TALARIA

# Talaria Global Equity Fund - Wholesale
## Quarterly Update | March 2020

FUND MANAGER OF THE YEAR 2018
MONEY MANAGEMENT | Lonsec
WINNER
Retirement and Income Focused

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*Signatory of:*
PRI Principles for Responsible Investment

## Portfolio Summary

- The portfolio has ample cash to continue to take advantage of opportunities offered by today's uncertain markets
- With March's higher volatility, the portfolio has already generated income of 2% which will be realised in the second quarter
- Rebalancing the portfolio is taking place as the opportunity to buy high quality equities is improving
- The portfolio trades at 14.2x average 10-year earnings
- On a valuation basis the portfolio is at a 30% discount to the market, with 40% of stocks offering exceptional value
- The parallels with the GFC are encouraging, given Talaria recorded strong performance in the three years post October 2008

## Investment Insights

Our quarterly report 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.

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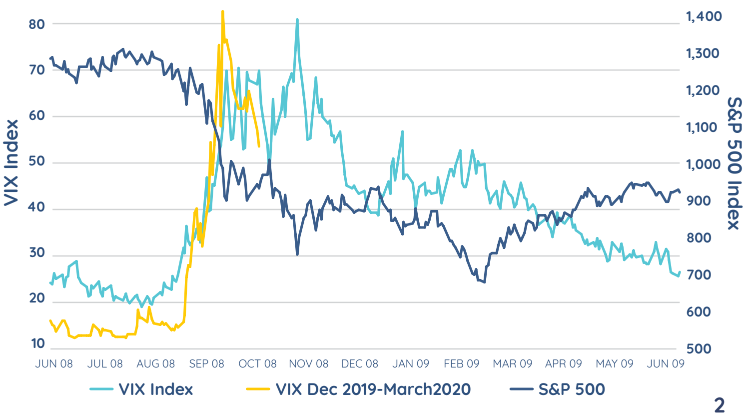
Furthermore, the success or otherwise of efforts on health, fiscal and monetary fronts will not be evident for some time. In this context, volatility will remain high relative to the past - a regime the portfolio is built to benefit from. For example, the portfolio has been running for fifteen years 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

Despite being value investors, by avoiding traps such as banking and energy and through income generation the portfolio fell by only -9.24% in the quarter. Any decline is disappointing but context matters, and whilst index levels and share prices may have changed significantly year-to-date, market leadership has not.

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.

As a result, we would now say the portfolio is outright cheap, with around 40% of the holdings offering exceptional value. At quarter end the portfolio had an overall P/E of 14.2x on a conservative Shiller P/E basis, a weighted average credit rating of A, and had delivered earnings growth on average of 7% per annum for the last 10 years.

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 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.

As ever we thank you for your trust and partnership.

# March 2020 Quarterly Performance

**Global equities fell materially as investors absorbed the impact of the Coronavirus. Governments and central banks took unprecedented fiscal and monetary measures to support economies and ease stress in financial markets. The end of March saw tentative signs of stabilisation across various asset classes, but volatility stayed high and visibility was poor.**

US stocks fell, with the S&P 500 down 20.0% over the quarter. The tech heavy NASDAQ outperformed the broader index, down 14.2%.

European shares suffered badly with the STOXX 600 Index losing 23.0%. The Swiss market was the strongest major European market falling 12.3%. With Brexit in the past, a sideshow compared to the current global health crisis, the UK's FTSE 100 fell 24.8%.

Some Asian markets held up relatively well compared to Europe, with Japan's Nikkei, for example, down 20.0%. Counter intuitively perhaps, China's Shanghai Composite Index was resilient, down only 9.8%.

At a sector level, Health Care, Consumer Staples and IT were the best performing sectors globally. Sectors that underperformed included Financials and Industrials. Energy was by far the weakest sector following the collapse in the oil price.

The quarter was exceptionally tough for the Australian Dollar. It fell 13.1% against the US Dollar over the period, closing at US 61.0c.

An oil price war at a time of collapsing demand saw US WTI suffer its largest ever quarterly drop, from USD 61 to USD 20. Elsewhere in commodities, precious metals were rare safe havens.

In response to a lack of liquidity in Treasuries, the Federal Reserve took extraordinary measures. US 10-Year government bond yields fell from 1.92% at the end of December 2019 to 0.66% at the end of March 2020. Equity market volatility rose, with the VIX Index finishing the quarter at 53.5 having peaked at over 80 in mid-March.

The Talaria Global Equity Fund returned -9.24% for the quarter and 1.52% over 12 months.

**Distributions: The Fund paid a March 2020 quarterly distribution of 1.70 Cents Per Unit taking its 12-month income return to 7.84%.**

Uncertainty surrounding the Coronavirus dominated the quarter. There is a wide range of outcomes and no precedent to which investors can turn to provide a pathway. In this context, pharmaceutical majors proved attractive.

Demand for their products tends to be inelastic. Scale and balance sheet strength add to their defensive characteristics. Some may also offer a solution to the virus. Johnson & Johnson, Sanofi and Roche made positive contributions to the portfolio over the quarter. Johnson & Johnson announced a Covid-19 vaccine development programme in January. Sanofi, which is one of the world's four leading manufacturers of vaccines, is working on a solution. Roche initiated a phase 3 trial of Actemra to test its efficacy in treating certain types of Covid-19 attacks on the immune system.

Newmont and Wheaton Precious Metals both had good quarters, as both offer exposure to gold, a commodity that could benefit whether the future holds inflation or deflation. Newmont has attractive assets, strong management and is highly cash generative. Wheaton Precious Metals, which acquires the right to purchase streams of precious metals from producing or near-producing mines, announced record Q4 2019 results and a positive 2020 outlook.

UK advertising agency WPP was the main laggard. At quarter end, the company announced a suspension of its buyback and final dividend because of the uncertainty in its key markets. Share price weakness had arguably been partly in anticipation of such action. On the plus side, there were good new business wins, especially in the US, in the first two months of the year.

Increased volatility in the quarter saw us initiate or add to positions in high quality stocks like Prudential Financial, Schneider and Swiss Re. We also took the opportunity to exit positions in the shares of companies such as Allergan, BNP Paribas and Essilor Luxottica based on valuations and revised investment cases.

Given that this crisis is unprecedented, we expect volatility to remain high. This is because there is huge uncertainty about when health, fiscal, and monetary measures will begin to overcome the human, economic and market challenges.

**We share in the concerns ahead, but are also excited by the potential for our current holdings, the increasing number of opportunities that we see, and our ability to monetise volatility.**

## Stock in Focus - Swiss Re

**We have recently both initiated and have been increasing our exposure to Swiss Re. The Swiss Re Group, founded in 1863 is one of the world's leading providers of reinsurance, insurance and other forms of insurance-based risk transfer. They have approximately 15% of the global reinsurance market.**

While its services span the insurance spectrum, most of its activities have low levels of economic sensitivity with catastrophe type re-insurance a key example.

Swiss Re has an extremely strong capital position, as demonstrated by having twice the amount of capital required by the regulator. Standard and Poor's recently rated their risk-based capital at AAA. Put simply, Swiss Re is built to last.

Insurance companies have two sources of return and risk. They collect premiums and pay claims and earn a margin doing so. Secondly, they invest the premiums, as many years can pass until claims occur, which also generates a return. Likewise, losses from either are key risks.

For Swiss Re, the benefits of scale and diversification minimise the risk of outsized claims. Their 150 year track record is evidence of this skill set. Importantly the current pandemic is not a likely source of increased claims as most of its business is property and equipment reinsurance.

On the investment side, their portfolio is over 92% in fixed income of which over half is cash or government bonds. The balance which is credit exposure has an average credit rating of A-.

Historically the shares have traded in line with Book Value, which is approximately 100 Swiss Francs, alongside a dividend of around 9% on the current share price.

With the recent market sell-off and elevated volatility, we have been able to gain exposure to Swiss Re on very favourable terms. The current share price of around CHF 70 is a 30% discount to Book Value. Importantly this Book Value is in liquid assets. In effect there is no requirement to forecast or have a view on future business, as the existing assets alone are worth over 40% more than the current share price.

*'There is no requirement to forecast or have a view on future business, as the existing assets alone are worth over 40% more than the current share price.'*

Given the elevated volatility, our option implementation process obtains very high option premiums for agreeing to buy quality companies like Swiss Re, in addition to a greater buffer against loss.

The table below illustrates how we committed to buy Swiss Re 21% below its prevailing price, while receiving an option premium equal to a 22% annualised return. If we do in fact come to owning the shares, they would have a dividend yield of 10.5% and trade at 56% of Book Value, providing substantial upside potential.

| Swiss Re Trade Example | |
|---|---|
| **Trade Date** | 28 March 2020 |
| **Trade Type** | Sold June 2020 Put Option |
| **Underlying Share Price** | CHF 71.08 |
| **Option Strike Price** | CHF 56.00 |
| **Option Premium Received** | CHF 3.04 |
| **Annualised Return on Option Premium** | 22% |
| **Total Buffer Against Loss** | 25.5% |

# Talaria Global Equity Fund - Wholesale

## Top 10 Holdings*

| Company name | (% weight) |
|---|---|
| Roche | 6.6% |
| WPP | 4.8% |
| Sanofi | 4.6% |
| Johnson & Johnson | 4.6% |
| McKesson | 4.3% |
| Wheaton Precious Metals | 4.3% |
| Bayer | 4.0% |
| Prudential | 4.0% |
| Swiss Re | 3.9% |
| Asahi Group | 3.9% |

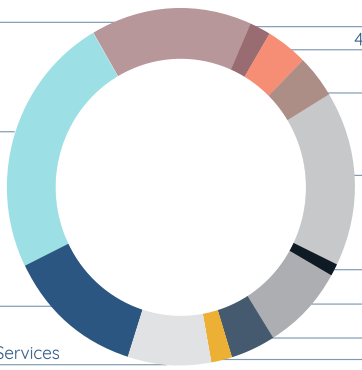
*Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

## Performance at 31 March 2020

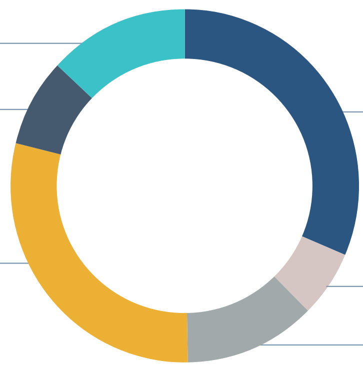
| Period | Income Return | Growth Return | Total Return | Average Market Exposure |
|---|---|---|---|---|
| 1 month | **1.75%** | -10.99% | -9.24% | 64% |
| 3 months | **1.75%** | -10.99% | -9.24% | 61% |
| 6 months | **2.90%** | -10.33% | -7.43% | 59% |
| 1 year | **7.84%** | -6.32% | 1.52% | 57% |
| 3 years p.a. | **8.30%** | -2.63% | 5.66% | 61% |
| 5 years p.a. | **8.03%** | -3.60% | 4.42% | 61% |
| 7 years p.a. | **9.51%** | 0.33% | 9.84% | 60% |
| Since Inception p.a. | **7.24%** | -1.28% | 5.96% | 62% |

[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




## Regional Allocation




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

## Quarterly distribution

| Period | Cents per Units | Reinvestment price |
|---|---|---|
| March 2020 | 1.7000 | $0.8626 |
| December 2019 | 1.2000 | $0.9690 |
| September 2019 | 1.2000 | $0.9620 |
| June 2019 | 3.4313 | $0.9311 |
| March 2019 | 1.5000 | $0.9212 |
| December 2018 | 1.2000 | $0.8961 |
| September 2018 | 1.2000 | $0.9643 |
| June 2018 | 4.6235 | $0.9258 |
| March 2018 | 1.3000 | $0.9214 |
| December 2017 | 1.0000 | $0.9286 |

| Asset allocation | % weight |
|---|---|
| Global equity | 37.6% |
| Cash – put option cover | 49.0% |
| Cash | 13.4% |
| **Total** | **100.0%** |

| Portfolio contributors# | Portfolio detractors# |
|---|---|
| Roche | WPP |
| Hydro | Prudential |
| Newmont | Centrica |
| McKesson | Land Securities |

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

# Talaria Global Equity Fund - Wholesale

## Fund Snapshot

| | | | |
|---|---|---|---|
| APIR Code | AUS0035AU | Inception Date | 18 August 2008 |
| Management Fee | 1.16% 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 | Buy / Sell Spread | 0.20% / 0.20% |
| Platform Availability | AMP North, Asgard, Ausmaq, BT Wrap/Panorama, CFS FirstWrap, Freedom of Choice, Hub24, Linear, Macquarie, Netwealth, Powerwrap | Distributions | Quarterly |
| | | Minimum Investment | $5,000 |
| Fund Size | $316m | Strategy assets under management | $478m |