Investment Insights

Dear Prudence, won't you come out to play?

The idea that prudence brings opportunity may raise eyebrows. Nowadays, everyone assumes that things like leverage, scale, and disruption bring opportunity. Prudence just brings weak tea and crumpets.

That was certainly true for last year's equity markets as prudence delivered only modest returns. The widening spread between what people paid for shares and the cash flows those shares generated stood out. Liquidity, momentum, and sentiment grew the gap between price and fundamentals, with valuations in the US, for example, moving to near all-time highs.

Looking at the S&P500, the latest forward price earnings ratio of 21.7x is 1.9 turns higher than the five-year average and 3.4 turns higher than the ten-year average. Contrary to popular opinion, tech does not have a monopoly on what's expensive as the rating of sector neutral indices demonstrates.

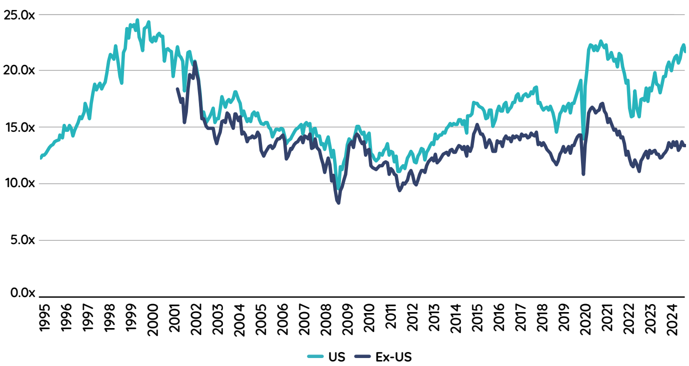
Early in 2025, the resultant risks are in plain sight but calling time on any associated trend is not the focus of what follows. After all, even at a more than twenty-year extreme, it would be bold to ring the bell, say, on the valuation gap between US shares and the rest of the world's markets.

Instead, this report looks at the index and the portfolio with a longer-term view, acknowledges our surprise at the strong performance of indexes in 2024, particularly as the lagged effect of interest rate hikes on earnings came through, examines our risk-taking and decision-making against various criteria, and asserts the attractions of the portfolio.

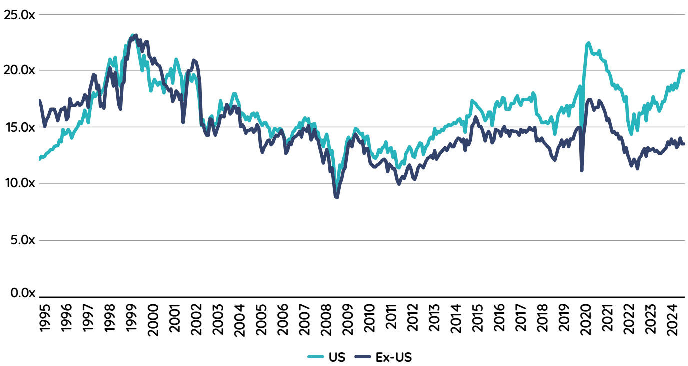
Our strategy is prudent, inherently exposing our investors to less risk and characteristics that are not in vogue. We are confident in this approach, which provides a significant margin of safety today in the same way it has done for nearly two decades. The improvement in our holdings' fundamentals is yet to be reflected in valuations, and the sectoral, regional and factor exposures are very different from both the index and other global equity funds.

US is extremely expensive relative to the rest of world

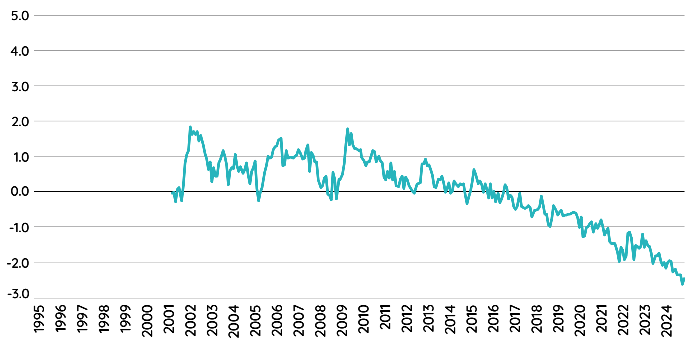
P/E, NTM



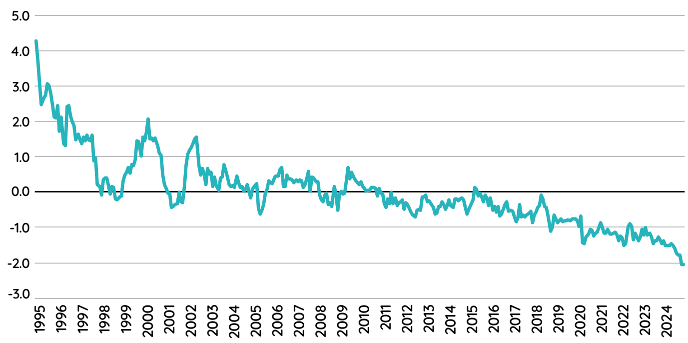
Sector neutral P/E, NTM



Z-Score for Relative P/E



Z-Score for Relative Sector Neutral P/E



Source: Piper Sandler

Perspective

One of the core advantages of a long track record is that it offers perspective, something that becomes especially apparent when reflecting on a year like 2024. That perspective, born out of experience, shows that it is a mistake to infer too much from any one 12-month period, especially when it stands out.

For instance, in 2022, the Talaria Global Equity Fund was up 8% net while the index was down 15%, a strong result. But there was no reason to get carried away because it's understood that any single year is no more than one data point in a longer series.

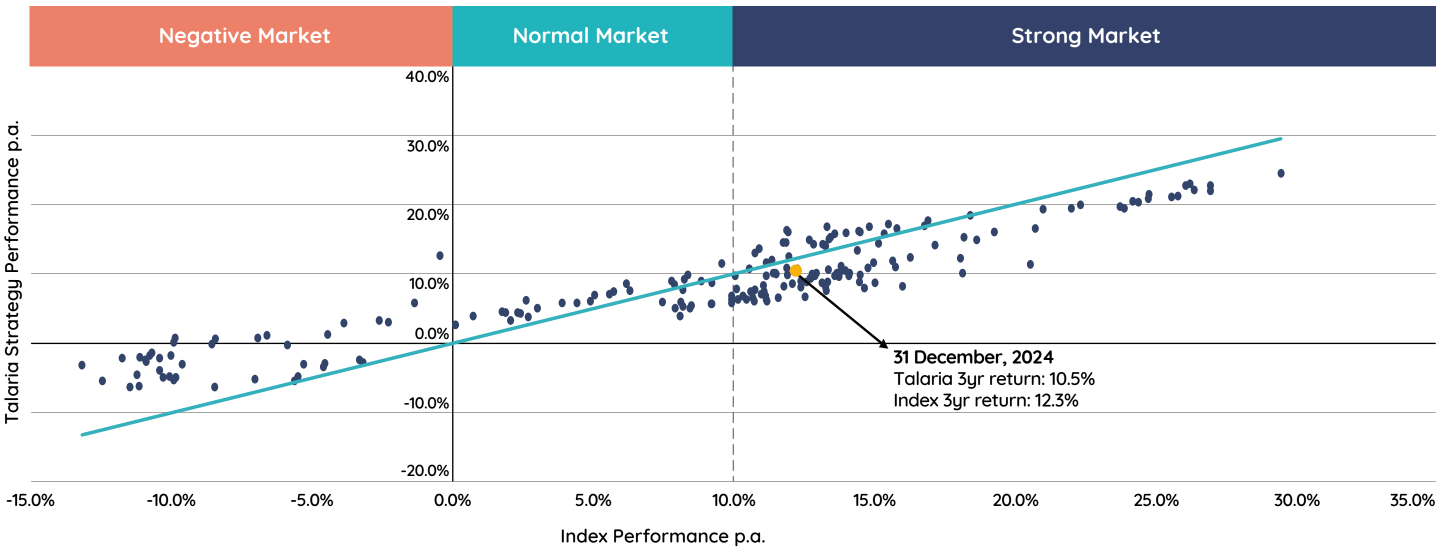
Arguably, what 2022 best highlighted was the rather mundane fact that the Talaria strategy is consistent. The approach isn't designed for extreme outperformance in one-off market years, even if it can occasionally deliver this.

While 2024 was an exceptionally strong year for global equity markets, Talaria's performance was only in the high-single digits, but making too much of such a year, as with 2022, would be to ignore the bigger picture.

The chart below helps draw that bigger picture using data going back to September 2008. It compares the strategy's monthly rolling three-year annualised returns with the index in three different return regimes. In down markets, we consistently outperform, sometimes generating positive returns when the market is negative. In more moderate markets, we tend to keep pace with the index, and in strong markets, our performance may lag but still delivers attractive numbers.

The orange dot shows that the latest three-year annualised gross return was 10.5% versus the index's 12.3%. What it does not show is how much less volatile the strategy's journey to 10.5% was compared to the index's to 12.3%, but that's another story.

Talaria rolling 3-year returns v Index



Performance	Down Market (3yr Index Return <0%)	Normal Market (3yr Index Return 0-10%)	Strong Market (3yr Index Return >10%)	Total Return
Talaria Mean Return	-1.8%	6.3%	12.6%	9.2%
Index Mean Return	-8.0%	6.2%	15.1%	9.2%
Talaria Outperformed in	41 / 41	24 / 38	29 / 117	94 / 196
Outperformance %	100%	63%	25%	

Returns are based on Talaria Global Equity Strategy (pre-fees) and assumes the reinvestment of distributions. All data as at 31 December 2024.
MSCI World (ex-Aust) Index in $A Net Dividends Reinvested.
Past performance is not an indicator of future performance.

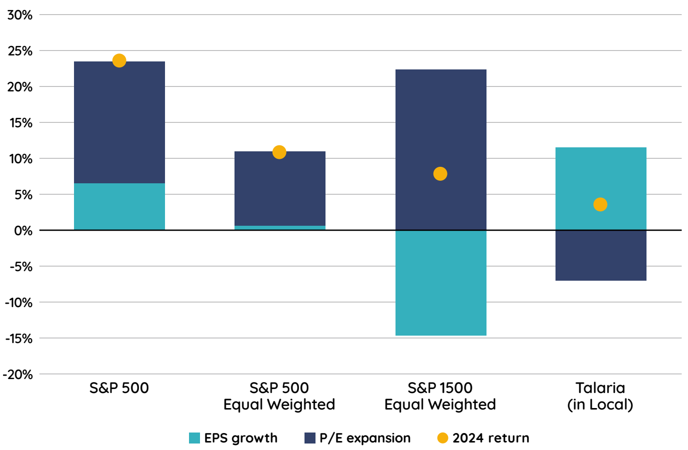
Source: Talaria, Bloomberg

Surprised

While perspective is invaluable, it would be disingenuous to claim we weren't surprised by the strength of equity markets in 2024. In December 2023's quarterly, we expressed a view that the long-term outlook for global equity returns was poor. Yet, the positive way this anticipated low-return decade began was not something we expected.

The exceptional performance of global equities was driven by the United States, with the S&P 500 up +23% for the year (see table below). While 7% EPS growth contributed, the much larger driver was valuation, as investors were willing to pay significantly more for each dollar of sales or earnings.

% Attribution to Return

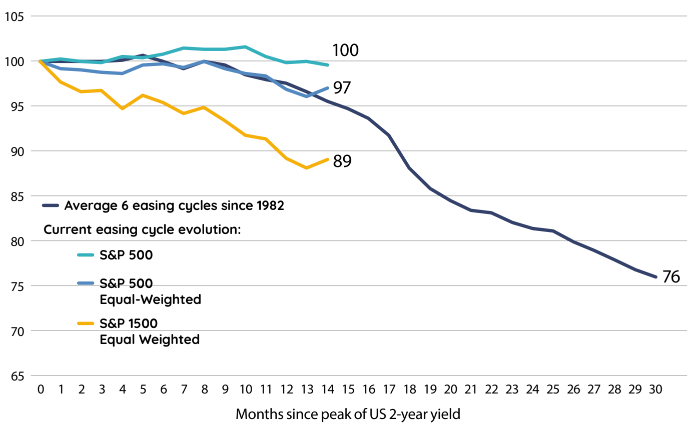


Talaria return is only local performance of gross capital at risk of holdings as of 31 December 2024 for illustrative purposes.

Source: Talaria, Bloomberg

Driven by the Magnificent Seven, it helped that forecasts for the headline index held steady. This defied the usual trend after interest rates peak when earnings forecasts two years out are typically revised down.

2yr forward EPS change, post end of tightening



Source: Piper Sandler, Bloomberg

Nevertheless, while continued enthusiasm for mega tech may have made sense, what arguably went against logic was the degree of enthusiasm for a broader cohort of U.S. stocks where the numbers were not compelling.

For the S&P 500 Equal Weighted, EPS increased by 1%, while the index rose +10%, driven almost entirely by valuation. Even more striking was the performance of the S&P 1500 Equal Weighted, which reflects a broader and more representative sample of U.S. listed companies. Here, EPS fell by -15%, yet the index still delivered a +8% return, driven by a dramatic multiple expansion from 15.8x to 20.0x.

Unlike the headline index, forecasts for the S&P 500 Equal Weighted followed a similar pattern to previous monetary policy cycles, with post-peak rate forecasts declining steadily. Again more strikingly, two-year forward earnings estimates for the S&P 1500 forecasts were -11%, much worse than the historical average.

Thus the rationale for investors paying significantly more for many U.S. shares cannot be solely related to recent and near-term fundamentals. The appetite seems to reach further into the future, appearing to rely on optimistic assumptions around further margin expansion from current highs, robust topline growth even as inflation moderates, and, in a dynamic out of the George Soros reflexivity theory, continued multiple expansion.

At today's valuations there must be very little room for error.

Thinking about risks and decisions

Last year's performance presents an attractive opportunity for investors in our strategy, but it also prompts self-examination. It's one thing to bring perspective to any single year, but we still need to test whether we remain true to our investment process.

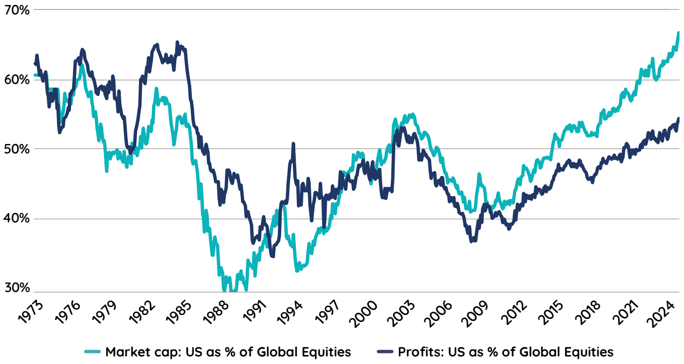
When reflecting on 2024, we can assess our approach by considering two overarching risks: the risk of permanent capital loss and the risk of failing to maintain purchasing power. These headline risks can be divided into three key dimensions: taking enough risk, exposing the portfolio to holdings that fail to deliver, and taking on valuation risk.

Through 2024, our delta-adjusted equity exposure averaged 63.8%, in line with our long-term average. With hindsight, having more capital at risk would have been better but the consistency of our exposure demonstrates that there was no decline in our risk appetite.

Execution from our holdings has been strong. As well as growing earnings last year, the estimates of our portfolio companies have been resilient, with no signs of underperformance or failure to deliver. There is no evidence that the investment team has failed to identify companies capable of executing, nor that the mix of holdings has drifted toward lower-quality companies.

In terms of valuation and reflecting last year's growth in EPS, the portfolio's average forward P/E of 12.5x, is lower than at the start of 2024 and significantly below the broader market. As a consequence of maintaining valuation discipline, we remained underweight US equities in general and avoided US tech entirely. This restraint, while costly in relative terms for 2024, reflects a broader commitment to protecting capital over the long-term, not chasing short-term returns.

US Stocks and Profit continue to gain market share in global equity



Source: Factset, Refinitiv, Societe Generale

The portfolio's risk positioning is the result of innumerable individual decisions made throughout the year. Each position, weight, and exit reflect a probabilistic assessment made under conditions of uncertainty. Our investment process is rooted in the idea that good decisions are based on probabilities, not outcomes.

This principle mirrors the concept of Annie Duke's "thinking in bets." Just as a poker player should bet on the strength of a hand, not on the result of a single round, we base our investment decisions on probabilities, even if those decisions don't always produce favourable short-term outcomes.

The relationship between the quality of decisions and their outcomes is not always obvious in the short term, but over time, they converge. Probabilities and outcomes cannot be entirely independent. To achieve favourable outcomes consistently, probabilities must be assessed correctly.

Consider the poker analogy further. A player who mistakenly believes weak hands are strong may be lucky, winning a few rounds, but over time a flawed assessment of probabilities will result in poorer outcomes compared to a player who calculates odds more accurately.

While poker is a simpler and less serious activity than investing, the principle holds. Sound decisions don't guarantee immediate success, but over time, a disciplined approach to assessing probabilities should result in more favourable outcomes.

Portfolio versus index

We ended 2024 with a portfolio that has upside both in absolute and relative terms. The portfolio's fundamentals have improved without this being reflected in multiples.

The table below gives a snapshot of the portfolio against a broad global index, treating Talaria's gross equity holdings and the index as if they were each one company. Three things stand out.

Metrics (Index 100 = Sales)	Talaria Portfolio	FTSE Developed
Income Statement Figures		
Sales	100	100
EBIT	12.5	16.1
Interest Paid	1.1	1.2 (1)
Pre-Tax	11.5	14.8
Tax Rate	23%	20% (1)
After-Tax Profit	8.9	11.9
Dividends	4.0	4.3
Retained Earnings	4.9	7.6
Balance Sheet Figures		
Equity (Book Value)	63	74
Debt	41	96
Cash	15	65
Net Debt	26	31
Total Capital (Equity + Debt)	89	105
Leverage Ratios		
Debt / Equity	66%	130%
Net Debt / Equity	43%	44%
Net Debt / Total Capital	30%	30%
Efficiency/Profitability Ratios		
Sales / Total Capital	124.1%	92.5%
EBIT / Total Capital	15.6%	14.9%
ROE	15.7%	15.8%
Return on Total Capital	11.0%	11.0%
Valuation Figures		
Price	110.5	229.1
Price / Sales	1.1	2.3
Price / Book Value	2.0	3.0
Price / Earnings	12.5	19.3
Earnings Yield	8.0%	5.2%
Dividend Yield	3.6%	1.9%
Retained Earnings Yield	4.4%	3.3%
Dividend Payout Ratio	45%	36%
Enterprise Value / EBIT	10.7	16.3

Notes: (1) Based on Talaria estimate of index interest expense and tax rate.

Source: Bloomberg, Talaria

First, the Talaria portfolio has less balance sheet risk through lower total debt to equity than the index. It also has lower refinancing risk and lower vulnerability to credit spreads widening.

Second, the portfolio's holdings have similar levels of profitability to the index. This might be a surprise given the relatively low exposure to the US and to tech.

Third, and perhaps most importantly, the portfolio's holdings have a lower starting valuation, reflected in an earnings yield of 8.0% compared to the index's 5.2%. While analysts project the index to grow earnings by around 10% in 2025, outpacing the portfolio's expected 7% growth, this 3% spread is overshadowed by the portfolio's higher initial yield, even if we hold that spread long into the future.

To illustrate, we modelled a long-term nominal earnings growth rate of 4% for the portfolio and a 7% rate for the index, consistent with next year's forecasts and above the average spread of the past decade. Despite the index's higher growth rate, our model indicates it would take approximately 25 years for its cumulative cash flows to converge with those of the portfolio.

Summary

The Beatles asked Prudence to come out to play. In markets, exactly when she does so is hard to say because prudence and patience are closely related. However, on making an appearance she will no doubt prove her worth.

If investors are asking themselves where to put their incremental dollar it's conceivable that the answer for some is "in what's working, give me more of what's going up". But bringing a longer-term perspective, we do not believe it is controversial to say that a rational approach would be to invest in portfolios with desirable, perhaps also unfashionable characteristics, attractive valuations and less risk.