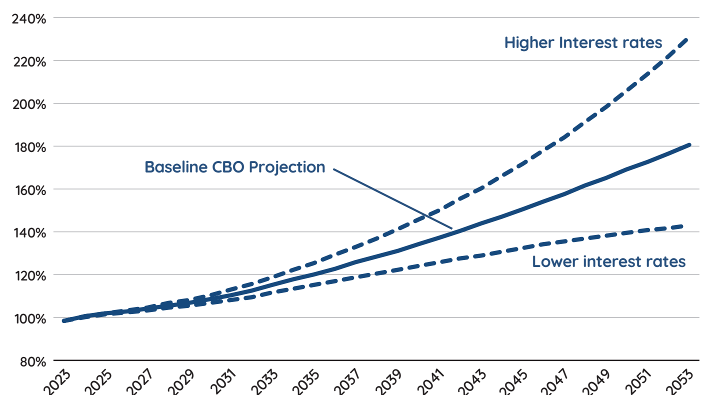
Public debt

The pandemic driven explosion in US fiscal spending drove the country's government debt to GDP ratio to around 100%, close to the high recorded after World War II. This was an extraordinary position, highlighting how significant the policy responses were to Covid-19 in fiscal terms.

Whilst forecasting a minuscule pullback in the short-term, the Congressional Budget Office (CBO) projects government debt to GDP to rise to 110% at the end of 2032, "higher as a percentage of GDP than at any point in the nation's history – and heading still higher in the following two decades".

Driving this deterioration will be budget deficits which the CBO projects should average USD 1.6 trillion between 2023 and 2032 or 5.1% of GDP. In 2033 the CBO sees the deficit at an eye-watering 6.9% of GDP, which we have only seen five times since 1946. The projections below show that it should continue to deteriorate thereafter.

US CBO deficit projection, % of GDP (2023-2053)



Source: CBO

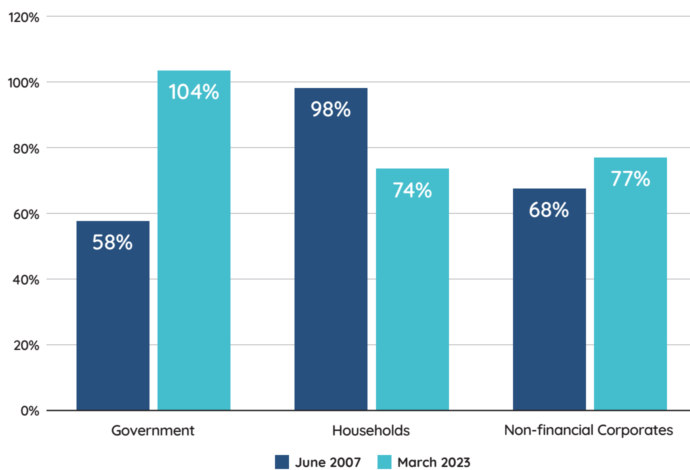
Although like-for-like comparisons between countries are imprecise, most of the world's major developed economies are in a similar position. Japan, the UK and some countries in the EU are running significant deficits and many have high government public to GDP ratios. China is has the same debt problem but different economic characteristics as we discuss later.

Private debt

Public debt is not the only problem, private debt is also elevated. In terms of debt service ratios (interest costs to income), countries like China (21.3%), France (20.5%) and Switzerland (20.6%) are at or close to their previous highs and above the 20% that risks triggering a crisis when interest rates are on the rise.

The US (14.9%) and the UK (13.9%) are, by contrast, in better shape, although looking at debt levels in the US versus before the GFC, the position is worse in both the public and corporate sectors (chart below).

Debt to GDP (%) in various sectors, US



Source: BIS

Past solutions to high debt levels

History shows that governments have only a few options, usually used in combination, when it comes to bringing down their debt to GDP levels: grow the economy, cut costs and increase taxes (austerity), default on or restructure the debt and employ financial repression usually accompanied by a measure of inflation.

Whilst we focus on the characteristics and mechanics of financial repression at the end of this section, we want to emphasise upfront that it seems inevitable financial repression is coming and is bad news for savers. Their focus ought to move from return on capital to return of capital in real terms. One way or another, savers will be forced to own assets that will give them low or negative returns.

Growth

For reasons that are too obvious to state, growth is the most desirable way to liquidate debt. After World War II it came to the rescue not least because much of Europe and Asia had to be rebuilt. However, it is going to be a challenge for economies to grow their way out of the current debt problem. Against them stand long-term barriers such as the debt itself, which inhibits growth, demographics, deglobalisation, inequality, capital misallocation etc.

Austerity

It is unclear how effective austerity has been in the past. The potential positives of cost reduction, shrinking government and easing the cost of borrowing may be outweighed by higher unemployment, diminished social services (education, health etc), and unrest such as strikes.

Default or restructuring

Defaults or restructurings are only theoretical or desperate options for the major developed economies. With the US dollar as the world's reserve currency, either would be unthinkable for the United States economically and politically. With the stakes only marginally lower for other developed countries, default would be a most unlikely last resort.

Financial repression

Financial repression is neither as easily understood nor as well-known as the other avenues to debt liquidation. Yet financial repression was an arrangement used widely in developed and developing economies from 1945 – 1980. Given the limitations of the other options, it is also a remedy that we expect governments increasingly to employ to address unsustainable fiscal positions.

Financial Repression is an umbrella term for measures by which a government may reduce debt via transfers from creditors (savers) to borrowers, the government itself being the most important borrower in this instance. Examples of financial repression are caps on interest rates, high reserve requirements, and transaction taxes on assets.

Characteristics of financial repression are opacity, complexity and stealth. Unable to grow, cut or default to solve a debt problem, governments deploy innumerable, often obscure measures to relieve other parts of the economy of their money through "repression taxes." For those interested in the details of the history and the mechanisms, "The liquidation of government debt" (Reinhart/Sbrancia) is an excellent paper.

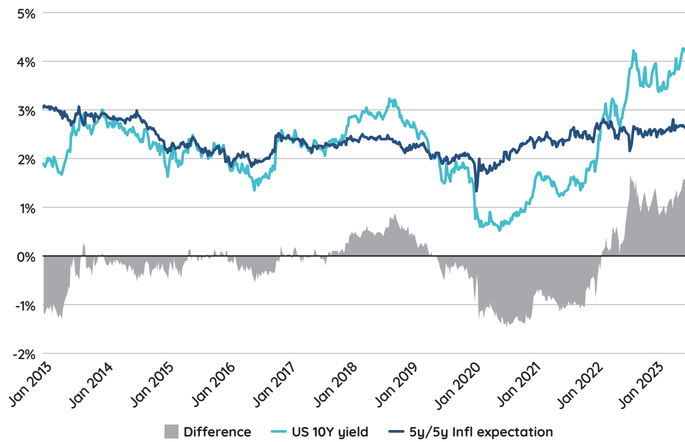
Debt matters now

Like so much in financial markets, debt does not matter until it does. The levels of debt to GDP and the options available to improve the ratio have been secondary considerations for most of the previous fifteen years. In a world of zero or negative interest rates, who, except the prudent, cares about debt?

This quarter there have been signs that the general indifference is diminishing. One of the most striking recent signals has come from US treasuries, where yields have moved up sharply to reach around 4.5%.

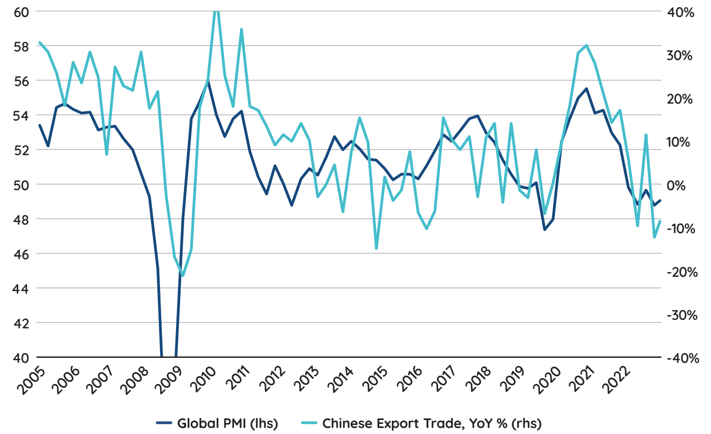
Inflation expectations have hardly changed, staying within the long-run range, and short-term interest rates have not risen sufficiently to explain the jump in yields. Therefore, greater term premium, the excess return investors require for duration risk seems to be the main driver.

Inflation expectations and interest rates (%)



Source: Bloomberg

Chinese exports and Global PMI index



Source: Cornerstone Macro, Bloomberg

Clearly one of the risks taken on regarding longer maturity assets is from repression at home, but another is the spill over from action overseas. Since the Japanese authorities' attempt to move away from yield curve control in July, JGB yields have risen somewhat, and fixed income investors are bound to worry that Japanese savers will be forced to repatriate capital to buy domestic bonds. This could lead to upward pressure on bond yields elsewhere, as Japan is a huge player in global fixed income, and especially in US treasuries.

Whilst not a direct risk to treasuries but striking for those on alert for signs of financial repression, the Italian government's hostile, clumsy and surprise bank windfall tax fits the bill. Proposing out of the blue taxes and clattering share prices are effective means of securing future cooperation.

3. China syndrome

It is not just the scale of China's debt problem that is so striking but also the dynamic it represents for the rest of the world. From being a sort of lender of last resort before the GFC, it is now swamped with debt. The world's second-largest economy has non-financial debt to GDP of 297%, well above the developed world average of 268% and the US at 256%.

What has driven this change is vast malinvestment. This is most often cited in relation to a huge overhang of residential housing and the risk of various property companies collapsing. But it is not just housing that is the problem. There is idle manufacturing as well; for example, the Chinese auto manufacturers are operating at capacity utilisation not much above 50%.

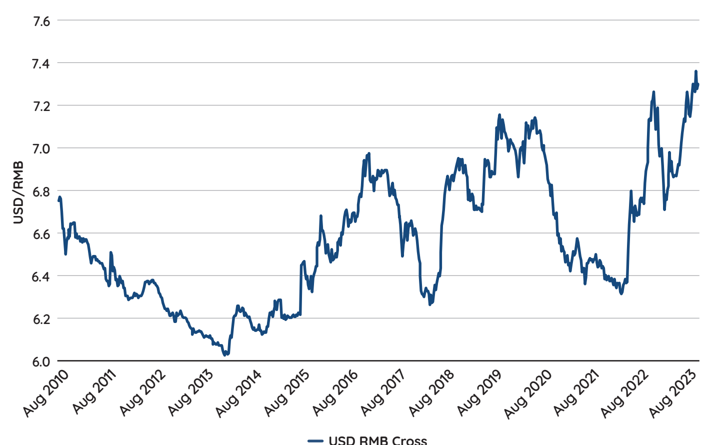
As a trade sensitive economy, China's economic outlook is increasingly tied to the now struggling developed world. Given all that we have said in the sections above, exports are unlikely to come its rescue.

Ten years into his presidency we know that it will be President Xi who decides how to respond to what is increasingly looking like a debt deflation. While the rest of the world wrestles inflation and tries to cap interest rates, Xi presides over a country that could spiral downwards in the classic negative feedback loop of falling asset prices, debtors paying off loans, credit contracting, a further fall in asset prices, debtors paying off loans etc.

We understand that some people believe that President Xi is even prepared to let things take their course, burn it all down in effect, and then assume even more control with a full nationalisation of the private sector. Whilst anything is possible, this is a high stakes approach for a government that already runs the banking sector, other state industries and has enormous power over private enterprise.

It is more likely that the Chinese Communist Party will try to engineer a reflation by instructing banks to lend money at cheap rates to encourage a domestic consumer led recovery. However, success in stimulating growth and inflation would necessitate an upward move or even a break in the pegged renminbi. Perhaps it has been anticipation of this sort of approach that helps explain RMB weakness.

USD/RMB spot FX



Source: Bloomberg

Time will tell if this is how things play out and whether RMB weakness evolves into abandonment of the peg. Not having the steam valve that a floating currency offers, China is having to lean heavily on other economic levers to get it out of trouble. Owners of Chinese equities rubbing their hands in anticipation of a devaluation should bear in mind that in today's multi-polar world it is likely that such a currency move would provoke a protectionist response.

4. Summary

Perhaps we are a broken record but having stepped through some of the challenges ahead for the global economy, we maintain the view that an investor should own different equities from those that prospered from the early 2009 low to the 2022 high. They should look for good value, short duration, income generation that, at the least, balances capital growth and returns from different sources. Moreover, strong balance sheets and good free cash flow generation will become of greater relative value in the debt encumbered world we describe above.

September 2023 Quarterly Performance

A broad-based decline in global equities left investors with few places to hide this quarter. A surge in oil prices and bond yields were the two most noteworthy developments. Some would argue that a market pullback is only natural after a strong first half of the year. We are of the view that recent weakness is a continuation of a turbulent period for equity markets that started last year and that is more reflective of underlying economic realities.

The reality that interest rates might have to stay higher for longer drove bond yields to fresh, multi-decade highs and weighed heavily on investor sentiment. Supply concerns pushed oil prices significantly higher and further exacerbated the upside risk to inflation. At the same time, the AI hype that propelled tech stocks earlier in the year fizzled out somewhat and led to the tech sector underperforming the broader market. Risk indicators like the VIX rose, reminding investors that coming out of the woods unscathed is not a given amidst the most aggressive monetary tightening cycle in recent history.

Almost all major equity indices suffered losses in the third quarter. The broad-based S&P 500 and the tech-heavy NASDAQ fell by -3.6% and -4.1%, respectively. Asian markets were also weak with the NIKKEI down -4% and Hong Kong's Hang Seng down -5.9%. In Europe, the Euro Stoxx 50 dropped by -5.1% with both the French CAC and the German DAX in the red. UK's FTSE 100 was the only notable index that bucked the trend and finished up 1%.

Against this challenging backdrop, the Fund delivered a positive quarter, gaining 0.84%, taking the 12-month return to 14.45% while maintaining substantially lower market risk.

Energy was the only sector that delivered meaningful positive returns of +10.4% on the back of resurgent oil prices. Utilities were at the other extreme, suffering a -9.9% drop with a surge in bond yields the main culprit. Tech is also worth noting, down –6.2%, and underperforming the broader market for the first time this year as excitement around AI subsided. All other sectors were down low to mid-single digits in a broad-based market weakness.

Oil prices saw their strongest quarter since June of last year, increasing significantly by 28.5% and closing above the $90 mark. Constrained supply rather than a surge in demand is to blame with other commodity prices increasing only modestly (Bloomberg commodity index up just 3.3%). US treasury yields surged, with the 10-year increasing by a whopping 73 bps and closing the quarter at 4.57%, the highest since 2007. The VIX jumped by 4 points from June lows not seen since pre-COVID to 17.5 points. The USD gained against nearly all major currencies.

Two American firms contributed most to the Fund's performance this quarter. On top was H&R Block, a tax preparation company with operations in the US, Canada and Australia. It delivered a better-than-expected margin and stronger buybacks that have propelled the shares materially higher. A close second was CF Industries, an agricultural fertiliser manufacturer. Strong results and the gas price differential between Europe and the US stabilising, supported the shares.

The largest detractor to performance this quarter was Swiss pharmaceutical giant Roche (see stock in focus). Despite recent weakness we see significant value and took advantage of the weakness to add to the position. Brazilian brewer Ambev was another detractor. Weakness in the Brazilian Real and a P/E derating on the back of worsening sentiment on Argentina, one of their key export markets, were some of the main drivers.

The fund initiated a new position in KDDI, the second biggest Japanese telecom. Low levels of debt provide balance sheet optionality while carrying a low valuation relative to earnings potential and growth. The fund exited two positions on valuation grounds after reaching our price targets - CNQ, a Canadian energy company, and Loews, an American insurance conglomerate.

Stock in focus: Roche

Roche is the largest pharmaceutical company by sales in Europe and the third largest in the world. Headquartered in Switzerland, the company has a diverse portfolio of innovative and life-changing medicines that treat a range of debilitating ailments from various forms of cancer to rheumatoid arthritis and multiple sclerosis.

One example is Ocrevus (10% of 2022 group sales), the most popular drug for treating Multiple Sclerosis (MS) in the world. It was first approved in 2017 and since then has significantly helped slow the progression of MS symptoms for hundreds of thousands of patients globally (there are 2.8m people suffering from the disease worldwide).

Roche possesses several features that make it stand out as an attractive investment. The company is a dividend aristocrat (the dividend has grown every year for over 30 years) and has a current dividend yield of c4%. It also has a short duration of cash flows, and we expect it to generate ~CHF 15bn per annum over the next few years even after accounting for annual R&D spending of CHF13.5bn (~7.5% free cash flow yield). The balance sheet is strong, with a net debt to EBITDA ratio of less than 1x in 2022.

But perhaps the biggest attraction comes from the sizable discount to fair value that the shares are trading on.

The value of New Science

Pharmaceutical companies strive to strike a fine balance between maximising cashflows from existing patent protected drugs (“Existing Science”) and investing in the development of innovative new drugs (“New Science”).

The money spent on New Science for pharmaceutical companies is significant. In 2020, European and US majors spent collectively $74bn on Research and Development (R&D) of new drugs, equivalent to approximately 18% of revenues. Working out the effectiveness of R&D efforts is therefore critical in determining the value of a pharmaceutical company.

In the following paragraphs we explore how we approach this valuation challenge. We use Roche as an example and demonstrate that the shares are trading at a discount to fair value.

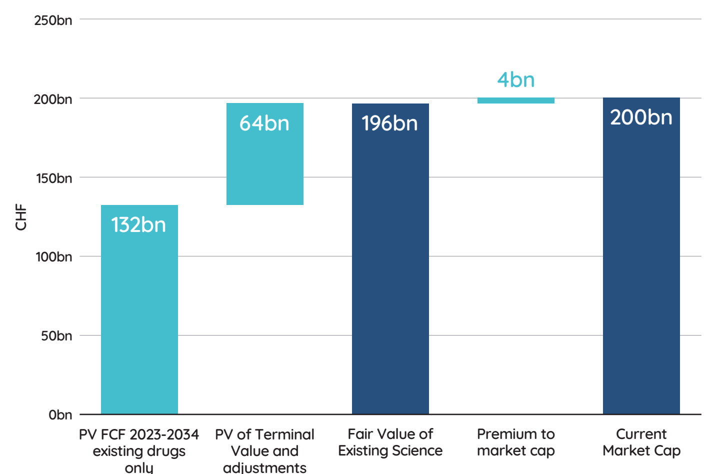
Determining the value of Existing Science

We first take the projections of cashflows generated from the sale of existing drugs. There is a high degree of certainty with regards to such cashflows since these drugs are protected by patents and command high margins. When a patent expires, the loss of exclusivity (LOE) typically leads to a rapid drop in sales and cashflows. This moment is often referred to as a “Patent Cliff” and is prevalent for all large pharmaceutical companies.

Chart 1 below shows the present value (PV) of cashflows generated by Roche from its existing, patent protected drugs up to 2034 (first bar), the PV of the terminal value (second bar) and the gap to current market value (fourth bar). There are two important points to note. One, the R&D spend on New Science is funded by the sale of the existing drugs. This means that cashflows in our projection period are lower than they would have otherwise been had the company stopped funding R&D altogether. And two, the revenues generated by any future drugs that have not been yet approved are excluded from any future cash flows – in other words, the R&D spend in the forecast period is assumed to simply be nothing but a cost without an offsetting benefit..

Put simply, existing drugs generate significant value of CHF 196bn in PV, just CHF 4bn shy of the current market cap. This is even before we incorporate the value of New Science. In fact, New Science has a negligible value of CHF 4bn attached to it – meaning the market is pricing that R&D spend is almost entirely squandered.

Chart 1: Roche Value of Existing Science and discount to current market cap (in CHF)



Source: Talaria, Company Reports, Bloomberg

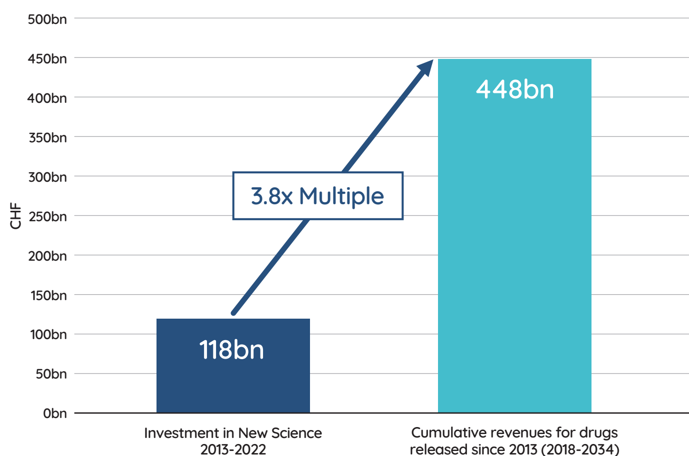
Evaluating the effectiveness of New Science spending

Now that we know the market is assuming New Science carries a negligible value, we examine Roche's actual track record of turning R&D spending into sales.

For the ten years starting in 2013 the company has spent a total of CHF 118bn on R&D, (see Chart 2). To judge the productivity of these investments, we have taken the cumulative revenues generated by drugs that went into circulation after 2013. The forecast period for sales extends to 2034 and the cumulative expected sales for the period are CHF 448bn. This implies that investment in New Science has yielded 3.8x of revenues with reasonable certainty (all drugs in the analysis are already released, protected by patents and generating sales that are unlikely to deviate significantly from the projections).

With an average cashflow margin of 33%, it means that Roche is at the very least able to recover fully 1.2x the amount of money invested in New Science.

Chart 2: Roche Productivity of New Science



Source: Talaria, Company Reports, Bloomberg

Valuation and conclusions

New Science for the past decade carried a 3.8x multiple of sales on investment or roughly 1.2x multiple of cashflows on investment. We expect the company to spend on average 14.6bn per annum on R&D over the next decade. The PV of this spending is equal to CHF 105bn.

Bringing it all together, the fair value of Existing (CHF 196bn) and New Science (CHF 126bn, 105bn at 1.2x multiple) is equal to CHF 322bn, or CHF 404 per share. Today's share price in effect suggests ten years of R&D spend will yield no commercially viable New Science in a stark contrast to the previous decade, making Roche an investment with a very attractive positive skew.

Talaria Global Equity Fund (Managed Fund)

Top 10 Holdings*

Company name	% weight
Roche	5.7%
Gilead	5.4%
Johnson & Johnson	5.1%
Sanofi	4.9%
Sodexo	4.6%
Secom	4.1%
Novartis	4.0%
Chubb	3.9%
Wheaton Precious Metals	3.8%
Redeia	3.7%

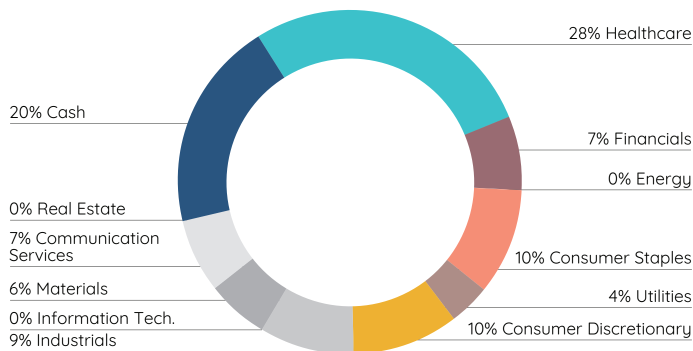
* Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

Performance at 30 September 2023

Period	Total Return	Average Market Exposure
1 month	-0.26%	55%
3 months	0.84%	58%
6 months	4.48%	57%
1 year	14.45%	56%
3 years p.a.	13.67%	56%
5 years p.a.	7.24%	57%
7 years p.a.	7.69%	58%
Since Inception p.a.	7.69%	59%

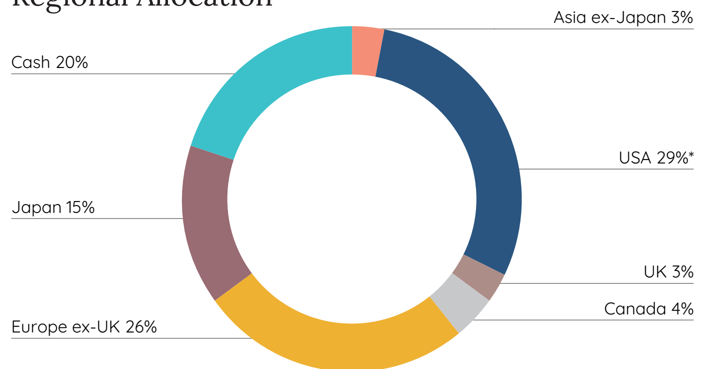
1 Fund Returns are calculated after fees and expenses and assume the reinvestment of distributions
2 Inception date for performance calculations is 18 August 2008
3 Income Return includes realised capital gains
4 Past performance is not a reliable indicator of future performance
5 Average Market Exposure based on delta-adjusted exposure of underlying portfolio

Sector Allocation



* Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

Regional Allocation



* USA includes American Depositary Receipts (ADRs) listings.

Quarterly distribution

Period	Cents per Units	Reinvestment price
June 2023	16.8078	$5.6610
June 2022	26.444	$5.2023
March 2022	8.100	$5.5794
June 2021	33.783	$5.2060
March 2021	8.500	$5.3360
December 2020	7.000	$5.0885
September 2020	7.000	$4.6795
June 2020	19.834	$4.6770

Asset allocation

Asset allocation	% weight
Global equity	53.0%
Cash – put option cover	27.0%
Cash	20.0%
Total	**100.0%**

Portfolio contributors	Portfolio detractors
H&R Block	Roche
CF Industries	Ambev
Alibaba	Henkel
Nippon Telegraph & Telephone Corp	Redeia

1 Portfolio contributors and detractors are based on absolute quarterly contributions to return, including option positions

Talaria Global Equity Fund - Currency Hedged (Managed Fund)

Fund snapshot

APIR Code	WFS0547AU	**Inception Date**	31 December 2012
Management Fee	1.20% p.a. of the net asset value of the Fund plus Recoverable Expenses	**Liquidity**	Daily
Recoverable Expenses	Estimated to be 0.12% of net asset value of the Fund each Financial Year	**Exit Price**	$5.6941 (30 Sep 2023)
		Buy / Sell Spread	0.25% / 0.25%
Platform Availability	Asgard, Ausmaq, BT Wrap, BT Panorama, CFS FirstWrap, Hub24, IOOF, Linear, Macquarie, Mason Stevens, MLC Wrap, MLC Navigator, Netwealth, Powerwrap, Praemium, Grow Wrap/Voyager	**Distributions**	Quarterly
		Minimum Investment	$5,000

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