TALARIA

Talaria Global Equity Fund - Hedged
Quarterly Update | March 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

- Q1 came and went with a rush. A lot of noise, but also more substantive and significant moves including falling government bond prices and an equity market rotation from Growth to Value stocks.
- Extraordinary monetary and fiscal stimuli drove an improving economic and corporate outlook and in turn financial markets.
- The inflation question became more mainstream, as investors realised they don't have to believe in the return of it, to recognise that it has become more likely.
    - This matters because investors are positioned for the status quo, for a lid to remain on prices, for interest rates to stay low and for value to be out of favour. But that's less and less likely.
    - Even a minor rise in investors' required returns would mean material capital losses in expensive assets and markets.
- Looking ahead, further challenges come in the form of over exposure to a small number of equities (concentration risk) and new market actors driving egregious moves (retail speculation in options)

The Talaria advantage

- Our high income component of return offers protection if rates/required returns rise,
    - Our stock, geographical and sector diversification offer exposure to value and reduce concentration risk,
    - And our implementation strategy allows us to take advantage of any increase in implied volatility.

The loud and quiet noise

The first quarter's racier market events must have had the boomers shaken.

Wallstreetbet's favourite share GameStop went from about US$19 to around US$180, having touched nearly US$350 at the end of January. The early move drove emergency capital raisings for zero commission online broker Robinhood and some well-known short sellers.

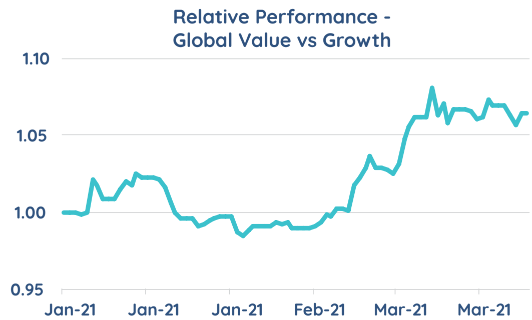
Crypto continued its recovery, with Bitcoin rising from some US$ 29,000 to US$ 59,000, whilst Bitcoin buyer and electric vehicle manufacturer Tesla's share rose 20% to a new high before falling 24% from there.

Price moves were not the only startling phenomena. There was also enormous volume flowing into different assets. ARK's suite of ETFs attracted unprecedented inflows. New issues of Special Purpose Acquisition Companies (SPACs), which are speculative by definition, broke all records [SPAC issuance in Q1 has exceeded total issuance in 2020 – itself a record. ARK Innovation ETF had its single biggest day of inflows in Q1 and January saw inflows nearly 5 times higher than Nov at over $3bn.

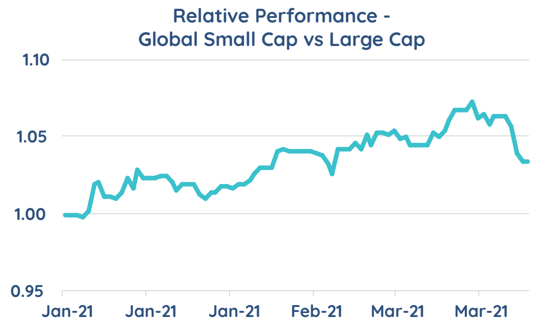
Yet just as these moves were capturing the headlines, there were also lower profile occurrences that were of much greater consequence for investors. Chief among these was the rise in yields (falling prices) of many government bonds.

For example, the US Benchmark 10-Year Bond yield went from 0.92% to 1.74. As the asset off which so many others are priced, this coincided with other notable developments, and in equity markets there was pronounced rotation, with outperformance of Value versus Growth, Small Cap versus Large Cap and Energy versus Tech.

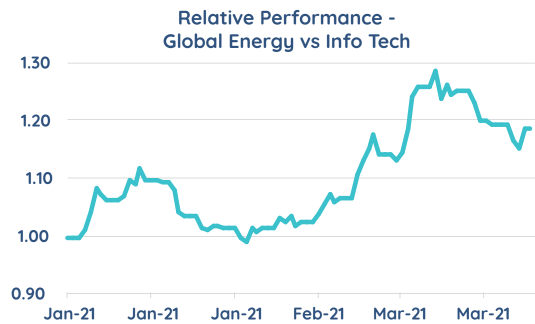
Q1 price relatives



Source: Bloomberg, S&P Global



Source: Bloomberg, S&P Global



Source: Bloomberg, S&P Global

Economic drivers

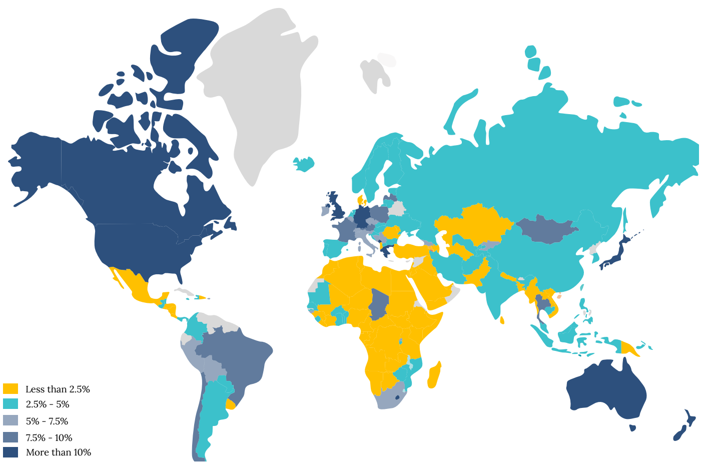
In the wake of the pandemic, coordinated fiscal and monetary stimuli were the main drivers of these moves. On the one hand, they provided the extraordinary liquidity that found outlets in traditional as well as headline grabbing assets. On the other hand, they drove recoveries in growth and prices that made government bonds less attractive.

Looking just at fiscal activity, the first quarter saw the US approve an enormous US$1.9 trillion of additional support. Morgan Stanley said the total package is three times the size of the estimated remaining gap between actual and potential GDP. They also gauge the support to exceed the economic impact of the pandemic by US$ 1 trillion and put the level of household savings at US$2.3 trillion.

Without expecting those savings to be spent fully, there is almost certain to be a significant boost to consumption in coming months which may drive US GDP growth as high as 8% in 2021 before falling to a still above trend ca. 3% in 2022.

Not all countries are offering programmes at the US's level, but as the chart from the IMF below shows, there is material fiscal support forthcoming from major economies in North America, Europe, and the Rest of the World.

Additional spending and foregone revenue in response to the COVID-19 Pandemic
Percent of 2020 GDP



Source: IMF. The boundaries, colours, denominations and any other information shown on the maps do not imply on the part of the International Monetary Fund or Talaria any judgement on the legal status of any territory or any endorsement or acceptance of such boundaries.

The growing risk of inflation

If, in the first three months of the year, financial markets were digesting the enormous liquidity poured into the system, at another level they were also wrestling with the growing possibility that strong economic growth will trigger inflation. We discussed this topic in the last quarterly, and it is worth revisiting because there is probably no bigger risk for investors.

Since the early eighties, there has been an inexorable decline in developed market government bond yields (chart right) as deflation (falling prices of goods and services) has been the order of the day. Japan for thirty years and other central banks since the GFC have consistently failed to reverse this trend.

Falling government bond yields since the early eighties

Whether or not governments, now adding their considerable weight to the efforts of monetary authorities, can engender inflation is yet to be seen. However, the balance of probability has shifted more towards rising prices than continuing deflation.

The investment implications of inflation risk

If investors were positioned for inflation, then this shift wouldn't be a problem. However, the evidence is that many are placed for the status quo: for there to be a lid on prices and for interest rates to stay low.

Most investors' intuition would be that the less their money is earning in the bank or in so-called risk free assets such as bonds, the longer they would be willing to have that money tied up elsewhere. If interest rates are zero, then a share offering a dividend yield of 1% might look attractive.

Looking at the last fifteen years, this intuition has been one driver of the falling dividend yields offered by the FTSE World Index, and the S&P 500 (table below):

	Dividend Yields and Payback Periods	Dividend Yield (%) Payback Period (years)
2006		
FTSE World	2.3	44
S&P 500	1.8	56
2021		
FTSE World	1.8	56
S&P 500	1.5	68

Source: Bloomberg

Another way of expressing this falling dividend yield is a measure of the time it takes to recoup an investment.

Looking at the table above and all else being equal, in 2006 a buyer of FTSE World at a dividend yield of 2.3% would expect to recoup her money in just under 44 years. In 2021 someone buying at a dividend yield of 1.8%, would expect to recoup her money in just under 56 years.

Falling dividend yields and longer payback periods become a problem when interest rates rise. In these circumstances, the opportunity cost of being out of an interest-bearing asset increases.

As this is the case, an investor should want a higher dividend yield to compensate. The table below shows the implied reduction in the value of capital if investors require an increase in dividend yield of just one tenth of one percent (10 basis points).

Capital loss and payback periods assuming investors require a 10 basis point higher yield

	Cap loss (%)	New Payback Period (years)	Previous Payback Period (years)
2006			
FTSE World	4.2	42	44
S&P 500	5.3	53	56
2021			
FTSE World	5.4	56	53
S&P 500	6.3	63	68

Source: Bloomberg

So focusing on the FTSE World over the last 15 years, its payback period increased about 30% from 44 to 56 years. The same scale of change in yields would require a repricing of equity to compensate. Thus, a 10bsp increase in yields, all else being equal, would leave equity holders with losses of some 5.4%, while a 0.50% increase – a return to the rough average of the last 20 years which took in the internet bubble and housing bubbles – would leave the World market 22% lower and payback of circa 44 years, significantly lower than the US market.

Changes in market structures exacerbate the risks

The shift in the balance of probabilities towards inflation does not just highlight the risk of capital losses, it also brings home risk relating to market structure.

One of these is concentration risk, something which matters when investors are over-exposed to the same parts of the market and want to reduce that risk simultaneously - like a theatre audience rushing to use the exits in the event of a fire.

And there is financial markets precedent here, like the few days in August 2007 when a number of funds saw unprecedented losses as they were forced to liquidate what turned out to be shared positions in the face of stop losses and the requirement to deleverage.

Changes in the market structure may mean that many investors do not understand that they face this sort of risk. Investors in the ever-growing cohort of passive funds now represent nearly 50% of the ownership of US equities. When a passive manager is given a US$ to invest in, for example, the S&P 500 she will buy irrespective of price automatically, generally according to the weighting of the stocks in the index. Currently, more than 20c of that US$ is going into just the five biggest stocks, all of which are tech.

This is all well and good as long as markets remain liquid but can become a serious problem if liquidity dries up, as it did in March last year or if greater than 50% of passive fund orders are to sell.

A further risk to markets and stocks is the growing influence of speculative investors using options to gain leverage to ever higher prices. Options, the right to buy or sell an asset, are known as derivatives because their value is derived from an underlying instrument. The recent explosion in retail activity has seen the usual relationship turned on its head. Short term traders using options as ends in themselves have been driving movements in the underlying equities as other market participants are forced to buy the underlying stock to cover the liability of having to provide stock at potentially higher prices. A joke doing the rounds is that equities are now the derivative whilst derivatives have become the underlying.

This sort of highly speculative activity can disrupt the smooth running of a market as we have seen in the high volatility of GameStop, and, more significantly, Tesla which while is just outside the S&P 500s top five but still represents 1.9% of it.

How Talaria fits

A significant component of Talaria's returns is generated by income. For example, for the last 10 years, Talaria has distributed over 8.3% per annum of income to investors in the fund. Not only is this high versus the index, peers and other sources, it means that investors have a payback period of just 8 years, all else being equal. This is in a different league from the benchmark and the S&P 500 of well over 50 years. (see table left).

Moreover, Talaria's portfolio not only offers better value than the market but also has attractive fundamentals.

Using 2019 numbers in order to remove the impact of the pandemic on both the index and the portfolio (after all the value of an equity is in the very long stream of cashflows it will produce), we find that the fund's holdings have similar returns on capital as the Index; generate more bottom-line earnings; use less leverage, are growing businesses and are materially cheaper.

Even using 2019 earnings for the market and 2020 earnings for our heavily pandemic impacted holdings, the fund has companies that are cheaper, return more cash to shareholders and retain more earnings to reinvest at attractive rates of return.

	FTSE Global All Cap Index (FY19 P/L)	Talaria Portfolio (FY19 P/L)	Talaria Portfolio (FY20 P/L)
Valuation Figures[1]			
Price	189	102	108
Price / Sales	1.9	1.0	1.1
Price / Book Value	2.7	1.1	1.1
Price / Earings	25.7	12.6	17.5
Earnings Yield	3.9%	7.9%	5.7%
Dividend Yield	2.0%	3.3%	2.9%
Retained Earnings Yield	1.9%	4.6%	2.8%
Dividend Payout Ratio	51.6%	41.7%	50.4%
Enterprise Value / EBIT	21.4	13.1	17.4

Source: Bloomberg, Talaria

In addition the fund is diversified, thereby avoiding the concentration risk, and uses options to implement its investment views, which means it can take advantage of the sort of distortions in the derivatives market previously discussed.

Year to year something always generates superior returns compared to our own process. But risk management is amazingly forgiving. Consider that from the 1995 to 2009 despite two equity market peaks (Nasdaq and Housing) and the fuel of EM growth and China, equity returns lagged short-term bonds over the period.

Consider that since the start of 2009 – our risk focused, value conscious, benchmark agnostic, income generative process has delivered strong absolute returns, whilst taking only 2/3 of the market's risk, with lower volatility and the benefits of diversification in sector, geographical and component of return terms. In this time:

- Value has lagged Growth by the greatest amount over the longest period ever,
- Markets have ended the period at the highest multiples ever on a number of measures,
- Price insensitive buyers in the form of passive investors have been almost continuous buyers and now make up the greatest proportion of investors ever,
- And volatility for most of the decade was below the long-term average and annualised returns in absolute terms were very strong for both us and the markets.

In the decade just passed – risk paid.

Looking ahead the likelihood of risk paying looks to be diminishing. As of today, prospective returns will be lower thanks to starting prices. Investors are dealing with heightened concentration risk, the potential for price insensitive buyers to turn price insensitive sellers at any time has literally never been greater, the prospect for volatility to be above long-term averages for the foreseeable future due to changing market structure looks good, and a far wider range of potential inflation outcomes than the last decade are on the table.

Investors need a Sherpa

Against this future - the prospect for a value conscious, anti-short term and unlevered investor to generate superior absolute and benchmark returns taking less risk has not felt more likely for some time. Our track record and process is well set up to help investors navigate this new world, guiding them to their goals because we know as the world and markets keep turning, so it is that investors are obliged to turn with it.

March 2021 Quarterly Performance

Rotation was the theme of the quarter, with multi-year trends reversing. Broad European indices outperformed their US counterparts, Value outperformed Growth and Small Cap outperformed Large Cap. Cyclical sectors were the best performing, Tech the worst. The portfolio was well set-up for these moves.

US stocks rose, with the S&P 500 up 5.8% over the quarter. The NASDAQ underperformed, up only 2.8%. The S&P 600 Small Cap Index, which was up 30.8% in Q4 2020, had another very strong three months, up 17.9%. The broad European Index, the Stoxx 600, was up 7.8% while Germany and France both did well with the DAX up 9.4% and the CAC up 9.3%. In Asia, Japan again stood out, with the Nikkei 225 rising 6.3%. China's Shanghai Composite was down -0.9% - the weakest of the major indices.

Energy, Financials and Industrials were the best performing sectors globally. Sectors that underperformed were Consumer Staples, Utilities and Tech. This is the second quarter in a row that Energy and Financials have led. Tech's appearance as an underperformer, in this case as the worst performer, is a rarity but may occur more frequently if the market continues to demonstrate an appetite for Value.

On this theme, perhaps the most significant phenomenon in financial markets was the continued sell-off in US bonds. The US 10-Year treasury yield finished the quarter at 1.74%, having been 0.92% at the end of December 2020. As the asset which so many others are priced off, rising US bond yields lift the returns investors require elsewhere. Among the most sensitive to this mechanism are Tech equities. This is because their valuations often rely on investors' willingness to consider cash flows that may be far off into the future. As bond yields rise, the opportunity cost implicit in this willingness rises as well.

The broad Bloomberg commodities index was up 6.8%. Crude oil prices were again notably strong with the US benchmark WTI up more than 24.8% to USD 60.55. Equity market volatility fell, with the VIX Index finishing the quarter at 19.4 having been 22.8 at the end of the last quarter. The Australian Dollar consolidated after its strength at the end of last year, closing 1.6% lower at US 76.0c.

Against this backdrop, the Fund performed well, delivering a total return for the March quarter of 6.54% while the 12 month return is well up at 32.24%. This has been achieved with substantially less market risk.

Distributions: The Fund paid a March 2021 quarterly distribution of 1.7 cents per unit taking its 12-month income return to 10.88%.

A major contributor to the portfolio's performance was Dutch banking and insurance group, ING. ING's prudent lending combined with a strong capital position has allowed it to weather the challenges of the pandemic well. Given 70% of group revenue is interest income, it is also a major beneficiary of yield curve steepening. Even in the absence of further changes to rates, the share remains an attractive opportunity given a reasonable 0.75 book value.

Food services and facilities management company Sodexo also made a solid contribution to the portfolio. Its shares rallied after the company upgraded first half margins on the back of better pricing and cost-outs. It also flagged improving revenue run-rates across the business. Management re-affirmed guidance for post-pandemic margins to be above pre-COVID levels once headwinds dissipate. On this basis, we still think there is decent upside for shareholders with potential share price outcomes over €90 per share.

Clothing company Hanesbrands (HBI) was a new addition to the portfolio. HBI owns several well recognised brands including Bonds in Australia and Hanes in the US. It also has the global rights to Champion. The main issue is whether new management can sustain Champion's impressive growth and reverse the weakness in US Innerwear (~50% of profits). This segment has suffered from years of underinvestment by the previous management. We will get more details on the turnaround plan in May, however at 10x P/E we think that even if HBI fail to turn the ship, the downside from here is not material. On the flip side, we think a successful turnaround could see the shares above $35/share (>80% upside).

Selling stocks

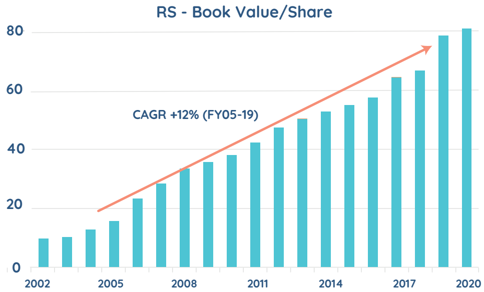
We sell stocks mainly for two reasons. One reason is a change to our investment thesis. Whenever we buy an equity we have a rationale that goes beyond our assessment of value. For example, we might buy stock A because the end of a multi-year capex programme implies a boost to future cash flows. If stock A's management then announce a new, unexpected investment commitment we might want to sell the share.

The other reason is because a share goes through our price target. Sony is a recent example of this despite making an excellent contribution during the quarter. Ahead of its earnings' release in early February, we looked at our holding in Sony, concluding that at Yen 10,500 we should keep our position because our modelling suggested the stock could still deliver our 8% p.a. target return. However, two days after the release the share was trading more than 15% higher which was our cue to exit. We still like the Sony story, but we do not like it at any price.

Stock in Focus – Reliance Steel & Aluminium Company.

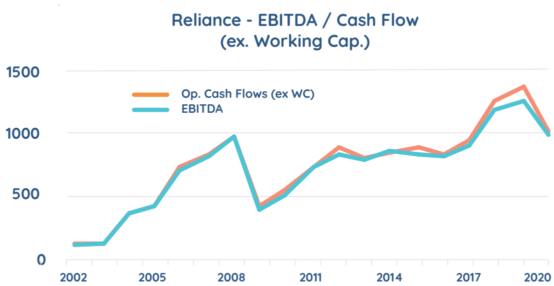
During the quarter, the fund gained exposure to Reliance Steel & Aluminium, the largest metal distributor in North America. Below we discuss what attracted us to Reliance, particularly through the prism of our accounting quality framework, and where we think there is scope for Reliance to improve on ESG matters.

Reliance is a typical 'capital allocation-champion', characterised by a long history of generating exceptional returns on incremental capital. Historically, capital deployment has been by way of highly accretive M&A, investments in new greenfield facilities, and good capital management. Given its low levels of debt, Reliance should have no issues continuing to fund these initiatives, which have all contributed to very strong growth in Book Value/Share.



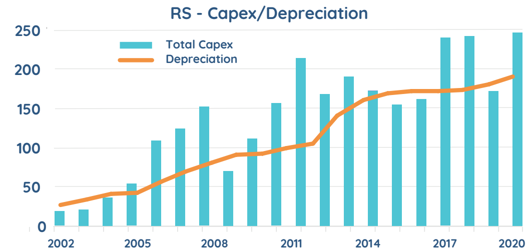
As part of our investment process, we spend a lot of time diagnosing a company's earnings quality. One particular area of focus is the trend, nature, and size of accruals (the discrepancy between booked profits / costs and cash into the business) because after all it is the cashflows we own not the profits, and it helps us assess how aggressively accounting standards have been applied. As numerous corporate collapses can attest to, accounting is a notoriously grey area!

In the case of Reliance, we believe its earnings quality is solid, with a history of conservative accounting policies. One example of this is that when presenting earnings, very few cash costs are stripped out by management as one-off items. This means that after adjusting for the volatility in working capital flows, there is almost no cash shortfall between EBITDA and operating cash flows.



Another example where Reliance has taken a conservative approach is in its application of acquisition accounting. Despite significant M&A in recent years, management have rarely made any adjustments to the fair value of acquired assets and liabilities. In years where there have been some revisions, these have been minor.

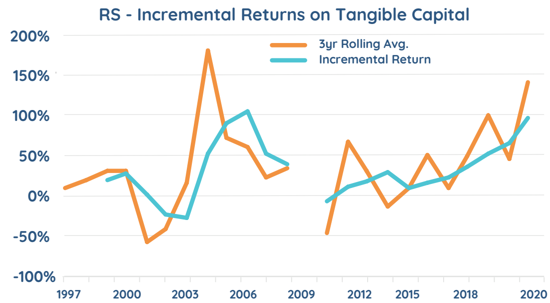
Acquisition accounting is an area we pay particular attention to for highly acquisitive companies given the opportunity for them to massage future earnings. Typically, we become concerned when we see a downwards revision to assets (e.g., a lower carrying cost of inventory which aids next year's gross margin as it is sold) and an upwards revision to liabilities (e.g., provisions created and reversed in future years to boost profits).



While there is no way to be definitive on the driver of higher capex, we have concluded that recent increase in capital expenditure is consistent with previous periods of elevated spend, and depreciation continues to trend higher.

An examination of Reliance's executive remuneration structure also gave us comfort on this, as it is very much aligned with the goal of creating value for shareholders. As part of our work on Governance we regularly assess management's Key Performance Indicators (KPIs) given how important these are in driving management's actions.

For Reliance, it is no coincidence that the business has managed to deliver solid incremental returns over many years given that a Return on Asset (ROA) metric is a core part of management's remuneration. ROA is among the most effective KPIs in ensuring long term value creation. The inclusion of a returns' measure means that Reliance's management has less incentive to 'window dress' the results as they will still be penalised by the decision to capitalise costs (i.e. all else equal a step up in assets means lower returns).



We also consider Environmental and Social issues when weighing all investment decisions at Talaria, and feel there is room for improvement for Reliance here. For starters we would like to see greater transparency on their Total Recordable and Loss Time Injury Frequency Rates as measures of workplace safety, as well as greater disclosure on its energy intensity and environmental footprint, particularly regarding water intensity, greenhouse gas emissions and any reduction targets. We're not suggesting that Reliance is underperforming in these areas, just that more insight on their performance would be appreciated, and in our view in the best interest of the company.

Strong ESG credentials are vital not only for good corporate citizenship, but also in identifying those companies that can deliver sustainable growth for shareholders. We are encouraged by the industry's growing interest on this area, while constantly looking to improve our own.

Talaria Global Equity Fund - Hedged

Top 10 Holdings*

Company name	(% weight)
Total	6.0%
Prudential	4.9%
ING	4.8%
Bayer	4.3%
Sodexo	4.0%
Roche	3.7%
McKesson	3.7%
Canadian Natural Resources	3.6%
Asahi Group	3.5%
Wheaton Precious Metals	3.5%

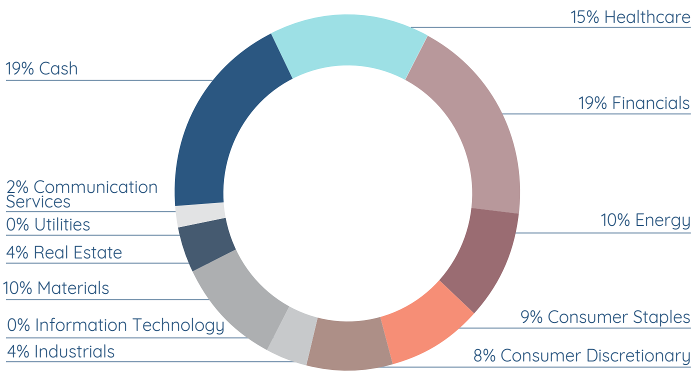
*Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

Performance at 31 March 2021

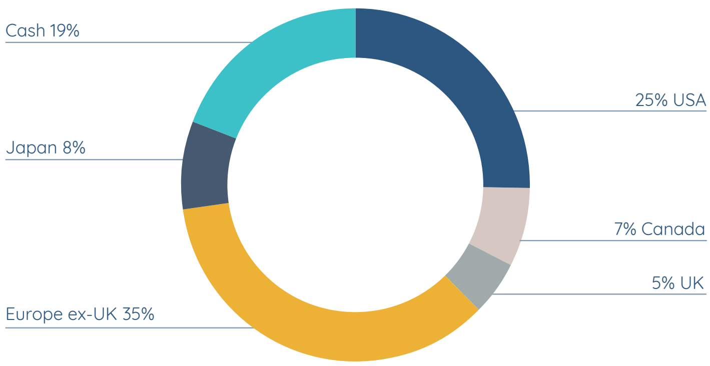
Period	Income Return	Growth Return	Total Return	Average Market Exposure
1 month	**1.63%**	2.59%	4.23%	52%
3 months	**1.67%**	4.87%	6.54%	54%
6 months	**3.41%**	14.02%	17.43%	53%
1 year	**10.88%**	21.37%	32.24%	51%
3 years p.a.	**4.46%**	2.22%	6.68%	57%
5 years p.a.	**5.64%**	1.53%	7.17%	58%
7 years p.a.	**6.44%**	-1.10%	5.34%	59%
Since Inception p.a.	**6.27%**	0.92%	7.18%	59%

[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
March 2021	1.7000	$1.0672
December 2020	1.4000	$1.0177
September 2020	1.4000	$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	45.0%
Cash – put option cover	35.7%
Cash	19.3%
Total	**100.0%**

Portfolio contributors#	Portfolio detractors#
Prudential	Ambev
Canadian Natural Resources	Lear
ING	AP Moller
Brookfield	Roche

[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