TALARIA

Talaria Global Equity Fund - Foundation
Quarterly Update | Jun 2021

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

The Brass Tacks

- Large cap. US equities are priced to deliver low future returns in the long run. This is not a matter of opinion but of maths.
- Large cap. US equities and US government bonds currently trade in tandem as both have negative real yields.
- Both these factors should encourage investors to diversify towards strategies other than growth, regions other than the US, and equities other than 'bond proxies'.
- Whether or not inflation persists, the balance of probability has shifted more in its favour, whilst many portfolios remain concentrated in areas most at risk if the market cycle has in fact changed.
- Investors are over-weight equities that lean heavily on capital growth as a component of return, when income is likely to reassert its importance.
- **Talaria's funds offer solutions to these challenges through its attractive valuation, its high income, and its broad diversification.**

We are grateful that over the last year our process has delivered good risk adjusted returns. Over the last few months in particular, performance has been strong. This has partly been a function of a change in the market cycle that may well persist and that has material consequences. In this quarter's Investment Insights, we discuss our thinking.

Savers are paying

Over the last year we have argued that monetary and fiscal measures globally have increased the probability of inflation and rising interest rates. These measures reflect a political shift - as fear of inflation and rising debt has receded - highlighting that well established norms are seen as neither binding nor limiting... the past is seemingly not prologue. In the US, this can be seen in the breaching of the previous red line level of government debt at 100% of GDP as well as the Federal Reserve's increased tolerance for higher prices via its approach to targeting average inflation.

There will be costs from this shift and savers will likely cover them either through reduced purchasing power and/or higher taxes.

Regarding purchasing power, we suspect there would be less debate about whether inflation will be more than transitory if the stakes were not so high. The broad US equity and growth indices are made up disproportionately of "long duration" stocks, whose prices are most sensitive to changes in interest rates. As of today, savers are overwhelmingly positioned for inflation to be transitory.

Financial repression

With government debt at globally unprecedented levels and still rising, we are already in a world of financial repression, where the nominal returns savers receive are below the rates of inflation. Today, the real, inflation adjusted yield on all developed market bonds is negative, and the earnings yield on the largest equity market in the world is zero.

It is imperative that savers recognise that the future may well not be like the recent past. Relative returns from income will likely increase while those from capital decline. Many recent stock and fund winners have prospered as a function of falling interest rates. As a consequence, savers have an opportunity to reduce risk and benefit from the crowding into a relatively small number of "favoured" stocks by diversifying into the opportunities the "less favoured" stocks of the recent past afford.

Low future returns

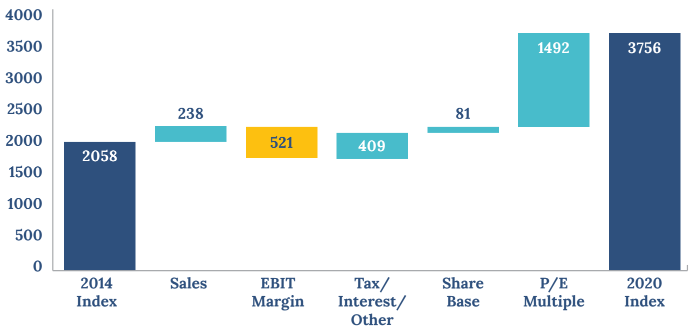
By any measure, bond yields in developed economies are close to historic lows. TIPS, the US 10-year inflation linked security, currently yields a -0.83%, explicitly showing the market's acceptance of negative real returns on these treasuries.

Given that government bonds are the primary reference points for other asset classes, the trend of persistently falling rates has been to drive prices up and yields down across a variety of asset classes including global equities.

For example, the S&P 500 has grown in price nearly 7 times faster per annum than have earnings in the last seven years to leave it with a current real earnings yield of zero, the lowest it has been since 1985 - and the start of the persistent secular decline in bond yields.

In the waterfall chart below, we drill down to show the points' change in the S&P 500 from 2014-2020 and the compound annual growth rate of various constituents. What stands out is that the share price has grown by more than 10% annually whilst earnings are broadly flat (Exhibit 1).

Exhibit 1: S&P500 Change (FY14-FY20)



Portfolio contributors#

Sales	2.1%
EBIT	-2.8%
NPAT	1.0%

EPS	1.6%
S/P	10.5%

Source: Talaria, Bloomberg

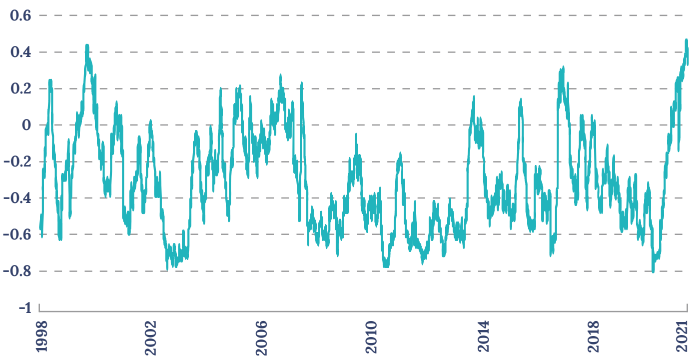
In practical terms, this has meant 'substantially' bringing forward the index's potential future equity returns. One way to visualise this is by taking a simple measure of long-term prospects:

Using the current dividend yield:	1.4%
Adding the last decade's growth rate:	3.6%
Assume the average rolling 10 year p/e of the last decade as an exit multiple:	18.6x
Implies an annual total return in nominal terms of:	1.3%
Adjusting for current pricing of 10-year inflation of:	*2.3%*
Suggests a prospective real return from the US stock market of:	**-1.0%**

Risk from equities and bonds moving in tandem

With similar real yields on US government bonds and equities, prices of both have started to move in tandem: when bonds fall, US equities fall. Moreover, with an equity market concentrated around a small number of expensive "winners" (stocks that are highly sensitive to interest rate movements) the US index now relies on US 10 year yields to fall further from their historically very low levels to make progress (Exhibit 2).

Exhibit 2: 3 months correlation of daily returns of NASDAQ 100 vs US 10yr bond

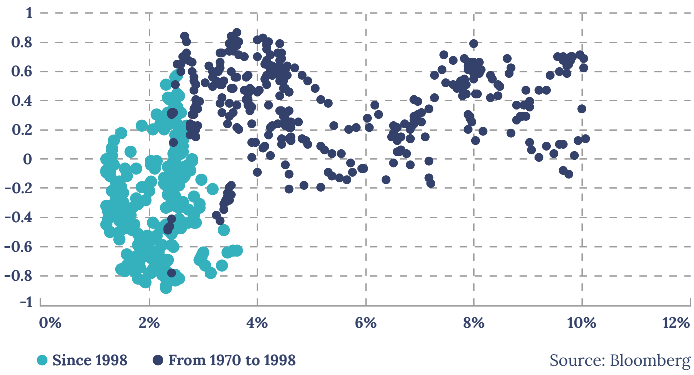


Source: Bloomberg

As a result, should inflation turn out to be anything but transitory, many investors will suffer significant and permanent real capital losses. After all, the bedrock of the savings industry, a 60% allocation to equities and a 40% allocation to bonds, rewards handsomely when interest rates are falling but does not do so in a rising interest rate environment.

Furthermore, whilst the positive correlation of bonds and equities is a new phenomenon compared to recent history, the very recent history has actually been the outlier. In the period from 1970 – 1998 bonds and equities moved in tandem the vast majority of the time (Exhibit 3).

Exhibit 3: Equity/Bond Correlation since 1970 – tends to be positive with higher inflation



Source: Bloomberg

As this is the case, it makes sense then for investors to shift equity weightings towards those equities and components of return less correlated with bonds.

The need to diversify

One way to achieve this shift is to reduce exposure to securities where the price paid now is on the promise of cashflow far into the future, cutting back exposure to so-called bond proxies.

There has been tremendous demand and crowding in these "duration" equities as bond yields have fallen. This appetite has been heavily based on the concept of the time value of money and the idea that a dollar today is worth more than a dollar in a year's time.

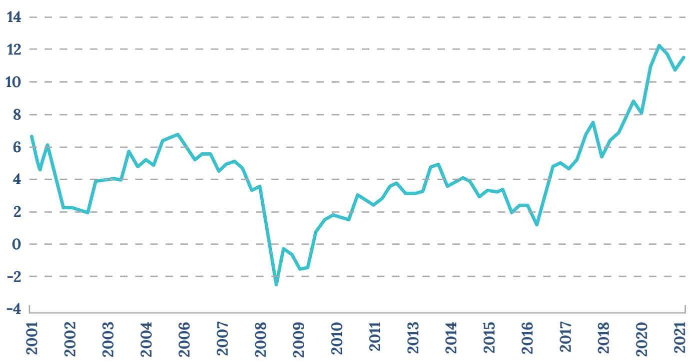
According to the maths, when the discount rate is zero, $100 today is worth the same as $100 in 10 years' time. With interest rates as low as they have been, this has been hugely supportive of the Tech sector, which, broadly speaking, makes a virtue of investing for growth and for a payback at some time in the distant future.

However, when for example the discount rate is 2%, $100 in ten years' time is worth just $82. With rates at 4%, which is the long-run average on the US 10-year Treasury, then $100 in ten years is worth just $68. At higher rates, long-dated equities are far less attractive.

This argues for owning a range of securities that are not dependent on the level of interest rates to generate satisfactory returns. It makes interesting those companies that balance solid near term cashflows and returns to shareholders, with opportunities to invest at attractive returns to drive future growth.

Despite the strong performance of such companies since September, the difference in valuation between shorter duration and longer duration companies, or the spread between value and growth, remains extreme by nearly any measure (Exhibit 4).

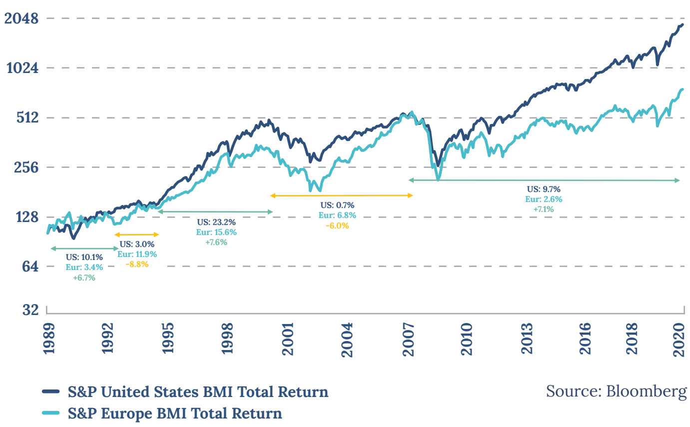
Exhibit 4: Russell 1000 Growth vs Value Valuation Spread



Source: Bloomberg

Regional diversification is another way to reduce exposure to positive equity bond correlation. With the strong performance of US equities vs other regions since the GFC, recency bias (the belief that the future will look like the recent past) means it is easy to forget how the cycles of US vs other regions of the world equity outperformance come and go (Exhibit 5).

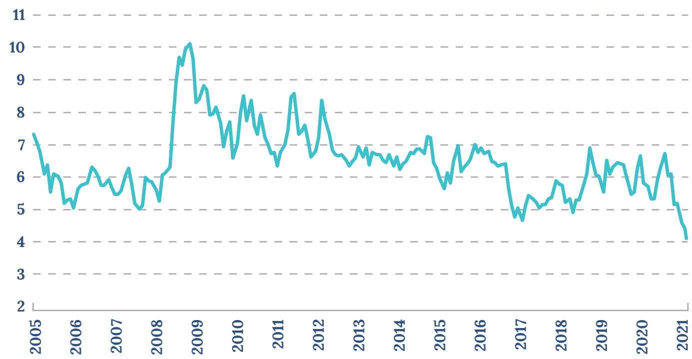
Exhibit 5: S&P BMI Total Return - United States vs Europe



Source: Bloomberg

Not only are periods of regional outperformance nothing new, but they also afford significant opportunities. For example, Europe at the index level today has a real earnings yield over 400bsp higher than the US (Exhibit 6). Given this, is it any surprise that Europe has outperformed the US year-to-date?

Exhibit 6: S&P Europe 350 12M real forward earnings yield (%)



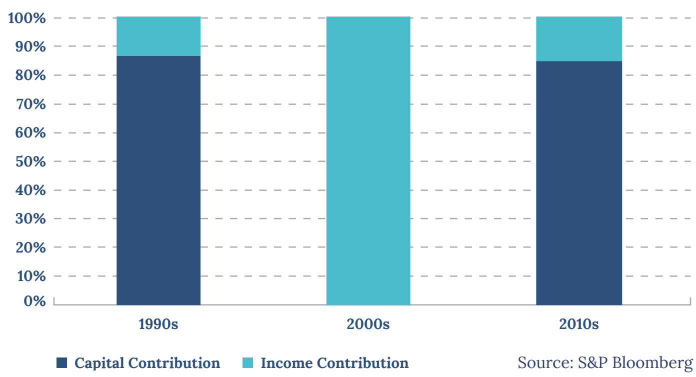
Source: S&P Bloomberg

In Europe, in addition to the prospect of greater absolute returns, there is also the promise of better protection in the event of falling bond prices as there is only a very slight negative correlation between equities and bonds. So as of today, a rise in yields would be commensurate with a rise in European equity indices. This is in stark contrast to US equity market Indices.

The growing importance of income

Savers have long recognised the need to balance income and capital, but recently this has proven difficult as yields of all asset classes have fallen to very low levels. The only decade where returns to capital in the S&P500 were as high as the last decade was the 1990s, and, as a result, the following decade's return was entirely down to the income component (Exhibit 7).

Exhibit 7: Total Return - Capital v Income component - S&P 500



Source: S&P Bloomberg

In short, since the GFC, it has been better to hold the capital than seek income but with prospective returns low and interest rates at some point likely to rise this is going to change. In practical terms, income will be a greater component of total returns going forward whatever the inflation outlook.

The issue of course in equity markets is where to get such yield?

Many equities with higher prospective yields are challenged with all or some of a trade-off between yield and growth, yields that are unsustainably high, high volatility, and a greater sensitivity to risk-off events.

Finding a source of income which diversifies risk, does not result in markedly higher volatility, and changes the mix of savers' returns to more balance the capital and income component is important but not easy.

Talaria helps on multiple fronts

So given this uncertainty around the medium-term inflation and interest rate outlook, the key for investors is to diversify portfolios, gain a greater balance between capital and income as a source of return, and move away from the crowded "must have stocks". Talaria can help.

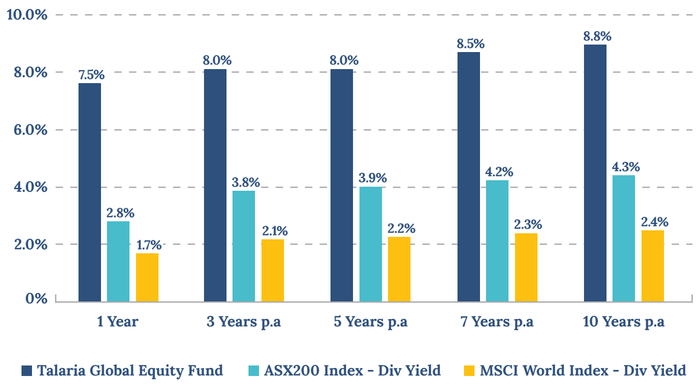
The fund currently has an earnings yield of 7.5%, leaving it less sensitive to movements in the level of 10-year bonds and, by extension, arguments over whether inflation will be "transitory" or not.

Our bottom-up process and price discipline has resulted in only 23% of the fund's capital being deployed in the US stock market and included in our 10 largest holdings are companies from Italy, Brazil, Switzerland, Japan, Canada, and France. So, the fund has geographical and sectoral diversification.

In addition, we have always recognised the importance of diversifying sources of return. This is why we have a unique implementation process, receiving a minimum 15% contracted rate of return per annum as a result of our commitment to buy a share we want to own. This flows through to the fund in the form of an income stream which is not dependent on a company's ability or management's desire to pay a dividend to shareholders.

Not only has this source of income proven stable over time, but it actually increases when capital values fall, thus smoothing the journey for investors. Over the last year we have enjoyed a good mix of income and capital growth, with an income component of 7.99% within a total return of over 17.76% (Exhibit 8).

Exhibit 8: Historically higher distributions than both domestic and foreign indices



1 Talaria Global Equity Fund distribution calculations based on Talaria Global Equity Fund – Wholesale Units (post-fees) as at 30 June 2021 S&P/ASX 200 and MSCI World (ex Aus) Index (MXWO) Dividend Yields = 12mth DY. Source: Bloomberg
Sources: Bloomberg, FactSet, Talaria
Numbers may not sum due to geometric compounding and rounding.
Past performance is not an indicator of future performance

Given today's backdrop of very low bond yields and high starting valuations in many parts of the equity market, investors need to diversify by geography, reduce duration and plan for a future in which the components of return are more balanced between income and capital growth.

Our process for over 15 years has been delivering exactly that and it is needed today more than ever.

June 2021 Quarterly Performance

The quarter was a tug of war between investors positioning themselves for higher economic growth, inflation and interest rates, and others who believe that any recovery will be transitory before we return to the pre-COVID world of low economic growth, capped real world prices, and depressed interest rates. In the last weeks of June, the transitory narrative gained the upper hand as evidenced by falling bond yields and renewed outperformance of long-duration, growth equities.

Consistent with this dynamic, US markets performed strongly during the quarter with the NASDAQ and S&P500 up 9.5% and 8.2%, respectively. Performance in US small caps was more modest, with the S&P600 Small Cap Index up 4.2%. In Europe, the French CAC was the standout, up 7.3%, followed by the UK FTSE and German DAX, up 4.8% and 3.5% respectively. Asian markets were also mixed, with the main Chinese bourse up 4.3% while the Nikkei 225 finished down 1.3%.

Unsurprisingly, Tech was the outperformer during the quarter, finishing up 11.3% with most of this strength coming through in the last month. Telco and Healthcare were also strong, up ~9%, while Energy was not far behind, up 7.8%. On the other hand, Industrials, Utilities, Staples, Materials and Finance sectors, were all lower through the month of June. Financials were particularly weak, down 3.5% in June, as some banks flagged the prospect of lower loan growth and trading revenues and pressure on margins from lower bond yields as earnings headwinds over the next few periods.

While the Bloomberg Commodity Price Index was up ~13% for the quarter, a lot of this came in the first month after which prices broadly went nowhere, albeit with bouts of volatility which can potentially be attributed to a strengthening USD which rose 3.1% against the AUD in June. Another driver of this came from reports Chinese authorities were clamping down on surging prices by releasing supply reserves and applying greater scrutiny to the activities of state-owned enterprises. WTI remained strong throughout the quarter, finishing up 24% on robust demand and ongoing supply management by OPEC members. VIX took another leg down through the quarter, falling 3.6pts to finish at 15.8.

Against this backdrop, the Fund performed well delivering a total return for the June quarter of 5.22% while the 12 month total return is 17.76%. This has been achieved with substantially less market risk.

Distributions: The Fund paid a June 2021 quarterly distribution of 1.77 cents per unit taking its 12-month income return to 7.99%.

Two of the biggest contributors to performance during the quarter were our two brewery holdings, Ambev from Brazil, and Asahi from Japan. Both reported strong Q1 results which were well received by the market. Ambev managed to deliver exceptional top-line performance driven by strong pricing and volume trends, which have persisted into April. In the case of Asahi, strong performance in the recently acquired Australian business more than offset weakness elsewhere with management re-affirming FY guidance. Given the upside to returns in both Ambev and Asahi, we think they continue to look attractively priced.

Our position in US pharmaceutical and medical supplies distributor, McKesson, also contributed to performance. During the quarter, McKesson delivered a good set of FY20 results with EPS growth of 15% more than outpacing sales/net income growth of 3%. Management also guided to a further 9.5%-13% in EPS growth next year. McKesson's strong EPS momentum largely reflects the combination of the firm's free cash flow generation and a long-standing commitment to buybacks. We remain confident that McKesson can continue this level of EPS momentum over the next few years. Furthermore, while opioid litigation remains an overhang on the stock, we think recent settlements between other co-defendants and some US state attorneys-general has provided some clarity on the potential size of any payout. In any case, McKesson has the financial strength to absorb a significant cash drag and at <10x P/E we believe the valuation is sufficiently compensating us for a lot of the litigation risk. After the quarter end, McKesson also announced the sale of some European assets which we hope is the beginning of a broader process of portfolio optimisation.

During the quarter, the Fund initiated new positions in Swedish industrial company SKF, Japanese auto-maker Toyota, industrial conglomerate Mitsubishi Electric and security services firm Secom.

Secom's core security business accounts for ~75% of profits. While this is a stable, high margin, cash generative business, the issue is that incremental capital is being deployed to lower margin segments. This partly reflects the mature nature of security and has been dilutive to group returns. However, Secom's balance sheet is flush with optionality (~25% of Secom's market cap is comprised of net cash). Hence, while return on assets may continue trending lower, we think there is a significant opportunity to boost return on equity should Secom decide to deploy even part of its excess cash.

As an industrial conglomerate, Mitsubishi Electric (ME) manufactures a range of products for the transport, energy, home appliances and industrial automation sectors. While clearly a very diversified business, we were most attracted to its Industrial Automation unit (~30% of Total Assets). This is a quality business with a large installed base, strong market position and a history of generating solid returns (which are currently cyclically depressed). Following the quarter's end, there has been controversy surrounding the falsification of product testing data. While this has undoubtedly increased the 'riskiness' of the investment in the short term, we think the medium-term prospects of the company remain sound given ME's solid balance sheet and diversified revenue base. As such, we have taken the opportunity presented by this uncertainty to acquire more exposure at what we believe to be very attractive prices.

Stock in focus: Carrefour

One of France's largest retail companies, Carrefour operates a chain of hypermarkets, supermarkets and convenience stores across Europe, Latin America, and Asia. We see growing evidence that new management is reinvigorating the business, driving customer engagement and reprioritising shareholder outcomes. We discuss our thinking below.

Long term shareholder returns have been impacted by weakness in Carrefour's core French Retail business and poor capital allocation at the group level.

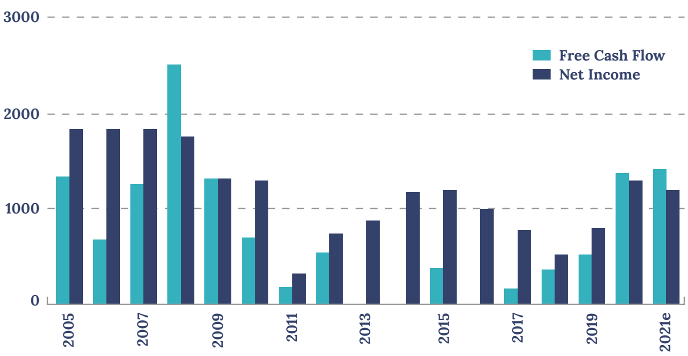
Weakness in the French Retail business has primarily been a function of poor sales momentum within Hypermarkets (~50% of sales in France) where like-for-like (LFL) trends have usually been flat to negative. Given this sluggish top-line, coupled with embedded cost inflation, margins in French Retail have come under significant pressure such that the division's EBIT has fallen from ~€2bn in FY03 to <€500m in FY20.

Carrefour's problems have been further exacerbated by poor capital allocation decisions. To help illustrate, consider that between 2002 to 2017 Carrefour spent ~€33bn in capex and M&A, only for EBITDA to fall ~20% over the same period. Given the weakness in operating cash flows, Carrefour introduced a dividend reinvestment plan which has seen shares on issue increase by 20% since its commencement.

However, since the appointment of Alexandre Bompard as CEO in 2017, we have started to observe a number of positive changes at the firm. Chief amongst these has been the improvement in management's remuneration framework via the inclusion of specific KPIs focussed on Free Cash Flow (FCF), NPS (a measure of customer satisfaction) and relative Total Shareholder Returns (TSR). We have seen these changes translate to better performance at the firm and shareholder level over the past three years.

The inclusion of a FCF measure as part of the CEO's pay package has meant that there now appears to be a lot more discipline around investment. This has resulted in a significant reduction in capex and a significant improvement in FCF. The strength in FCF is set to continue with management guiding to >€1bn over the next few years.

Carrefour - Free Cash Flows

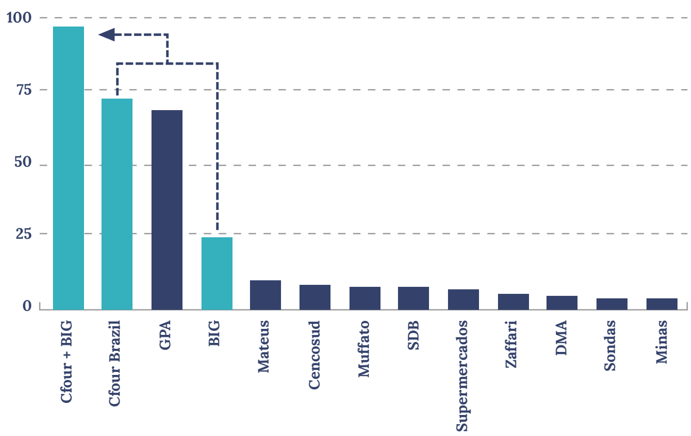


Source: Company Reports, Talaria

In addition to stronger FCF, another positive is that more of this is being returned to shareholders by way of higher dividends and the announcement of a new ~€500m buy back program (~4% of the current market cap). Given the inclusion of a TSR measure in the CEO's remuneration structure, we would not be surprised if more capital management initiatives are announced over the next few years.

More recently, M&A has been the other bright spot for Carrefour in terms of capital allocation. In Mar-21, they announced the acquisition of Brazilian grocery chain BIG Group for ~€1bn from Advent Private Equity. BIG is the third largest grocery chain in Brazil and was formerly the Brazilian subsidiary of Walmart which sold it to Advent in 2017. This deal sees Carrefour double down in a region where it has had considerable success such that Latin America now accounts for ~35% of group EBIT. At a high level, we think this is a good deal for Carrefour given the upside to BIG's margins, reasonable deal multiples, decent cost synergies and a much better industry structure post completion. Furthermore, while the deal will be largely cash funded, Carrefour's balance sheet will still be strong enough to allow flexibility should other opportunities arise.

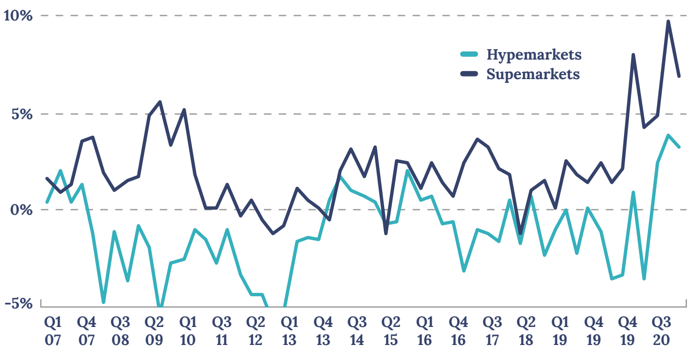
Brazil Grocery - FY19 Sales (BRLbn)



Source: Company Reports, Talaria

We have also been impressed by improvements in the performance of the French Hypermarket business where LFL trends have recently turned positive. While a big part of this clearly reflects a boost from repressed demand post lockdowns, we think it is also a function of more competitive pricing which has seen Carrefour regain market share. This has largely been at the expense of peers whose excessive financial leverage has constrained their ability to also invest in prices.

Carrefour - LFL Sales Growth



Source: Company Reports, Talaria

While still early days, we think a focus on pricing is the right strategy to be employing to help drive more foot traffic and sustainable growth in LFL sales. Given that management have guided to a further €2.4bn in cost outs by 2023 (~3% of sales), we are hopeful that there will be more re-investment in prices to stimulate more top-line momentum.

While all of the above are incremental positives, we acknowledge that Carrefour operates in a difficult sector, within a difficult region. Despite this, we still think there is decent upside for shareholders should management be able to truly orchestrate a successful turn-around in the business. On the flip side, we think a lot of the downside is capped thanks to the combination of improving cash flows, a solid balance sheet and decent valuation support (Carrefour is currently trading on a prospective FCF yield of ~8%). On that basis, we have recently added Carrefour to the portfolio.

Talaria Global Equity Fund - Foundation

Top 10 Holdings*

Company name	(% weight)
Prudential	5.0%
Total	4.4%
McKesson	4.2%
Asahi Group	3.9%
Roche	3.8%
Sodexo	3.8%
Intesa Sanpaolo	3.5%
Ambev	3.5%
Canadian Natural Resources	3.1%
Land Securities	3.1%

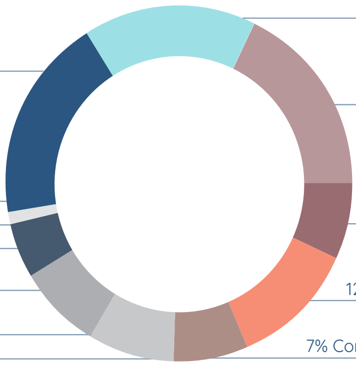
* Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

Performance at 30 June 2021

Period	Income Return	Growth Return	Total Return	Average Market Exposure
1 month	1.79%	-0.57%	1.22%	53%
3 months	1.87%	3.35%	5.22%	53%
6 months	3.79%	8.15%	11.94%	53%
1 year	7.99%	9.77%	17.76%	51%
3 years p.a.	7.64%	-0.50%	7.14%	56%
5 years p.a.	7.76%	0.33%	8.09%	58%
7 years p.a.	7.81%	-0.04%	7.78%	59%
Since Inception p.a.	7.15%	0.18%	7.32%	61%

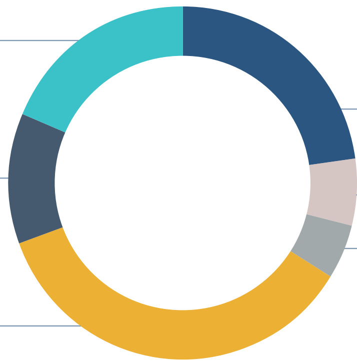
1 Fund Returns are calculated after fees and expenses and assume the reinvestment of distributions
2 Inception date for performance calculations is 1 October 2005
3 Income Return includes realised capital gains
4 Past performance is not a reliable indicator of future performance
5 Average Market Exposure 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



Quarterly distribution

Period	Cents per Units	Reinvestment price
June 21	1.7752	$0.9836
March 2021	1.5906	$0.9517
December 2020	1.5916	$0.9096
September 2020	1.6421	$0.8813
June 2020	4.2809	$0.8962
March 2020	1.5373	$0.9288
December 2019	1.0177	$1.0431
September 2019	0.6081	$1.0358
June 2019	3.2512	$1.0026
March 2019	1.9257	$0.9924

Asset allocation	% weight
Global equity	48.5%
Cash – put option cover	32.9%
Cash	18.6%
Total	**100.0%**

Portfolio contributors#	Portfolio detractors#
Prudential	Sumitomo Mitsui
Ambev	Mitsubishi Electric
Roche	Teva
Canadian Natural Resources	Centrica

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

Talaria Global Equity Fund - Foundation

Fund snapshot

Management Fee	Nil	**Inception Date**	1 October 2005
Performance Fee	20% - subject to High Watermark	**Liquidity**	Daily
Distributions	Quarterly	**Availability**	Wholesale Clients Only
Minimum Investment	$50,000	**Buy / Sell Spread**	0.20% / 0.20%