TALARIA

Talaria Global Equity Fund - Hedged
Quarterly Update | June 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

The Koala has an unusually small brain compared to the size of its head, occupying only 40% of its cranium with the rest being fluid which acts as a protective cushion if the koala falls from a tree. This strikes us as a good illustration of a trade-off: if koalas were more intelligent, they might fall out of trees less often, but it would hurt more.

We mention this because the last few months have been a reminder that the market can make anyone feel like a koala: not as bright as you'd like and capable of tumbling from what seemed like a secure position.

In this 'Investment Insights' section, we explore how the recent market activity could have shaken anyone from their perch; the factors making it an unusually difficult environment for savers; and the benefits of our approach to investing when the only certainty about the future is that there'll be one.

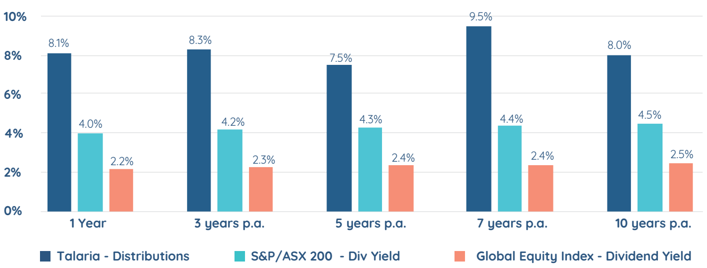
When looking at the market, the stand out feature is not so much the recent ups and downs but the fact that the global equity market index is almost unchanged from the start of 2018. A Rip Van Winkle waking from a 30-month sleep might look at the equity index and assume he'd missed little. However, if curiosity got the better of him, he'd realise he'd been spared potential losses, and that his inactivity may have paid off.

Companies have been cutting dividends globally, whether by choice or because authorities have intervened. This means many investors who rely on this income from their savings have had or are about to have massive pay cuts. It's pleasing therefore that our process ensures a substantial component of our return (income generation) is entirely separate from corporate dividends.

As a result, we've delivered a June 2020 quarterly distribution of 3.6c taking the full year distribution to 8.14% for the Wholesale Fund – in line with our decade long average distribution return to investors.

We also note the Hedged Fund has paid a June quarterly distribution following material currency fluctuations in recent years. The Hedged Fund's distribution was [XXX] cents per unit for a 12-month yield of [XXX%].

Historically higher distributions than both domestic and foreign indices



1. Based on Distribution Return of Talaria Global Equity Fund - Wholesale Units as at 30 June 2020.
2. S&P/ASX 200 and MSCI World (ex Aus) Index Dividend Yields = 12mth DY. Source: Bloomberg
3. Sources: Bloomberg, Talaria
4. Past performance is not an indicator of future performance

A collapse in dividends is not the only challenge posed by the market. Many asset classes are offering investors exceptionally low absolute returns and no protection from potential inflation. While equities might be the least 'dirty shirt' this is not to say they are offering much by way of long run returns.

Against this difficult backdrop, more than ever we're convinced of our value proposition to investors: for our ability to turn uncertainty into income; our portfolio characteristics that offer greater protection against loss; and for the diversification that is essential to investing.

Recent market moves

The first half of 2020 has been extraordinary. The global COVID-19 pandemic ensured the longest economic expansion on record ended with a collapse, evidenced by terrible data and genuine hardship. Central banks and governments combined in making unprecedented moves to address the challenges and consequently Debt to GDP ratios have ballooned.

In global financial markets, major equity indices delivered the fastest ever 30%+ decline, the biggest rally since the Great Depression and more large daily moves than the whole of 2008. With safety at a premium, bonds were the best performing asset with US 10-Year Treasuries gaining 11% in 1H 2020.

A lower income, more expensive equity market

Today the equity market has two defining characteristics which we explore further below:

1. Dividends will be materially lower than last year and likely stay low for a considerable time.
2. Valuations leave many markets, particularly those in the US, priced to generate low future returns for savers.

1. Dividend cuts

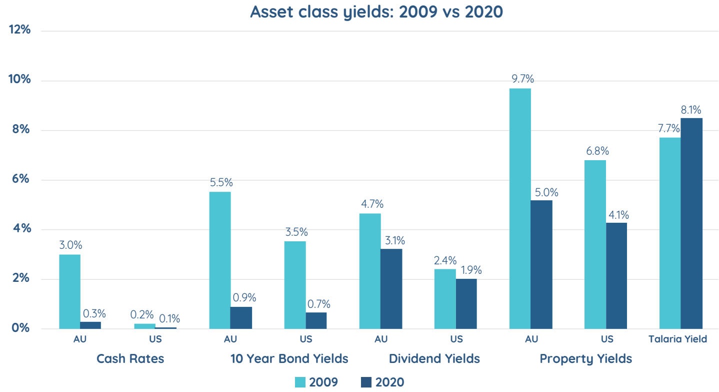
The collapse in the global economy has and will continue to have a direct impact on the size of dividends paid to shareholders.

This may be because companies are unable to pay as much as before, or management choose to hold more capital amidst ongoing economic uncertainty. Alternatively, the decision may be taken out of their hands by way of Governments and regulatory authorities vetoing payments to shareholders - as happened with the US Federal Reserve recently capping dividends and banning share buybacks by US banks.

We can gauge the scale of these cuts by looking at financial instruments that price in the likely future level of dividend payments for individual stocks, sectors, and indices. The S&P 500 Dividend Index is an example, and as of July, expectations for 2020 dividends are about 30% lower than they were in February, while dividend expectations for 2022 are 20% lower.

In effect, anyone reliant on equity dividends has taken a significant pay cut, with few opportunities to mitigate this impact with income from other traditional sources given the broader scarcity of yield.

Asset class yields: 2009 vs 2020



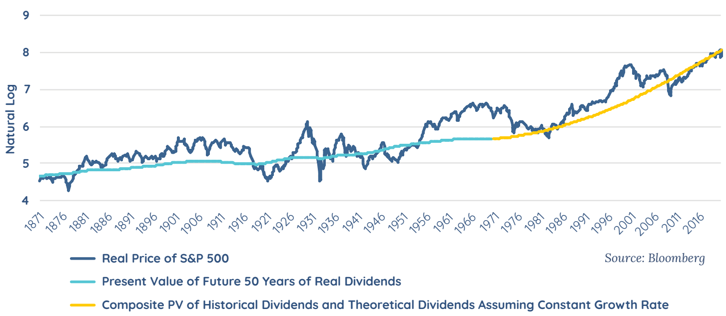
Source: Bloomberg, Talaria.
Talaria Yield is 1 year Distribution Return for Talaria Global Equity Fund – Wholesale Units

2. Lower Capital Growth

On top of this bad income news, many major stock markets - especially the US - trade on valuations suggesting investors should prepare themselves for lower future returns. We say this because theoretically an equity is the right to share in the excess cash a company generates. Therefore it's possible to calibrate prospective share price upside by looking at dividend growth rates and required returns.

For example, assuming an investor wants a long-term return of 7% in order to invest in US equities today, they would require dividend growth to be more than double the rate of the last 150 years. We show this through the steepening yellow line in the chart below.

Log of S&P 500 Real Price Index vs Theoretical True Real Value



Source: Bloomberg

Given demographics, productivity growth trends, resource constraints and debt levels this assumption of growth doubling is hardly credible. A better explanation for current US valuations is to assume the historic dividend growth rate remains and the required rate of return falls to below 5% per annum. Though this is more feasible it does imply that investors in US markets will still bear all the normal equity risks but are going to be paid more than a third less than they have historically received for doing so.

Investing in a challenging environment

From points 1 and 2 above, we have outlined this is a challenging environment in which to grow savings in real terms.

There are certainly some distinguished investors who hold this view. Stanley Druckenmiller and David Tepper have said that the current risk reward in equity markets is unattractive. Jeremy Grantham and Howard Marks think that the outlook has rarely, if ever, been as uncertain.

After fifteen years and a unique six months we, more than ever, believe our process can help savers not only survive but potentially thrive in this environment.

Turning uncertainty into money

We use options to implement our views on individual companies we think are attractively priced. Of the multiple benefits from doing so, perhaps the most important is that the premium we receive from this approach provides a differentiated income source for our investors.

By using options, we benefit from the current high volatility, but this is not to say we don't make money out of our approach in calm markets. This is important because, though it may be hard to remember, most of the time markets are unstressed. Despite this, we've generated an average of more than 7% p.a. income for investors since 2008.

There are better and worse stages in the market cycle for our approach but, regardless, we have delivered income to investors with metronomic regularity for 15 years.

Making it easier to hold 'em

High volatility, and the weak markets with which it generally correlates, can devastate long term returns as it encourages investors to lock in unrealised losses and remain uninvested. There are well known behavioural reasons for this:

- risk aversion (losses are more painful than the gains are pleasurable),
- recency bias (emphasising later over earlier events),
- herd mentality (it's easier to run away with the crowd).

It should help investors to know that Talaria benefits from these tendencies. Firstly, we generate higher option premium in a stressed market, and secondly the stock opportunities available to us increase as share prices come down, meaning we actually put more money to work in falling markets.

For example, we deployed 7% of the portfolio's cash in the week of the recent lows - when many were raising cash levels. As a result, during the 2nd quarter we held the lowest level of unencumbered cash in our portfolio since early 2008.

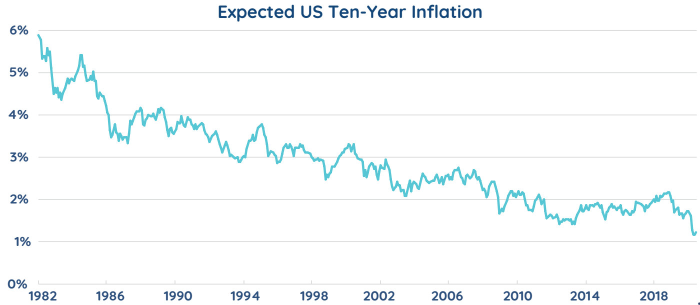
Diversification and Inflation

Whether or not we see inflation next year, soon after or even in the foreseeable future, one of the biggest risks to savers is financial markets move away from the current consensus view of 'deflation forever' to one of 'inflation is possible'.

There are credible reasons why this shift might happen and these are based on the different responses to this GVC (Global Viral Crisis) versus the GFC (Global Financial Crisis). The consequences could be severe because the decline in inflation expectations over the last 35 years has broken records in driving bond yields down and the prices of so-called long duration equities up.

Over 90% of Government bonds globally yield less than 1% today and the equity market has never been more concentrated around a few low growth / low inflation winners in areas such as technology and staples.

Expected US Ten-Year Inflation



Source: Federal Reserve Bank of Cleveland

If investors begin to discount inflation, this would cause a significant change in the best investments to hold.

Talaria would be well positioned were these moves to occur for two main reasons:

Firstly, we sell put options with an average two month duration. In practical terms the major source of our income generation reprices every 60 days. This means it consistently reflects the current inflation regime and is not subjected to a mismatch between the rate one contracts at today and the inflation regime at some time in the more distant future which may in fact be very different.

Secondly, we do not value a company based on growth expectations. As a result, we own shares of companies we consider cheap based on its cashflows being generated soon. This leaves us materially less exposed to inflation risk as the time it takes to be repaid our initial investment is relatively short. This is in stark contrast to today's winners where the cashflows required to justify valuations are a long way in the future and reliant on inflation remaining at today's 35 year low.

After so many decades, we recognise that there will be scepticism around a change in inflation expectations. While we have no particular view on a change, financial support for borrowers in the form of state loans and credit guarantees in the United States, Japan, China, Germany, the UK, France, and a host of other countries has opened a path for it to occur. In addition, there is now a moratorium on payments by debtors in all the above countries except Germany.

This underwriting of private sector credit means banks have been incentivised to increase lending as loans have effectively been guaranteed by the government. This is something monetary policy alone singularly failed to do after the GFC. While the velocity of money (the frequency one unit of money is used to purchase items) is very depressed given many businesses are physically closed, even a modest rebound to February's previous all-time low would raise the prospects for a change in the inflation outlook. Persistent higher bank lending on the back of government guarantees combined with a higher turnover of money chasing the same number of goods and services is a recipe for price increases.

We acknowledge the risk that these government promises and guarantees will only be temporary. After all, the incredible monetary policy of the last decade was meant to normalise when things improved after the GFC. However, given that a politician's primary motivation is to be re-elected, there ought to be every chance that these measures are around for years. This would certainly be the implication of the Rooseveltian rhetoric that seems to be growing in popularity - politics leads economics and in the response to the pandemic it seems as if governments have crossed the Rubicon.

June 2020 Quarterly Performance

Equity markets staged a strong recovery in Q2, after breathtaking weakness in Q1. Stock markets traded in a narrower range in June and though still elevated, volatility is off its highs. These are signs of stabilisation, but there remains a high degree of uncertainty including the effectiveness of unprecedented Central Bank and Government intervention.

US stocks rose, with the S&P 500 up 17.8% over the quarter. The tech laden NASDAQ outperformed major indices rising an astonishing 30.6%. European shares also gained, with the STOXX 600 Index rising 12.6%. The strongest European market was the German DAX, up 23.9%. Rightly or not, the UK is judged to be having a bad pandemic, and the FTSE 100 underperformed, only rising 8.8%. At a sector level, Tech, Consumer Discretionary and Materials were the best performing sectors globally. Sectors that underperformed included Utilities, Consumer Staples and Financials.

After a weak first quarter, the Australian Dollar rallied 12.6% against the US Dollar over the period, closing at US 69.0c. Extreme weakness saw oil double from US$20 in March through to US$40 by the end of June. The broad Bloomberg Commodities Index gained 5% in the quarter but remains almost 20% down year-to-date. Despite declining from a March peak, equity market volatility remains high with the VIX Index finishing the quarter at 30.4.

The Talaria Global Equity Fund – Hedged returned xx% for the quarter as both underlying shares and the Australian dollar rebounded over the quarter.

Distributions: The Fund paid an annual distribution of XXXX Cents Per Unit taking its 12-month income return to xx%.

Importantly, the Fund continued to generate high levels of option premium over the quarter. This has the double benefit of flowing through to performance in future months as well as reducing stock specific risk given the large buffers against loss the options create.

Whilst uncertainty remains high and the range of outcomes is wide, higher share prices and lower volatility evidence a greater willingness to look through the current difficulties and a sense that systemic risks are decreasing. However, 'less scared' is not the same as 'unafraid', and it is unsurprising that once again safe havens prospered. Our gold exposed holdings Newmont and Wheaton Precious Metals made the greatest quarterly contributions to portfolio performance. We remain positive on both companies, with Wheaton especially attractive given its business model is less exposed to any potential rise in costs.

Another material contributor was German pharmaceutical, consumer product and crop science company Bayer. In 2018 it bought Monsanto, taking on major litigation risk surrounding the alleged carcinogenic characteristics of its glyphosate products (e.g. Roundup). In June 2020, Bayer announced the settlement of a significant majority of cases after prolonged negotiation. Although some outstanding issues remain, the settlement largely addresses what has been a major negative for the investment case.

UK advertising agency WPP contributed positively in the second quarter having been the main laggard in the first quarter. It is not news that traditional advertising agencies face structural challenges nor that their businesses are cyclical, but there is perhaps growing recognition that their shares are valued on the basis of very pessimistic assumptions.

Increased volatility in the quarter provided opportunity to initiate or add to positions in high quality stocks like Booking Holdings (refer Stock in Focus below), Ambev SA and LafargeHolcim Ltd.

We also exited positions in Cummins, Jetblue and Cisco Systems based on valuations and revised investment cases.

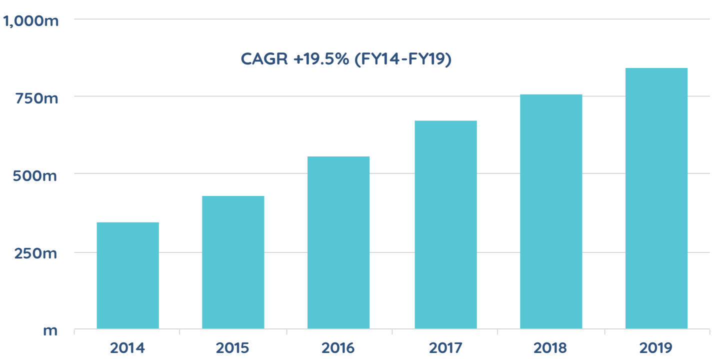
Volatility remains higher than normal however equity markets in June traded in a narrower range than preceding months. This implies that whilst uncertainty persists, there appears some confidence that measures by central banks and governments are closer to stabilising the many challenges. However, this year has been a reminder that things change quickly and we remain vigilant.

Stock in Focus – Booking Holdings

Concerns over travel and leisure have weakened shares across the sector. We utilised this opportunity to buy Booking Holdings, which has scale, a dominant market position, highly variable costs and a very strong balance sheet.

We recently initiated a position in Bookings Holdings, the largest online hotel booking agency globally. The company has been a remarkable success story with revenue growing from around US$3bn to US$15bn over the past ten years and profits enjoying a similar trajectory. Bookings has both driven and benefited from the move to online travel management. In 2019 they sold over 800 million room nights.

Booking Holdings – Room Nights (mil)



Source: Booking Holdings Inc, Talaria

The business model is very profitable with Bookings keeping approximately 15% of the room sale, a percentage that has been stable despite growing market share. This has allowed the company to earn operating margins of approximately 35%, which substantially flow through to cash given the very low capital requirements of the business. The travel industry has been among the worst affected by COVID-19 and Bookings has not been spared. Revenue this year will likely be down over 50% and profits closer to 80% lower. As expected this has had a negative impact on the share price; with weakness providing an opportunity to buy the stock at an attractive level.

Booking Holdings Share Price

Source: Bloomberg

In our assessment, the negative revenue impact will be transitory as the business model is very much viable. Furthermore, during the current challenging period, we expect weaker online and offline competitors to exit the industry, often through lack of scale and balance sheet weakness.

In terms of resilience, Bookings has no Net Debt, and liquidity of US$14.5bn which compares to costs of $6.9bn. This provides sufficient capital to operate for years, even if low activity were to persist. Approximately 60% of costs are variable and thus will fall in line with sales, and there is medium term flexibility on the remaining 40% of costs.

Given the very high share price volatility, we have options that agree to buy Bookings at approximately 15% below the current price yet still generate around 20% annualised return for a total position size of 3.7%. At our entry price we believe the shares offer up to 50% upside based on normalised earnings which we expect to be realised in the next three years.

Talaria Global Equity Fund - Hedged

Top 10 Holdings*

Company name	(% weight)
Bayer	4.7%
Wheaton Precious Metals	4.4%
Swiss Re	4.0%
Sanofi	3.8%
Newmont Mining	3.7%
Prudential	3.7%
Booking Holdings	3.7%
Asahi Group	3.5%
Land Securities	3.5%
Eaton	3.4%

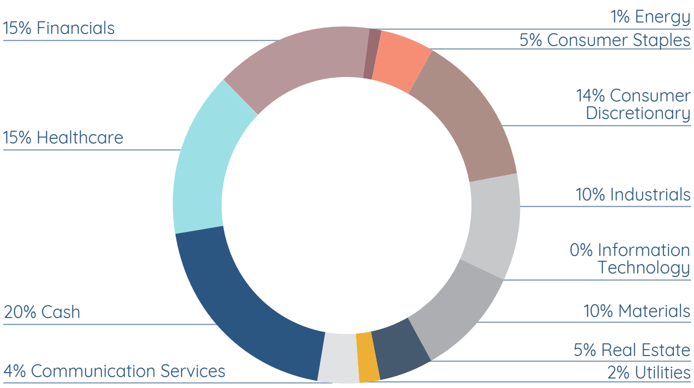
*Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

Performance at 30 June 2020

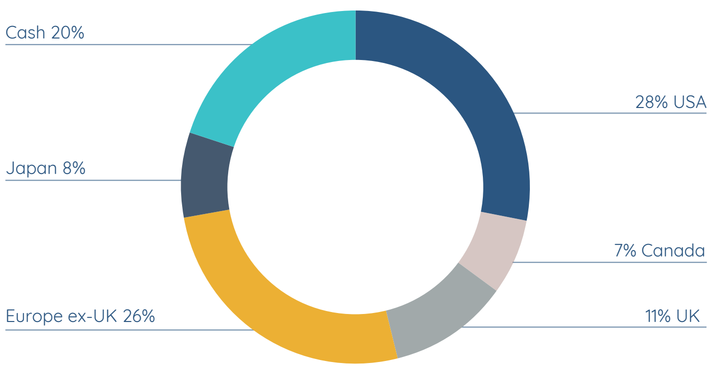
Period	Income Return	Growth Return	Total Return	Average Market Exposure
1 month	**0.00%**	0.00%	0.00%	47%
3 months	**0.00%**	0.00%	0.00%	51%
6 months	**0.00%**	0.00%	0.00%	56%
1 year	**0.00%**	0.00%	0.00%	56%
2 years p.a.				59%
3 years p.a.	**0.00%**	0.00%	0.00%	61%
5 years p.a.	**0.00%**	0.00%	0.00%	61%
Since Inception p.a.	**0.00%**	0.00%	0.00%	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 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	33.4%
Cash – put option cover	47.0%
Cash	19.7%
Total	**100.0%**

Portfolio contributors#	Portfolio detractors#
Wheaton	Sumitomo Mitsui
Bayer	Land Securities
Kingfisher	Centrica
Newmont	Loews

[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