TALARIA

Talaria Global Equity Fund Currency Hedged (Managed Fund)

Quarterly Update December 2023

Zenith FUND AWARDS WINNER 2022

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

Signatory of:
PRI Principles for Responsible Investment

Investment Insights

Summary

When fund managers, as they so often do, write about authorities outside of finance there should almost always be a pretentiousness alert.

Consider yourself warned.

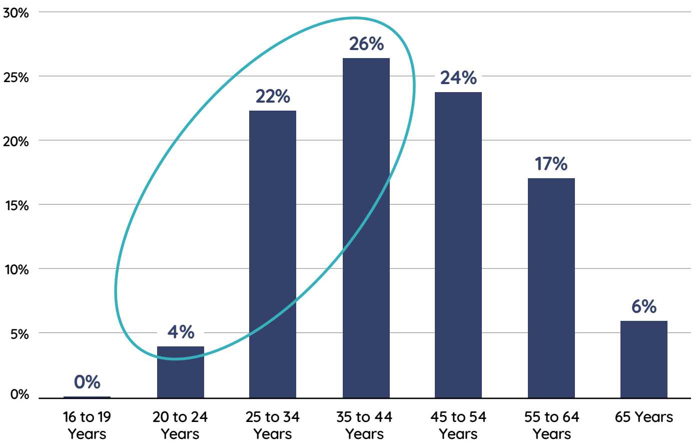
October 2023 saw the passing of the distinguished French historian Emmanuel Le Roy Ladurie. Ladurie once divided historians into two groups: truffle hunters and parachutists. Truffle hunters focus on down in the dirt and hard to find small but valuable items. Parachutists take-in the panoramic view and grand trends.

The analysts in Talaria's investment team are truffle hunters, searching for individual stocks that will generate returns. At the portfolio level, which is above all else about risk management, Talaria is of the parachutist mentality taking in the broad sweep of things.

However you look at it, history is of particular importance in markets today. This is because so few in finance can draw on deep personal experience to navigate the latest tightening cycle and its aftermath.

The chart below shows the age ranges of people employed in the US as financial analysts, financial advisors, credit analysts and financial managers. Only one quarter of the sample have experienced more than one tightening cycle, and around half were either young or not in the industry for the tightening running up to the GFC.

Finance Industry Age Ranges



Source: US Bureau of Labour Statistics

We have written before about how sceptical we are of forecasting. But as keen students of history, we believe looking at past precedent can be invaluable in preparing for the future. Not for the first time, this is our approach in this quarter's investment insights.

Focusing on the largest and most important economy and stockmarket and assuming that rates in the US have peaked, we look at the past to gauge the likelihood of a soft-landing versus an earnings and GDP recession. We also look at the scale of past peak to trough moves in EPS and the S&P 500 at the end of a tightening cycle. And we consider how to position in equities by looking at the performance of various factors in the 18 months after rates peak. Before all that, we review valuations of various asset classes to set out the lie of the land.

We find that US earnings and GDP recessions are odds on, that EPS and the index are likely to fall materially, and that income, value and low beta should outperform. We suspect the biggest surprise will be that growth is a factor to avoid. This is because in anticipating slowing but still expanding GDP, investors bid up the shares of companies perceived to have structural or resilient growth to high valuations. From here the path to outperformance for these equities in a post peak rate world is narrow. This is especially the case because growth too is cyclical – the chart of Microsoft's revenues and industrial production later in this report is a good example.

As we discuss later in the performance section, equity markets rounded off a strong year with a stellar fourth quarter. although most indices are only around where they were two years ago. With startling rapidity the interest rate story has moved on from higher for longer to soft-landing and rate cuts in 2024. With bad news taken as good, falling bond yields have allowed multiples to expand and shares to rise.

Investors and analysts are embracing what has been called an immaculate slowdown. The challenge to the latest, far from unique relief rally, is that it is vulnerable to the downturn in earnings that history says is inevitable. On the plus side, the strength in markets offers an opportunity to rebalance into our recommended value, short duration, high income as a component of return, low leverage and low beta assets.

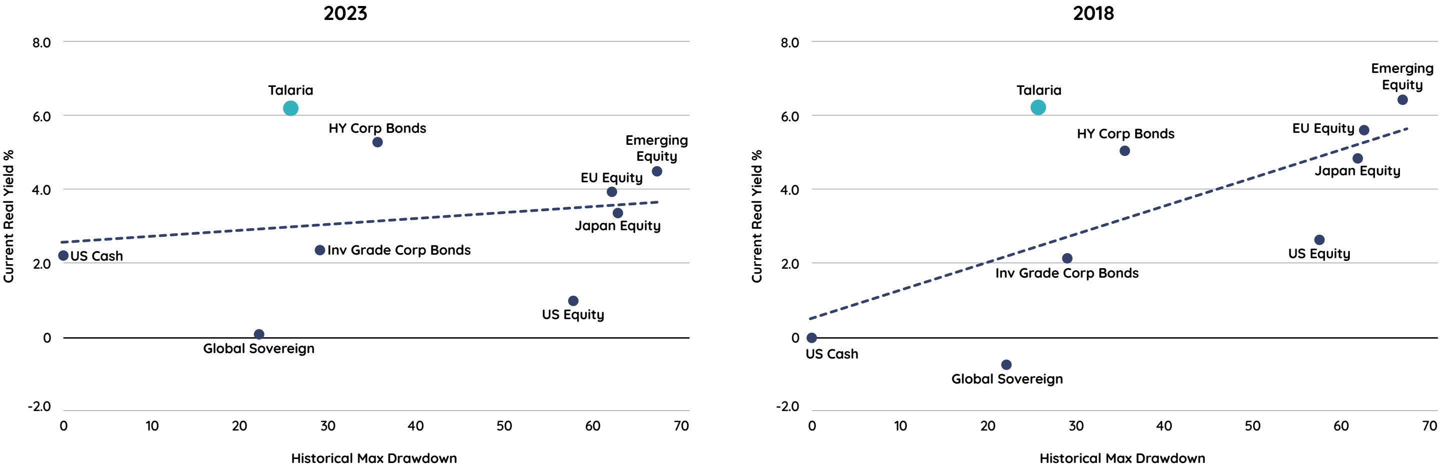
Real yields

To begin at the beginning, in this section we look at inflation adjusted valuations of various assets in absolute terms and relative to five years ago. We use headline CPIs of 2.2% for 2018 and 3.1% for 2023. We also show maximum drawdowns going back to 1993.

It is striking how much the trend line has flattened over the last five years. Assets with very different drawdown characteristics are now valued in a narrower range. Among other things, this signals good opportunities for diversification.

Cash is materially more attractive than it was, fixed income is not much changed, equities are significantly more expensive. Talaria offers the best value with the added benefit of a maximum drawdown that looks more like it belongs to credit rather than equity.

Real yield by asset class, 2023 and 2018



	US Equity	US Cash	Global Sovereign	Inv Grade Corp Bonds	HY Corp Bonds	Japan Equity	Emerging Equity	EU Equity	Talaria
Max Drawdown	57	0	22	29	35	62	66	61	25
2023 Real Yield	1.0	2.2	0.1	2.4	5.3	3.4	4.5	3.9	6.2
2018 Real Yield	2.7	0.0	-0.7	2.1	5.0	5.6	6.5	4.9	6.2

Source: Bloomberg, Talaria

Highlights

Cash has gone from yielding nothing to yielding something. In an uncertain world this is all the more welcome because cash does not suffer drawdowns. Another reason cash is a good choice is its optionality, providing the firepower to take advantage of any opportunities the market might provide.

Global sovereign bonds offer a little better but still miserly real yields. This may reflect the desire for relative safety and capital protection, but the 2022 drawdown shows that the journey to maturity need not be a smooth one. Enormous levels of public debt and future issuance might lead one to ask whether these valuations fairly reflect supply and demand. In a related point, we wrote in the last quarterly about a new era of financial repression in which governments will likely relieve savers of their money as they battle to cut their liabilities. One mechanism to achieve this is to force asset owners to buy sovereign bonds at the wrong price.

Investment grade and high yield bond valuations are barely changed over the last five years. This means the inter-relationship between the fixed income assets shown has barely changed as well. High yield offers the second best real return of the asset classes on show and looks somewhat promising. The key is to find a fund manager up to the challenge of assessing whether the yield adequately reflects the default risk. High yield bonds are known as junk for a reason.

All broad equity classes are more expensive than they were five years ago.

US equity now yields less than sovereigns, investment grade bonds and cash. This is confusing for anyone used to the idea of an equity risk premium. There are ways to rationalise this inversion of the usual position including tech related new paradigms such as AI. But the simple explanation is that US shares are very expensive.

Elsewhere in the equity classes, we note that whilst Japanese shares' real yields have fallen, the earnings from which the yields are derived are less vulnerable than those of US shares in particular. The latter are high having benefited from tailwinds that are now reversing. These include wage costs, and rates of taxation and interest. Moreover, in contrast with its developed market peers, listed Japan sits on net cash.

Talaria's real yield is all but unchanged and the best of the bunch. From a risk point of view, we note that Talaria's maximum drawdown is just three points higher than government bonds and four points lower than investment grade bonds. The fund's equity holdings are diversified by region and sector, offering lower levels of debt, higher returns, and more attractive valuations than the global index. With cash at its maximum allowed, the fund is also in a position to take advantage of any market weakness and the consequent opening up of opportunities. The fund is discussed in more detail in the portfolio in focus section later in this report.

Odds and Probabilities

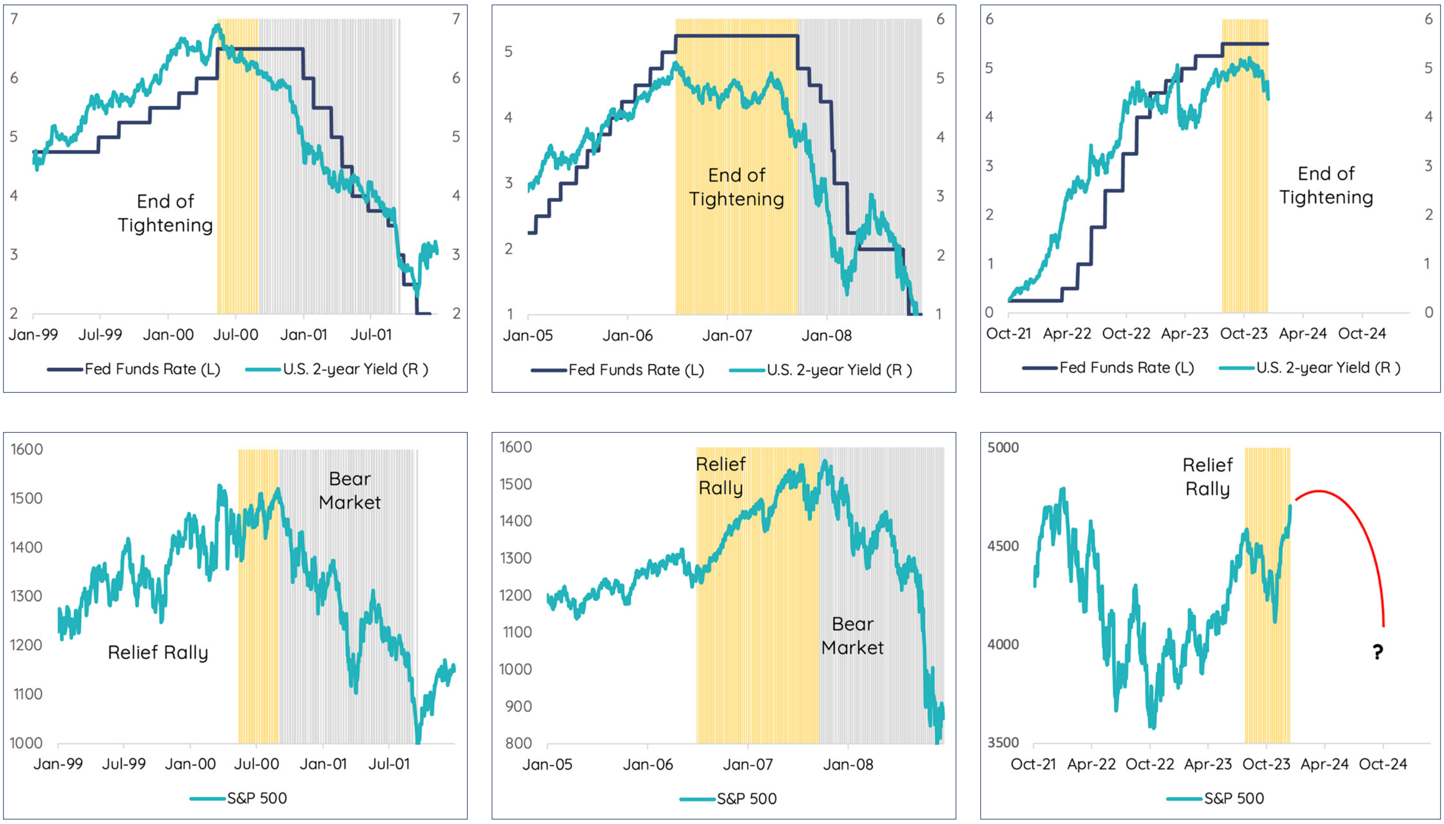
As managers of the money our investors have entrusted to us, we are playing a game, albeit a very serious one. What we mean by a game is that we are making decisions under uncertainty, always taking into account odds and probabilities.

As we write, global equities have just had their best month for three years. Very quickly the higher for longer interest rate and recession narrative seems largely to have been priced out. US markets in particular are pricing in rate cuts next year alongside a double digit reacceleration in corporate profits.

Whilst we recognise that anything can happen, evidence such as we provide below is against what seems to be the prevailing Panglossian view that all is for the best in the best of all possible worlds. The end of a tightening cycle has prompted relief rallies before (charts below), but they do not change our assessment of the outlook nor the potential for it all to end in tears.

S&P500 performance following the end of Fed tightening – 2000, 2008 and Today

1999-2001 Tightening Cycle | **2004-2006 Tightening Cycle** | **2022-2023 Tightening Cycle**

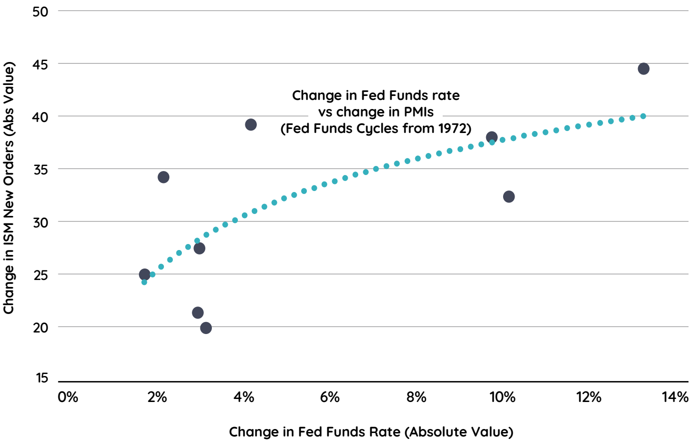


Source: Bloomberg

In the spirit of odds and probabilities:

1. The chart in the exhibit below shows the absolute value relationship between a change in the Fed Funds Rate and a consequent change in ISM new orders. The table in the exhibit below shows the 13 tightening cycles since 1954, and the follow-on in terms of new orders, and EPS and GDP recessions. In all cases, tightening was followed by the ISM falling below 50, which is where it currently sits. In 12 out of 13 cases it was followed by an EPS recession. In 10 out of 13 cases it was followed by a GDP recession.

History of past tightening cycles

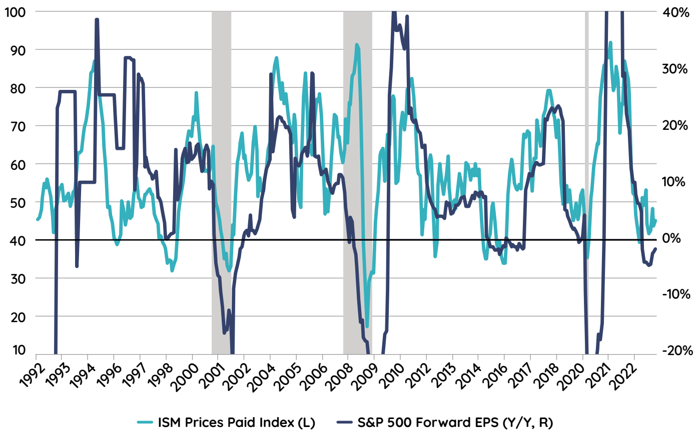


Start of Tightening	ISM Fell Below 50	EPS Recession	GDP Recession
1954	Yes	Yes	Yes
1958	Yes	Yes	Yes
1961	Yes	Yes	Yes
1967	Yes	Yes	No
1972	Yes	Yes	Yes
1977	Yes	Yes	Yes
1980	Yes	Yes	Yes
1983	Yes	Yes	Yes
1988	Yes	Yes	Yes
1994	Yes	No	No
1999	Yes	Yes	Yes
2004	Yes	Yes	Yes
2015	Yes	Yes	Yes
2022	Yes	?	?
Frequency	13/13	12/13	10/13

Source: Bloomberg

2. As the chart below shows, there is a strong relationship between inflation and EPS growth. This is hardly rocket science when organic revenues are unit price x volume, but it is another way of looking at the likelihood of earnings' weakness when markets seem to be greeting lower inflation numbers as a reason for unqualified celebration.

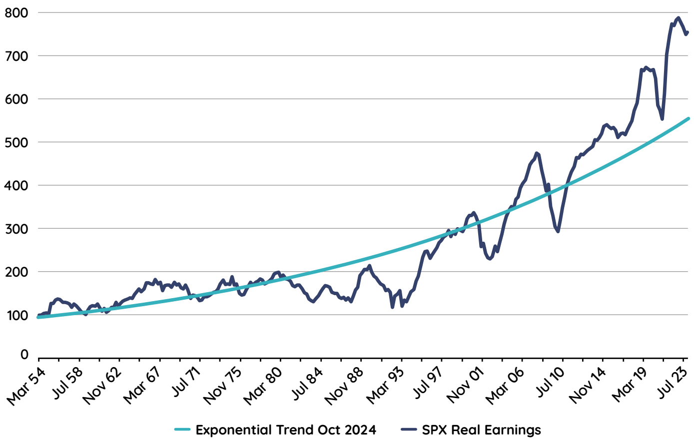
ISM Prices Paid index and S&P 500 forward EPS growth



Source: Bloomberg

3. Whilst 1994 bucked the trend by being a tightening cycle followed by neither an earnings nor a GDP recession, it did so at a time when real earnings were well below the exponential trend (chart below). Earnings in the tightenings after that were all above trend and were all followed by downturns. It would be an understatement to say that an EPS soft landing is odds against when S&P 500 earnings were 32% above trend in 2022.

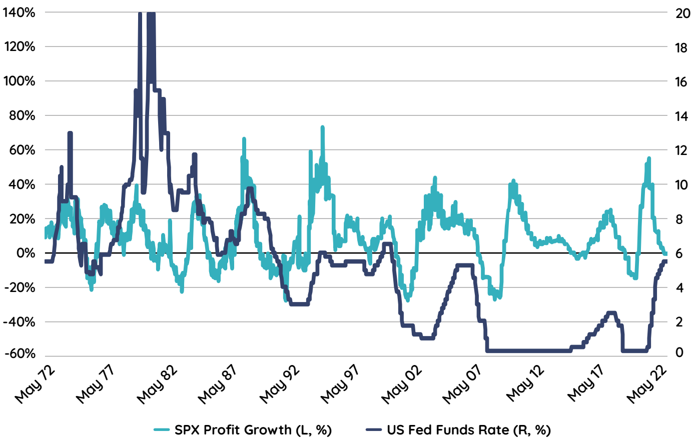
S&P 500 Real earnings growth trend, index



Source: Bloomberg

4. When the Fed does eventually cut rates, it will not be because it is unconcerned about the state of the economy. Yet this seems lost on sell-side analysts (chart below). They currently have the following forecasts for S&P 500 EPS: 2023 221; 2024 244 (+10%); 2025 270 (+11%).

S&P 500 Profit growth (%) and US Fed Funds Rate growth (%)



Source: Bloomberg

Gauging the end of a tightening cycle

The points above show that in the vast majority of cases, a rise in the Fed Funds Rate leads to an EPS and GDP recession. For equity investors, the question that follows is what does an EPS recession look like?

The table top-right shows that since 1957 the median peak to trough decline in nominal EPS has been 21% over the following 17 months. In 12 out of 13 instances EPS fell. It is also worth noting that there is usually a lag between peak rates and peak EPS. These are plateaus upon which relief rallies and soft-landing arguments can temporarily rest.

As for the behaviour of stock markets, the next table shows that following a cyclical peak in the Fed Funds Rate, the median decline in the S&P 500 has been 26% over the following 14 months. Again, more often than not there is a gap between the peak in rates and the peak in the market.

What neither table shows is that whilst trends in forward earnings are the foundational driver of the index's direction, the immediate cause is valuation. As investors anticipate a fall in earnings, multiples compress and, later, as investors anticipate a recovery, multiples expand.

Peak Fed Funds rate and subsequent change in nominal S&P 500 EPS

Peak FFR	Peak EPS	Trough EPS	Change in Nominal EPS	Months from Peak to Trough EPS
Aug-57	Nov-57	Apr-59	-21%	16
Sep-59	Jul-60	Jun-61	-15%	12
Nov-66	Nov-66	Jun-67	-16%	8
Aug-69	Feb-70	Jul-71	-18%	17
Aug-73	Aug-73	Aug-73	-1%	0
May-74	Jan-75	Feb-76	-22%	13
Dec-80	Sep-82	Jul-83	-26%	11
Aug-84	Feb-85	Sep-86	-21%	20
Feb-89	Aug-89	Dec-91	-22%	28
Feb-95	Feb-95	Feb-95	0%	0
May-00	Nov-00	Nov-02	-30%	24
Jun-06	Aug-07	May-09	-29%	21
Dec-18	Jun-19	Mar-21	-15%	21

Source: Bloomberg

Peak Fed Funds rate and subsequent change in S&P 500 price

Cycle Peak FFR	SPX Peak	SPX Peak to Trough	Months from peak FFR to bottom of SPX
Aug-57	Sep-57	-14%	2
Sep-59	Jan-60	-13%	14
Nov-66	Nov-66	0%	1
Aug-69	Aug-69	-28%	10
Aug-73	Oct-73	-44%	13
May-74	Jun-74	-33%	5
Dec-80	Jan-81	-26%	21
Aug-84	Sep-84	-4%	2
Feb-89	Oct-89	-18%	20
Feb-95	Feb-95	0%	0
May-00	Sep-00	-49%	29
Jun-06	Oct-07	-57%	33
Dec-18	Feb-20	-34%	15
Jul-23	???		
	Median	-26%	14
	Hit rate	85%	

Source: Bloomberg

Being proactive

In this section, we look at the performance of various factors in the 18 months after a peak Fed Funds Rate world, referencing the four examples over the last thirty years. This is intended as a granular and practical exercise in thinking about how to position within equities as an asset class.

Three of the best performing factors in the 18 months following peak Fed Funds Rate:

1. Shareholder Yield (+9.4% on average, outperforms 75% of the time):

Shareholder yield includes dividends, stock buybacks, and debt reduction. In a post-peak Fed Funds Rate environment, companies with strong shareholder yield might be seen as signalling financial health and confidence. Furthermore, income such as is incorporated in shareholder yield is almost certain to be a disproportionately large component of return given the pressure on capital growth.

The outperformance of shareholder yield is not confined to the first 18 months. Looking over the last thirty years, in the 36 months following a peak in the Fed Funds Rate, the factor was also strong, outperforming 100% of the time by 23.0% on average.

2. Enterprise Value/Free Cash Flow (+6.6%, outperforms 75% of the time):

EV/FCF does well in the 18 months after the Fed Funds Rate peaks. One explanation is that the metric's inverse, free cash flow yield to EV, is attractive at a time when capital growth is under pressure and investors need to lean on income as a component of return. To this extent it is related to shareholder yield.

EV/FCF, a value factor, also does well because value can be over-sold in the run-up to an interest rate peak. As investors anticipate slowing GDP growth, they tend to cut exposure to companies that they perceive as being cyclically sensitive. This widens the discount of these companies' shares both to their own fair value and to growth equities.

Whether they think of it this way or not, investors are always working an arbitrage between value and growth. At some point, often in anticipation of an economic recovery, investors deem growth overpriced relative to value. The spread then narrows to the benefit of shares trading on attractive multiples. Looking over the last thirty years, in the 36 months following a peak in the Fed Funds Rate, EV/FCF did well, outperforming 75% of the time by 18.0% on average.

3. Low Beta (+6.4%, outperforms 75% of the time):

This must be the least surprising performance of the factors we highlight. The message from the odds and probabilities above is that equity markets do poorly after a peak in the Fed Funds Rate. It follows that equities that do not fully reflect the magnitude of moves in the index, do better than the index itself and outperform higher beta stocks. Looking over the last thirty years, in the 36 months following a peak in the Fed Funds Rate, low beta outperformed 75% of the time by 4.9% on average.

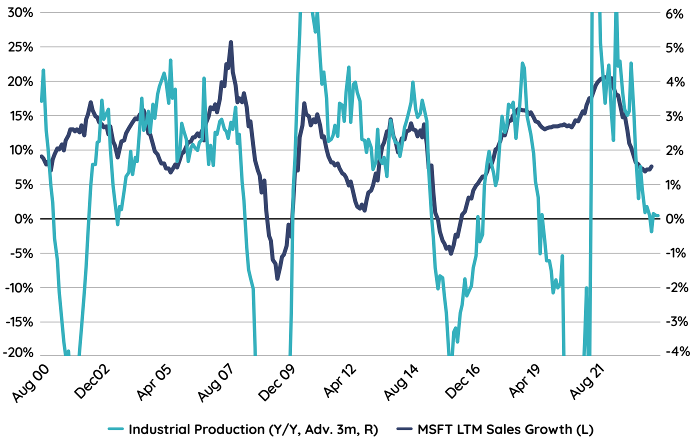
Three of the worst performing factors in the 18 months following peak Fed Funds Rate:

1. FY2 EPS Growth (-6.8% on average, underperforms 75% of the time):

A growth factor appearing as a poor performer after a peak in the Fed Funds Rate might surprise people. However, investors tend to pay up for growth at times of slowing but positive overall economic momentum. This reflects the perception that certain stocks have structural advantages underpinning revenues in the face of a slowdown.

As a result, growth equities move to high relative valuations leaving a very narrow path to positive performance when a downturn hits. Part of the challenge for growth stocks is that there is very little that is not cyclical. For example, the chart below shows the relationship between Microsoft's sales growth and industrial production.

Microsoft sales growth (%) and Industrial Production growth (%)



Source: Bloomberg

2. Low Size (-5.4% on average, underperforms 100% of the time):

Low Size, or small-cap stocks, may face challenges after a peak in the Fed Funds Rate as economic conditions deteriorate. Smaller companies might be more susceptible to economic headwinds than their larger counterparts. However, when looking over the last thirty years, in the longer period of 36 months following a peak in the Fed Funds Rate, the low size factor did notably better than over the shorter time horizon, performing in line 50% of the time. This improvement over the longer period makes sense as small caps' economic sensitivity turns from a negative to a positive.

3. Net debt/EBITDA (-2.3% on average, underperforms 75% of the time):

As equity ranks lowest in terms of the capital structure, investors understandably prefer companies with strong balance sheets in a period of slower economic growth.

Companies with high net debt/EBITDA that are sensitive to the health of the overall economy may see their EBITDA fall. Aside from the most basic negative consequences for EPS, this might also raise credit risk through breach of covenant. Loan agreements often cite a level of net debt/EBITDA above which there is default. Companies with high debt levels may also face challenges refinancing, particularly if they have failed to term out their debt when interest rates were low.

The saying is that leverage works both ways, but it is not just in the first 18 months after the peak in the Fed Funds Rate that it is something to avoid. Over the same last thirty-year period, in the 36 months following a peak in the Fed Funds Rate, net debt/EBITDA underperformed 75% of the time by an average of 5.9%.

Summary

We have spent much of this investment insights discussing the likelihood of GDP and earnings recessions, as well as the pullback in equities that should follow. We have also looked at the potential magnitude and duration of declines in both EPS and the index. And we have identified certain factors that have done well or badly in a post peak Fed Funds' Rate world.

The weight of evidence suggests the odds remain heavily in favour of declining GDP and earnings. By extension, and given the starting point valuations, the outlook for equities, is poor, certainly as far as long-term returns are concerned. In view of this. we continue to favour income as a component of return, value, short duration, balance sheet strength and low beta assets. The last year for equities was a good one, the last two years – not so much. There have been surprises, not least the transformation in sentiment in the fourth quarter. Whether truffle hunters or parachutists, historians know anything can happen. So, we are not making a forecast, but we are sceptical of the plain sailing future that many equities currently price in.

December 2023 Quarterly Performance

The fourth quarter was very strong for global equity markets. Expectations of a lower Fed policy rate in 2024, lower inflation, and the growing belief in a "soft landing" were the most noteworthy catalysts. Sentiment is high and investors are pricing in continued strong performance this year. But a lot must go right for this to happen.

Equity markets finished the year on a high. A notable decline in interest rate and inflation expectations unleashed a broad-based, risk-on market rally. Bonds, equities, gold, and risk currencies including the AUD all rallied in the quarter. For Australian based investors this translated into a 5% rally in global equity markets. The "higher-for-longer" narrative was replaced by expectations for rate cuts as early as Q1 2024. Cyclical and rate sensitive equities outperformed. While the move was impressive, on a two-year view many indices and equities have no more than round-tripped. As we discussed in the previous section, markets are pricing in a benign outcome already, so a lot must go right in 2024 and beyond for a sustained rally.

Almost all major indices were in the green in the fourth quarter. The US led the way with the broad-based S&P500 and the tech-heavy NASDAQ up 11.2% and 13.6%, respectively. Both indices closed the quarter within striking distance of all-time highs set in late 2021. The breadth of the rally widened considerably, and the S&P 600 Small Cap index gained an impressive 14.5% in the quarter. European stocks were also up, albeit a more modest 6.4% for the STOXX 600 index where stickier inflation has proven harder to shake off. In Japan, the NIKKEI 225 index increased by 5.0% capping off a strong year for the region. The Shanghai Composite index was the only major index in the red this quarter – down -4.4% and reflective of debt woes and deflationary pressures in the Chinese economy.

Against this backdrop, the Fund delivered a positive quarter, gaining 2.39%, taking its 12-month return to +11.35%.

Distributions: The Fund paid a December 2023 quarterly distribution of 8.57 cents per unit taking its 12-month income return to 4.80%.

All sectors except energy were up in the fourth quarter. Information technology (+17.4%) was the strongest performer. All cyclical sectors also did well with industrials (+13.5%), financials (+12.7%) and materials (+12.4%) leading the way. Defensive sectors were relative underperformers with healthcare and staples up just +4.7% and +5.6%, respectively. Energy was the only sector that was negative (down -4.8%) on the back of a weak oil price.

The big story this quarter was the change in narrative from "higher-for-longer" rates to "expect multiple rate cuts in 2024". At year end the market was pricing six interest rate cuts over the course of 2024. After nearly touching 5% in mid-October, the US 10-year yield fell back down to 3.88% at year end, a 111 bps drop.

Inflation expectations came down. The oil price fell by -21.1% to $71.65 a barrel while the Bloomberg commodity basket fell by -5.9%, reflecting a continuing easing of demand despite some ongoing supply issues (two regional wars and attacks on ships in the Red Sea). The VIX also fell by 5.1 points to 12.45, the lowest monthly reading since September 2018 and reflective of the giddy mood in financial markets.

Mexican retailer FEMSA contributed the most to performance this quarter. Solid execution on their recently unveiled strategy alongside strong organic growth in their core business supported the shares. Wheaton Precious Metals, a Canadian gold and silver streaming company, also contributed significantly to performance in the quarter. Higher gold prices and solid operating performance announced at the most recent quarterly result were the biggest drivers.

French pharmaceutical giant Sanofi was the largest detractor to performance in the quarter. The company announced an increase in R&D spend in late October that was received poorly by the market. We believe this was largely to do with less-than-ideal presentation from management rather than anything of substance. The shares have since recovered some lost ground and we continue to see upside from here. Another detractor to performance was Alibaba, an online retailer in China. Scuppered plans for IPOing several business divisions and continued general weakness in the Chinese economy weighed on the share price. We maintain our holding based on an attractive valuation.

The fund initiated two new positions this quarter. WEC, a US regulated utilities company, trades on an attractive dividend yield not seen in a decade while exhibiting a business model with defensive characteristics (revenues backed by the state). Medtronic, a US healthcare equipment maker, is a dividend aristocrat with a solid cashflow generation profile and attractive valuation. It has recently returned to mid-single digit organic growth, and we believe they can continue this momentum. The fund exited Japanese equipment manufacturer Mitsubishi Electric on valuation grounds.

Portfolio in focus

This quarter we depart from our customary focus on an individual portfolio stock. Instead, we take a deeper look at the overall Talaria portfolio and how it is positioned. We explore its defensive characteristics – low beta, low leverage, high income as a component of total return and the optionality of holding cash. We also look at the expected return in a bear market, a bull market, and a neutral market. But first we step through the basics.

The Talaria portfolio

In what follows we identify three key elements to consider when thinking about the portfolio, each providing a unique insight.

Gross Exposure

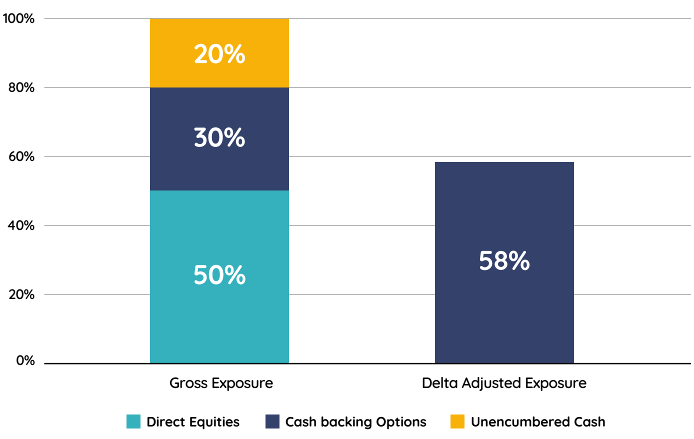
The core of the strategy is bottom-up fundamental analysis to identify mispriced through-cycle cashflows. We then always enter and (mostly) exit positions using put and call options (puts and calls). We sell puts on companies that we believe are undervalued; we sell calls on companies that we own and are happy to exit. In the process we generate premium income – providing a second lever of returns, exploiting what is known as the Volatility Risk Premium.

As of 31 December 2023, 50% of the portfolio is held in equities (Chart 1). Every one of our shares started its life in the portfolio as a put option that was exercised.

The cash backing puts, our commitment to buy shares we want to own, is another 30%. In simple terms this is the additional capital at risk or perhaps more easily understood as the percentage of additional equity the portfolio would gain if all puts were exercised.

The remaining 20% is currently held in cash – the maximum amount allowed under the mandate – which is entirely a function of the bottom-up opportunity set.

Talaria Portfolio Exposure (as of 30/12/2023)



Source: Bloomberg

Cash and its opportunity cost

All the puts we write are fully backed by cash. We use options to lower the risk to our investors' capital. 50% of the portfolio currently sits in cash, of which 30% is "encumbered", backing the puts.

The "encumbered" cash does not just sit there idly. It contributes meaningfully to total return by generating premium income from selling puts backed by the cash (and from selling calls backed by the shares we own). The contribution to total return from premium generated is around 5.3% over the last 12 months.

The remaining 20% "unencumbered" cash collects annual interest of 4%, or a 0.8% contribution to total return. While 20% "dry powder" might seem like a lot, the opportunity cost is investing it in expensive companies. There is value in holding spare cash that we can deploy at more opportune moments.

The strategy benefits uniquely in three ways from rising uncertainty and increased volatility. First, we are paid higher premiums for doing the same thing; second, the number of stocks which have 20% upside from the put strike prices to our assessment of fair value increases allowing the fund to deploy capital quickly; finally, the quality of companies which have sufficient upside to warrant deploying capital increases.

Delta Adjusted Exposure

The third and final element represents the sum of the equity exposure and the delta adjusted exposure of the puts and the calls. Delta adjusted exposure is our effective equity exposure taking into consideration the likelihood of the puts and the calls exercising.

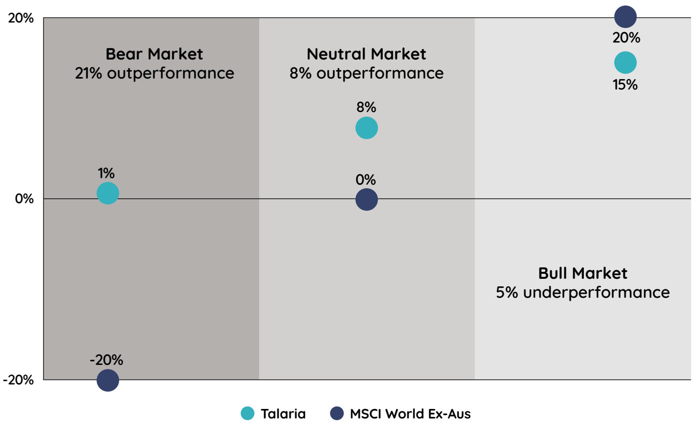
The delta adjusted exposure is sitting at 58%. It is a particularly useful metric when calculating how sensitive the portfolio is to movements in the market.

Portfolio beta and the three scenarios

The overall portfolio carries an effective beta of just 0.35. This is driven by a combination of a lower beta on individual stocks (a weighted average of 0.6, grossed up) and the low equity exposure. The 0.35 is calculated by simply taking the 0.6 beta of the grossed-up equities times the delta adjusted equity weight of 58%.

While this is absolutely not a forecast of what the fund's returns would be, Chart 2 shows how the portfolio could behave under three stylized hypothetical market scenarios.

Portfolio Scenarios, total return (%)



Source: Bloomberg

A bear market – MSCI World ex-Australia down -20% over the year. A low portfolio beta is very beneficial in a down market. When the market is down -20%, the portfolio would only theoretically lose -7% (0.35 times -20%). The return from our implementation process - our second lever of returns - will continue to generate premium from the puts and the calls (+5.3%), interest from the “unencumbered” cash (+0.8%) and dividend from the equities (+1.9% delta adjusted yield). This would result in an expected portfolio return of circa 1%, against a 20% decline in equity markets.

A neutral market – equity market flat. When the equity market is flat, we continue to benefit from our second lever of returns, producing a total return of 8% (option premium of +5.3%, interest from “unencumbered” cash of +0.8% and a delta adjusted dividend of +1.9%), outperforming the market by 8%.

A bull market – global equity market up 20%. We start to underperform the market once the benchmark begins delivering low to mid-teen returns as the opportunity cost of the cash backing the puts is higher than the benefit we gain from exploiting the volatility risk premium. However, we would still deliver a healthy absolute 15% total return with significantly less risk and a smoother journey along the way.

Portfolio factors

We discussed earlier in the Investment Insights section factors that typically do well and those that do poorly in the 18 months after a peak in the Federal Funds Rate. We now look at how Talaria’s portfolio is positioned with regard to those same factors. To be clear, the portfolio exposures are NOT a function of the ‘flavour of the day’ factors. They are simply an output. Our bottom-up work drives what shares we own.

The Table below treats the Talaria portfolio’s gross equity holdings and the index as if they were each one company. With sales for both set at 100, this common size analysis gives our investors an overview of what they own and how it is different from the index.

Common size analysis: portfolio holdings and the index (Indexed, sales = 100)

Metrics (Index 100 = Sales)	Talaria Portfolio	FTSE Developed	Comments
Income Statement Figures			
Sales	100	100	
EBIT	15.4	14.2	
After-Tax Profit	11.9	10.9	
Efficiency/Profitability Ratios			
Return on Total Capital	12.0%	11.2%	
Balance Sheet Figures			
Debt	43	93	Low leverage ✓
Cash	15	65	
Net Debt	28	27	
Leverage Ratios			
Debt/Equity	59%	132%	Low leverage ✓
Net Debt/Equity	39%	39%	
Valuation Figures			
Price	167.2	194.5	
Price/Earnings	14.0	17.8	Cheaper ✓
Enterprise Value/EBIT	12.6	15.6	Cheaper ✓
Earnings Yield	7.1%	5.6%	Cheaper ✓
Retained Earnings Yield	4.1%	3.5%	
Dividend Yield	3.0%	2.1%	High Dividend Yield ✓
Market figures			
Portfolio beta (not indexed)	0.59	1.00	Low beta ✓

Notes: (1) Based on Talaria estimate of index interest expense and tax rate.
Source: Bloomberg

- The portfolio’s holdings are better value than the index (P/E, EV/EBIT).
- The portfolio’s holdings are more profitable and generate higher returns on capital.
- The lower cost (cheaper) and better returns (higher Return on Total Capital) mean the portfolio offers both a higher dividend yield and a better level of retained earnings that can be reinvested at better returns on capital.
- The portfolio has less balance sheet risk through lower total debt to equity than the index. It also has lower refinancing risk and lower risk of credit spreads widening if the economy slows sharply.

Compared to owning the index, the portfolio’s equity holdings give our investors less balance sheet risk, lower beta, more efficiency, greater quality, and a higher retained earnings yield deployable at higher rates of return - all at a better price.

Talaria Global Equity Fund (Managed Fund)

Top 10 Holdings*

Company name	% weight
Roche	5.1%
Sanofi	5.1%
Gilead	5.0%
Johnson & Johnson	4.5%
Secom	4.3%
Sodexo	3.9%
Nippon Telegraph & Telephone Corp	3.9%
Chubb	3.8%
KDDI Corporation	3.7%
Henry Schein	3.4%

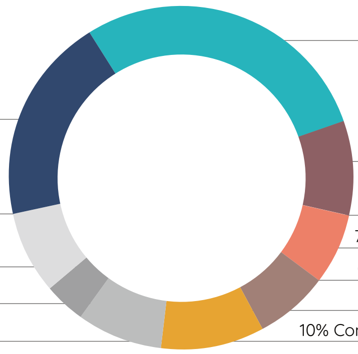
* Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

Performance at 31 December 2023

Period	Total Return	Average Market Exposure
1 month	1.75%	58%
3 months	2.39%	58%
6 months	3.25%	58%
1 year	11.35%	57%
3 years p.a.	10.91%	56%
5 years p.a.	9.41%	56%
7 years p.a.	7.29%	58%
10 years p.a.	6.65%	59%
Since Inception p.a.	7.73%	58%

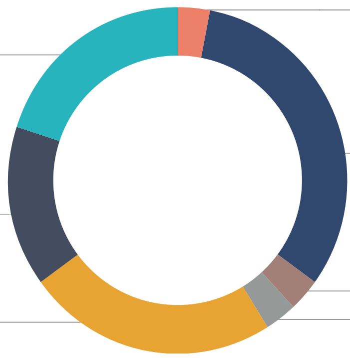
1 Fund Returns are calculated after fees and expenses and assume the reinvestment of distributions
2 Inception date for performance calculations is 18 August 2008
3 Income Return includes realised capital gains
4 Past performance is not a reliable indicator of future performance
5 Average Market Exposure 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
December 2023	8.5700	$5.7594
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	% weight
Global equity	50.0%
Cash – put option cover	30.0%
Cash	20.0%
Total	**100.0%**

Portfolio contributors	Portfolio detractors
Femsa	Sanofi
Wheaton Precious Metals	Alibaba
Bunzl	Johnson & Johnson
Gilead	Novartis

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**	$5.8304 (31 Dec 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