TALARIA

Talaria Global Equity Fund - Hedged
Quarterly Update | September 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

Investment Insights

Overview

They say justice is slow as well as blind: "Justice limps along, but gets there all the same."

- *Gabriel Garcia Marquez.*

Trends in financial markets can be like that, taking decades to arrive at the significant moment but demanding attention when they do. It has taken 40 years, but investors solving for a mix of income and safety are facing a reckoning because the default combination of bonds and equities looks like it is now not up to the job.

There are three main reasons for this:

Firstly, income from most sources is under pressure. Government bond yields in major developed markets are close to or below zero, share dividends have fallen, and cash rates are low. As the table shows, AU$1 million allocated five years ago to the traditional 60/40 mix of equities and bonds may have appreciated by more than 20%, but the income it generates has fallen from $33k to $22k.

Exhibit 1. AU$1 million portfolio matching a traditional 60/40 mix of equities and fixed income invested 5 years ago compared to today's values and the income generated.

Component	Starting Value	End Value	Start Yield	End Yield
Australian Equities	$300,000	$349,174	5.24%	2.92%
Global Equities	$300,000	$429,804	2.61%	2.03%
Global Fixed Income	$100,000	$112,229	1.73%	0.91%
Australian 10-year Bond	$250,000	$277,651	2.69%	0.99%
Cash	$50,000	$50,000	2.00%	0.13%
Total Portfolio	**$1,000,000**	**$1,218,857**	**3.30%**	**1.86%**
		Total Yield	**$32,985**	**$22,730**

Source: Bloomberg. Based on 5 year returns to 31 August 2020. Returns based on Australian Equities – S&P/ASX 200. Global Equities – iShares MSCI World ETF (AUD), Global Fixed Income (Barclay's Global Aggregate Index hedged into AUD), Cash return based on RBA Cash rates

Secondly, even assuming the status quo persists, an investor can no longer rely on bond prices to rise at times of economic distress. This is important because bonds in a portfolio have traditionally mitigated the almost inevitable losses equities deliver in a downturn.

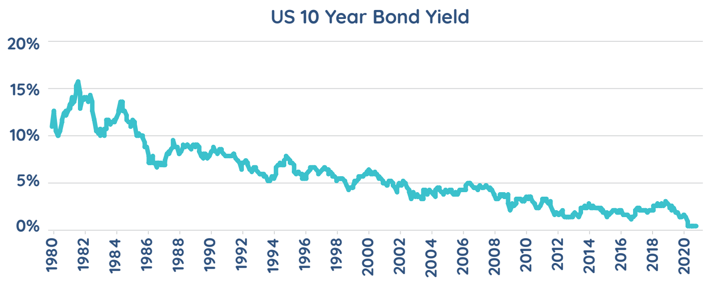
Thirdly, for the first time in decades inflation is a credible threat. Governments are providing fiscal stimulus on a scale previously unknown outside of wartime, and central banks are favouring economic recovery over keeping a lid on prices.

Investors thinking about total portfolio solutions ought to consider alternatives to improve the mix. Talaria's combination of income and safety is a good option. Over the last ten years we have generated an average of 7.5% p.a. of income into the portfolio, largely from how we buy shares, with the added bonus that this income tends to go up as equities fall. Furthermore, as far as safety goes, over the last fifteen years, in seven of the eight periods when the market has lost 10% or more the portfolio has materially outperformed.

Returning to our original premise, we elaborate below on the risks to the traditional combination of equities and bonds.

1. 40 years of falling bond yields means 40 years of falling income

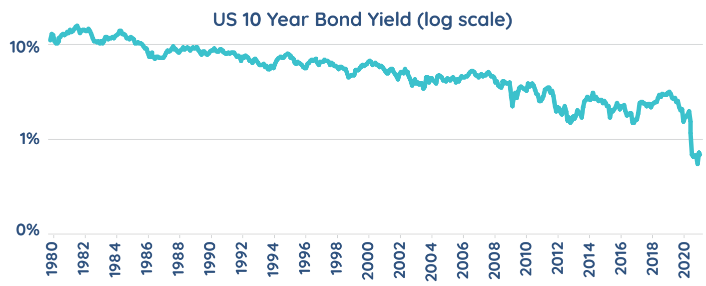
Yields on developed market government bonds have been sinking since the early 1980s. Taking the US 10 Year Benchmark Government Bond as an example (chart below), from the start of 1980 to the end of 2019 the yield fell from 11% to 2%. The high, in September 1981, was 16%. Even for those of us who were around then, that level seems unimaginable today.



Source: Bloomberg

For most of the time the decline in absolute terms was gradual. However, in terms of percentage change, momentum picked-up. After all, a 3% move through the 1980s from 11% to 8% is far less dramatic than a 2% move through the 2010's from 4% to 2%. The first saw yields decline by less than a third whereas they halved with the second.

However, the chart below shows that the pandemic driven dive at the start of this year to 0.7% has been sudden and breathtaking.



Source: Bloomberg

The consequences for savers are considerable and talking about the yield on ten-year bonds can obscure the hard reality: yield is income to savers. When we write about forty years of falling yields, we are also writing about forty years of falling income.

2. High prices, low growth

The disappearance of income from bonds is not the only problem. There are also the implications of high prices to contend with.

Firstly, yields to maturity (income plus capital gain or loss as an annual percentage) can be calculated with certainty, and the certainty in some developed markets is that if you buy a bond today and hold it to the end of its term you will lose money in absolute terms. Secondly, as mentioned and unlike in the past, an investor can no longer rely on the price of a bond to rise at times of economic distress, to help mitigate the likely losses equities deliver in a downturn.

Let's interrogate this more closely.

At times of crisis, investors look for safe havens: assets that are less sensitive to economic downturns and with prices that might even benefit from the falling interest rates that normally follow. Bonds have traditionally fulfilled this role and some of them proved their worth again earlier this year when panic in financial markets was at its peak.

For example, on February 20 this year, $100 of 10 Year US treasury bonds gave a yield to maturity of 1.9% per annum, and cost US$97. Just three weeks later, that same bond was worth US$110, having increased in price by some 12% reducing the yield to maturity to modestly above zero. Over the same period, the S&P 500 fell by about 33%. An investor that held US$100 in the S&P 500 would have been sitting on a loss of US$33, but an investor with US$40 in the bonds and US$60 in US equities would have lost just US$15.

This fixed income characteristic, offering capital gains at a time of equity market downturns, has been one of the drivers to the previous success of the 60:40 portfolio. Such a combination of equities and bonds has enabled investors to earn real (after inflation) mid-single digit returns and enjoy muted drawdowns (losses) for decades.

However, with bonds now offering very low yields and interest rates close to zero they are unlikely to behave in ways similar to the past. This is not theoretical. Over the same period that the US Treasury in the example above was making 12%, the Australian 10-year bond only moved 1.1%. At the start of the year Australian short rates were 75bps, which investors knew left the Reserve Bank of Australia limited scope to cut interest rates. Almost the best you can say is the Australian 10-year bond did not lose money, but unlike previous periods of equity market declines this sort of bond was not making money for the investor as she was losing money in equities.

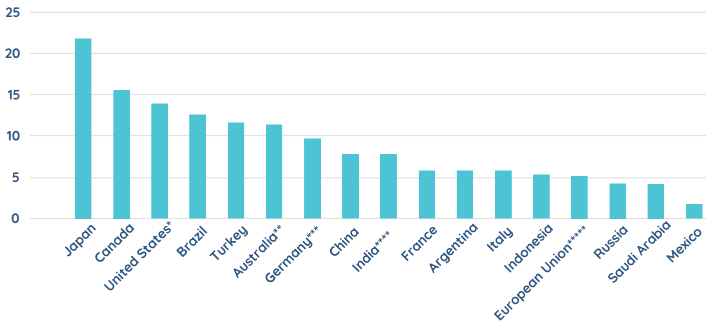
There are other reasons why a saver might still want fixed income exposure, however there is no way round the fact that anyone buying many developed market bonds today and holding them to maturity knows they are locking in a very low nominal return…or worse.

3. COVID-19 and the inflation risk to bonds

As we have outlined, even if the status quo does no more than persist, the outlook for investors in developed market bonds is unattractive and the consequences for portfolios are significant. However, there is a threat to the status quo that makes inflation a credible risk for the first time in decades.

Today we are seeing the largest level of non-wartime fiscal stimulus, nearly ten times as large as in the GFC. Including loan guarantees, G20 nations have provided fiscal stimulus to the end of June equivalent to 13.6% of GDP compared to 1.4% of GDP in March 2009. Many of these measures have taken the form of direct transfer payments and credit guarantees. These measures are quite different to monetary policy measures and have the power to directly affect credit creation and the velocity of money, in a manner that monetary policy alone does not.

Value of COVID-19 fiscal stimulus packages in G20 countries as of July 2020, as a share of GDP



Source: Statista / International Monetary Fund, July 2020

Central banks, already cutting rates and embarking on large-scale asset purchases, are signalling their tolerance for higher inflation should it materialise. Late in August, the US Federal Reserve Chairman announced a new framework for monetary policy, targeting full employment as a priority and shifting the inflation target from 2% to an 'average' of 2%. He also abandoned a 'balanced' approach to policy; meaning the Fed will no longer pre-emptively raise interest rates but rather let inflation versus target run high.

Whether or not such measures in the US and other countries succeed in combatting the economic effects of the virus, they raise at least the possibility of inflation. This is not something reflected in bond prices and makes them vulnerable to capital losses in real terms if held to maturity or absolute losses if sold as inflation moves higher. Should yields rise to 2.5%, our example US bond above would be valued 15% lower. **For the first time in thirty years, bonds and equities could fall together with both sides of the 60/40 portfolio losing money.**

Talaria offers an alternative

With all of this in mind, solving for a mix of income and safety is more challenging than it has been for decades.

We believe our approach at Talaria is a good alternative because we manage an unusual combination of income generation and safety. When we identify an equity we like, instead of simply buying the share, we sell a put option and receive a premium in return. This alone generates a significant income stream, an average of 5.0% per annum over the last ten years. This income tends to be inversely correlated with prices. When equity markets fell earlier this year, option premiums rose and year-to-date we have generated an annualised 9.4% of income.

It is important to acknowledge that ours is an equity fund and not a bond product: there is no guaranteed coupon or repayment of principal at the end of a fixed period.

Nevertheless, we can model scenarios suggesting that our better balance between increased income and safety is worth considering. Below we show two examples, looking at investments in bonds, Talaria and an equity fund.

Scenario 1

Over the 10 year period:

- Market multiple falls to 15-year Shiller Price/Earnings Ratio average of 23.1x
- Put option premium income remains in line with ten-year average
- Corporate earnings' growth in line with ten-year average
- Today's 2.1% dividend yield grows in line with earnings
- Talaria captures these dividends at the historical average of its direct equity exposure
- Equity markets fall 10% as earnings' growth fails to compensate for multiple contraction
- Reinvest at a level to preserve original principal

Result:

- Principal $100 maintained through reinvestment of $6.2 of income
- Income distributed $56
- Total return $ 156

Comparison:

- Talaria total return $156
- Bond Total Return $109
- Equity fund total return $107

The above Scenarios are theoretical and based on assumptions only. Actual portfolio performance may differ considerably as the assumptions used may not hold in all future market conditions. Past performance is not a reliable indicator of future performance.

Scenario 1 shows an excellent result for Talaria. However, there is an argument that using the 15-year average Shiller Price/Earnings Ratio does not adequately reflect the valuation risk of moving savings out of bonds, we note it stands today around 35% higher than its long run average of about 17x. Accordingly, we can rerun the same model to reflect this change:

Result:

- Principal $100 maintained through reinvestment of $39.2 of income
- Income distributed $16.8
- Total return $ 116.8

Comparison:

- Talaria total return $117
- Bond Total Return $109
- Equity fund total return $89 (loss of $11)

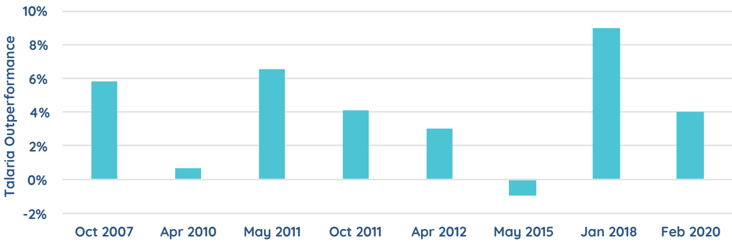
The above Scenarios are theoretical and based on assumptions only. Actual portfolio performance may differ considerably as the assumptions used may not hold in all future market conditions. Past performance is not a reliable indicator of future performance.

Even in Scenario 2, a Talaria investor would preserve principal and have around 90% more income per annum than being invested in bonds. Whereas an investor exposed directly to the equity market would require the reinvestment of all the income over the 10-year period to end up with $89 of their original $100. Clearly simply taking more equity market risk leaves portfolios open to less income and more risk.

Summary of scenarios

Both the examples assume an investor sticks to the long-term path even at moments of uncertainty and that we at Talaria do no worse than the index during equity market drawdowns. On this latter point, our process gives us a high likelihood of delivering. In seven of the eight periods when the market has fallen 10% or more over the last fifteen years the fund declined materially less.

Talaria Relative Performance During Market Drawdowns of >10%



Source: Talaria. Based on performance of Talaria Global Equity Fund - Wholesale units for all periods except Oct 2007 which is based on Talaria Global Equity Strategy adjusted for fees and based on monthly data.

Conclusion

60% equity and 40% fixed income has been the mainstay of portfolio construction for savers over the past 40 years. Today, as the bond component provides little income and limited capacity to appreciate at times of equity market declines, fixed income has lost much of its appeal. This gives savers the uncomfortable prospect of having to take on more equity market exposure at a time of high valuations in an attempt to generate adequate, stable, consistent income while limiting losses.

Talaria's approach has a role in helping build better portfolios to reflect the challenges of today's investment landscape. Whilst investors accept equity market exposure when switching out of bonds into equities, our portfolio's consistent income generation provides a level of compensation for this risk.

Critically, this is not the case for the equity market in general. The contrast is even more stark if one assumes a reversion to long run valuations – something that higher inflation would likely engender.

Doing nothing means living with less certainty and lower income - not an outcome anyone should be happy to accept.

September 2020 Quarterly Performance

The third quarter was a positive one at the global index level, however performance was mixed with US stock markets doing better than comparators in other countries. In September, indices fell from their highs as investors faced the continuing impact of the pandemic, economic uncertainty, and geo-political developments including an imminent US Presidential Election.

US stocks rose, with the S&P 500 up 8.5% over the quarter. The NASDAQ again outperformed the broader index, up 11.0%. Performance in Europe was anaemic with the Stoxx 600 up just 0.2%. The best major European Index was Germany's DAX up 3.7%. This compared well with France's CAC40 which fell 2.7%. In Asia, Japan was up 4.0% and China's Shanghai Composite was up 7.8%. Consumer Discretionary, Tech, and Industrials were the best performing sectors globally. Sectors that underperformed included Energy, Financials and Health Care. Energy's weakness was notable, down 16.9% over the period.

The Australian Dollar showed continued strength, up 3.8% against the US Dollar over the period, closing at US 72.0c. Crude oil prices were stable with the US benchmark WTI up 2.4% to USD 40.21. The broad Bloomberg commodities index was up some 9.5%, while US 10-Year government bond yields hardly moved; 0.68% at the end of September versus 0.65% at the end of June 2020. Equity market volatility fell, with the VIX Index finishing the quarter at 26.4 having been 30.4 at the end of Q2.

The Talaria Global Equity Fund – Hedged returned +1.56% over the quarter.

The Fund's 12.62% performance over 6 months highlights the Fund's participation in the broader market rally notwithstanding our lower risk approach.

Distributions: The Fund paid a September 2020 quarterly distribution of 1.4 cents per unit taking its 12-month income return to 5.15%.

Although UK equities continue to do poorly at the index level with the FTSE 100 down 4.9% over the quarter, the two biggest contributions to the portfolio came from UK stocks. Home improvement retailer Kingfisher led the way. UK & Ireland are its largest geographical exposure at 45% of sales, with France the next largest market. It also has stores across other European countries. Home Improvement has been resilient in past economic downturns and this time there has been an additional DIY tailwind thanks to work from home regulations. Moreover, confidence in the new management is growing as like-for-like sales were already showing signs of strength before the virus hit.

Bunzl also made a strong contribution. It has a wide range of activities such as selling packaging to supermarkets and supplying hospitals with protective clothing such as gloves and gowns. Its first half results were a positive surprise as it proved itself to be a beneficiary of Covid-19 related demand for sanitising, safety and hygiene products. However, our investment case for Bunzl is not solely based on the virus' impact, we also like the way it continues to make value accretive acquisitions,.

Having had a strong second quarter, Bayer was a disappointment in the third quarter. We maintain our view that there is good value in the share, but we recognise that its recent performance has been poor. Legal cases concerning the alleged carcinogenic properties of its fertilisers continue to weigh heavily as a judge in the US raised doubts over what had appeared to be a final settlement. Investors hate uncertainty, and having assumed a major source of concern had largely been removed, they voted with their feet when confronted with the reality that this story continues to run.

Increased volatility in the quarter gave us room to initiate or add to positions in stocks such as A.P.Moeller-Maersk, Owens Corning, PNC and Steel Dynamics. We also took the opportunity to exit positions in the shares of companies such as Publicis and Centrica.

As we discussed in the previous section of this report, investors are facing a significant change in markets. With bond yields at all time lows, dynamics are changing not just in fixed income but also in equities. As we have seen again this quarter, investors are still prepared to favour the expensive, long duration, tech heavy Nasdaq over more diverse indices. This ought to change if bonds weaken and is something for which we believe we are well prepared.

Stock in Focus – Prudential Financial

We have a large and growing holding in Prudential Financial given its very attractive qualities. Prudential is a diversified financial services business started in 1875. It is the largest insurance provider in the US, one of the largest asset management businesses globally as well as having significant operations in Japan. Assets exceed $900 billion and funds under management are over $1.3 trillion.

Notwithstanding its size in the US, half of its income is from foreign operations driven in large part from its Japanese division where it has successfully navigated low interest rates and derives a consistent mid-teen return on equity.

Despite an excellent track record, strong capitalisation, and resilient earnings Prudential's shares have declined significantly in the post-COVID environment providing us the opportunity to gain exposure.

Shares of insurance companies have been particularly weak in this most recent period and Prudential is no exception. This weakness is broadly due to three concerns: One is COVID related claims of which Prudential is not materially exposed. The other two main concerns are a) risk of credit losses from investments within the insurance business and b) low profitability from depressed interest rates.

We feel comfortable with Prudential's asset base as most assets are well above investment grade, with around 40% being Government backed securities. There is significant diversification, and a strong track record of low impairment. Less than 5% in total exposure is to below investment grade credit, retail and other highly COVID impacted industries. This is further strengthened by Prudential's insurance divisions holding over 3.5 times their required regulatory capital and a AA credit rating.

Historically, insurance company profits have been highly influenced by interest rates as the insurance float is primarily invested in credit instruments. However, when pricing insurance to achieve an expected return, companies can adjust other inputs such as price and terms to compensate for low interest rates. This is exactly what is happening currently, and can be seen in the success of the Japanese business where long-term rates have been negligible for many years.

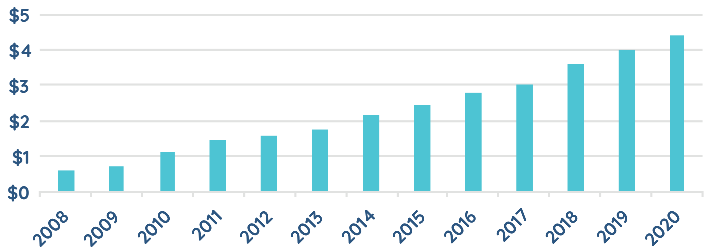
As a result of its scale and high margin businesses, Prudential has enjoyed a return on equity consistently over 10% notwithstanding very strong capitalisation and operating in a low rate environment. This has allowed significant cash generation to both pay dividends and buy back shares. We estimate its sustainable net income at over $4bn p.a. against a market capitalisation of $26bn, of which approximately 40% is used for dividends and the balance effectively grows book value through increasing capital, buying back shares, or making acquisitions.

Based on the current valuation we expect over 10% p.a. to be returned to shareholders annually via dividends (that continued to be paid in this period) which generate an approximate 6.5% yield, plus buybacks. This excludes any benefit from a reassessment of its valuation or operating earnings growth.

Over the long term, Prudential has traded at an average 1.2x Tangible Book Value vs the current 0.73x. With expected return on equity to continue to exceed 10% we see no reason why the shares cannot re-rate to at least 1.0x Tangible Book Value which alone produces a greater than 35% return.

It is this combination of high and growing dividends, sustainable book value growth and significant valuation upside, alongside its scale and capital strength that explains why Prudential is our largest portfolio holding.

Dividends per share



Source: Company reports

Talaria Global Equity Fund - Hedged

Top 10 Holdings*

Company name	(% weight)
Prudential	4.6%
Wheaton Precious Metals	3.6%
Asahi Group	3.4%
Bayer	3.3%
Johnson & Johnson	3.1%
McKesson	3.1%
ING	3.1%
Booking Holdings	3.0%
Swiss Re	2.6%
Bunzl	2.6%

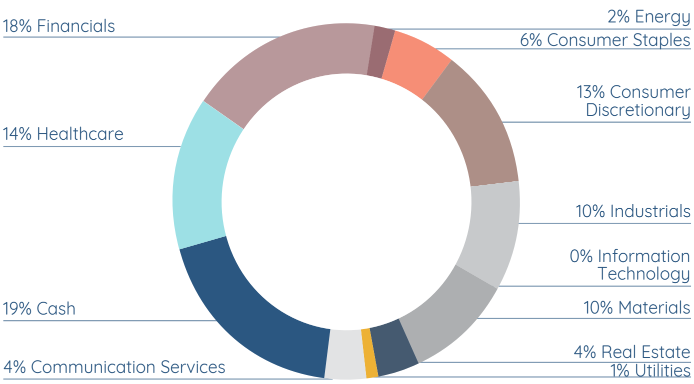
*Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

Performance at 30 September 2020

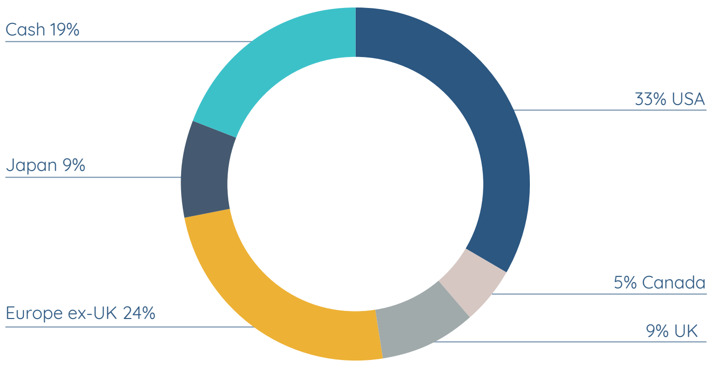
Period	Income Return	Growth Return	Total Return	Average Market Exposure
1 month	**1.45%**	-2.74%	-1.28%	50%
3 months	**1.50%**	0.06%	1.56%	47%
6 months	**6.17%**	6.44%	12.62%	49%
1 year	**5.15%**	-11.20%	-6.05%	54%
3 years p.a.	**3.46%**	-2.44%	1.02%	59%
5 years p.a.	**5.43%**	-1.34%	4.09%	59%
7 years p.a.	**6.34%**	-2.20%	4.14%	60%
Since Inception p.a.	**6.17%**	-0.72%	5.46%	60%

[1] Fund Returns are calculated after fees and expenses and assume the reinvestment of distributions
[2] Inception date for performance calculations is 31 December 2012
[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.

Distributions

Period	Cents per Units	Reinvestment price
September 2020	1.400	$0.9359
June 2020	3.9668	$0.9354
September 2018	0.1000	$1.0254
June 2018	4.2098	$0.9944
March 2018	0.5000	$0.9995
December 2017	0.1000	$1.0315
September 2017	1.0000	$1.0081

Asset allocation	% weight
Global equity	37.8%
Cash – put option cover	42.8%
Cash	19.4%
Total	**100.0%**

Portfolio contributors#	Portfolio detractors#
Kingfisher	Bayer
Bunzl	Canadian Natural Resources
Brookfield	Asahi
Eaton	Land Securities

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

Talaria Global Equity Fund - Hedged

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	**Buy / Sell Spread**	0.25%/ 0.25%
Platform Availability	AMP North, Asgard, Ausmaq, BT Wrap/Panorama, CFS FirstWrap, Escala, Evans & Partners, Hub24, IOOF, Macquarie, Morgan Stanley, Netwealth, Powerwrap, Praemium, Xplore Wealth	**Distributions**	Quarterly
		Minimum Investment	$5,000