TALARIA

Talaria Global Equity Fund - Hedged

Quarterly Update | March 2019

(Formerly Wingate Global Equity Fund - Hedged)

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

8 Frightening Words: "I'm from the government and here to help"

We entered the year with 13% unencumbered cash as we took advantage of single stock opportunities afforded by Q418's general market decline. This was our lowest level of cash (ie. highest market exposure) since fears of global deflation began to grip markets in late 2015. Subsequently, the 12% rebound in equity markets in 1Q19 leaves us back at the upper end of our historical range of unencumbered cash.

Against a backdrop of decelerating forward growth indicators and falling expectations for corporate profits, the first quarter was driven by the significant change in expectations for the rate path of Global Central Banks - most notably the Federal Reserve. In early January, Chairman Powell of the US Federal Reserve underscored that interest rate and balance sheet adjustments would be flexible to incoming data and in March the FOMC signalled that interest rate rises for this policy cycle are either finished or very close to being finished. Completing the dovish pivot made in December 2018, the Federal Reserve stated that efforts to shrink the size of its balance sheet would end in September 2019.

Markets - buoyed by policy moves and renewed optimism - enjoyed a very strong quarter with every asset class delivering positive real returns. This reduced the available yield on sovereign debt, corporate debt, equities and cash.

As a guide to market expectations for returns going forward, we note that the average assumed return on pension plan assets is 6.9% p.a. for the $1.5 trillion pension liabilities of the US corporate sector. However, this return level is not matched by US high yield corporate bonds let alone US corporate bonds, high yield equity indices, Emerging Market sovereign bonds, Developed Market sovereign bonds or cash. Thus, achieving this return is almost entirely predicated on the capital component of returns e.g. a combination of accelerating growth and / or expanding multiples.

From today's starting point this looks highly improbable the further out in time one looks - particularly when observing that over the last 20 years the best performing Developed Market index has delivered sub-4% p.a. nominal returns.

As capital growth and income drive total returns, we note their relative contributions fluctuate over the course of asset return cycles. The historical importance of income to long term returns however is irrefutable with around 70% of long term returns due to income.

Using Robert Shiller's data dating back to 1870, Exhibit 1 below shows income's contribution to the S&P 500's returns and how the split between income and capital has changed over time using a rolling 5-year time frame. The blue line shows the equity market's Shiller P/E at any given moment in time.

The chart shows that a period of strong capital growth (i.e. where income's contribution is relatively low) has tended to presage more moderate levels of capital growth over the next 5 years. In fact, only 9% of the time has the dividend component produced less than 20% of the prior 5-year returns – but from this point the subsequent 5-year median returns that came from dividends was a high 88% (i.e. capital growth was low).

All periods (prior 5 year contribution of income to returns <20%)		And Shiller >25
Average contribution of income to subsequent 5 year returns	156%	202%
Median contribution of income to subsequent 5 year returns	88%	210%
Hit Rate of increasing mix of returns from income	85%	84%
Incidence	9%	6%

Source: Bloomberg, http://www.econ.yale.edu/~shiller/data.htm

When overlaid with a starting valuation for the equity market the incidence of income becoming a greater component of return remains the same– but the median outcome changes materially such that in general more than 100% of return is derived from income over the next 5 years.

Using 140 years of stock market history as a guide - combined with strong returns over the last 5 years and today's level of market valuations - income over the next 5 years has a 9 out of 10 chance of being the primary source of protecting and potentially generating a return to capital.

With today's global debt levels at the government, corporate and consumer level the highest on record, much of the available (low) yield is likely to overestimate the realised yield that investors will receive relative to what they signed up for.

The component of our return contributed by income (Exhibit 2 below) remains not only sufficiently high to meet the US corporate pension fund threshold but is more valuable given its differentiated source. Our income is not reliant on dividends (i.e. companies' ability or willingness to pay) and option premium includes an embedded boost from higher volatility as the range of economic and market outcomes becomes wider.

For stewards of long-term capital or savers working to achieve savings outcomes, the opportunity cost of our process for foregoing direct market exposure is currently low by historical standards – and the income component of our return has never been relatively more valuable than now.

Exhibit 1: Income's Contribution to 5 Year S&P 500 Returns

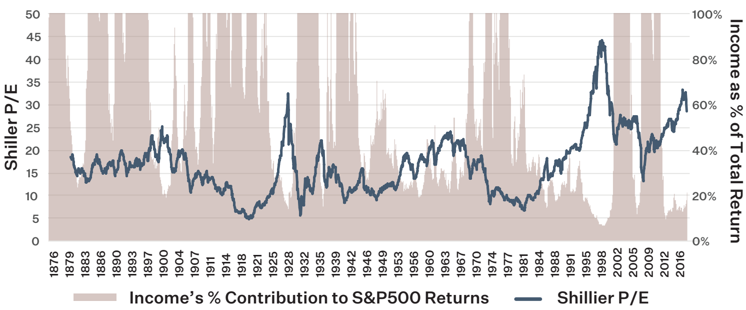
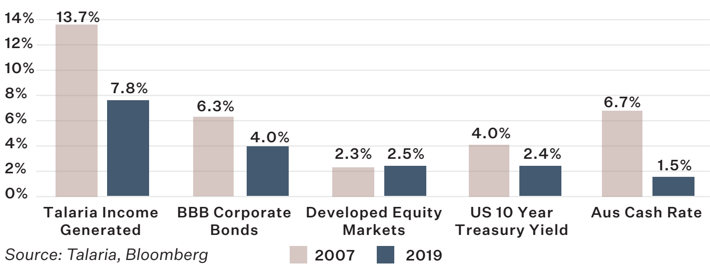


Exhibit 2: Declining yields: 2007 vs 2019



Source: Talaria, Bloomberg

A final thought for the long term inclined. Against this backdrop of very low available yield it's worth bearing in mind that debt has grown faster than GDP since 2010 leaving global debt levels at over 325% of GDP.

Developed market, emerging market, government and private sector debt levels have all markedly increased in the last decade – as a result of a policy decision to pull forward tomorrow's growth via debt with the transmission mechanism being higher asset prices.

The resultant rise in the "have nots" and "have yachts" is showing up in a political reaction with increasing policy rhetoric mooted to redistribute wealth from asset owners to wage earners and the leveraged. The policy slate of the major opposition parties in the UK, US and Australia to name simply three regions reads very much like one associated with classic financial repression – wealth tax, transaction taxes, "macro prudential" regulations to direct savings etc which – much like the last great financially repressive period from 1945-1980 is designed to mightily reduce the purchasing power of savings.

Beware the impending knock on the door - "I'm from the government and I'm here to help. "

March 2019 Quarterly Performance

Global equity markets recovered ground in the March quarter following the abrupt sell-off in late 2018. A dovish change in the US Fed's interest rate outlook was notable as the FOMC signalled interest rate rises for this policy cycle are either complete or approaching completion. This eased investor fears that a hawkish policy mistake would elicit a US recession. In Europe, a short-term Brexit extension was agreed though a definitive deal remains elusive.

US markets led global shares higher with the S&P 500 rising 13.1% over the quarter – its best March quarter in 20 years. The tech heavy NASDAQ surged 16.5%. European shares also rebounded with the Stoxx 600 Index gaining 12.3%, led by France's CAC Index which rose 13.1%. Asian markets were higher with Japan up 6.0% and the Shanghai Composite highlighted the market's risk-seeking exuberance recording a 23.9% gain.

The Australian Dollar rose half a cent to close at US71.0c. Oil rebounded 32.4% to US$60.14 following last quarter's decline. Unsurprisingly amidst the broad asset market rally, equity market volatility declined with the VIX Index declining from 25.4 to 13.7 over the quarter.

The Talaria Global Equity Fund – Hedged returned 5.58% over the quarter having taken approximately 63% market exposure over the period. Consumer Staples were the best performers for the portfolio this quarter led by gains at ConAgra Brands, Nestle and Asahi Group.

ConAgra, best known for its Birds Eye and Healthy Choice brands, rose after 3Q earnings provided a reassuring update on integration at its recently acquired Pinnacle Foods business. Nestle reported 3% full year organic growth and underlying improvement in operating profit. Japanese brewer Asahi also showed improvement in core operating profit and announced the acquisition of Fuller's beer assets in the UK.

The portfolio's Real Estate holdings were generally positive over the quarter. London based property developer Land Securities benefited as the British Pound recovered and likelihood of a no-deal Brexit appeared to recede. US strip mall operator, Regency Centers reported its seventh consecutive year of Net Operating Income growth of 3.4% or better.

Bayer, the German pharma company, was the portfolio's main laggard for the quarter. The company lost a second jury case in relation to its Round Up product, acquired as part of last year's Monsanto deal. Bayer is subject to 11,200 cases alleging a link between Round Up and cancer. While the legal process is ongoing, we assume that even with a €25bn Round Up liability the company represents reasonable value here. Refer Stock in Focus below for more information.

New positions during the quarter included contract caterer Compass Group and global eye wear manufacturer and distributor Essilor Luxottica. We also increased exposure to existing holdings in Asahi Group, ConAgra, Hydro One and JetBlue Airways. We exited our remaining small holding in Citigroup on valuation grounds.

We retain a cautious outlook given the current starting point for valuations and our expectations for long term future returns. The contribution to return of our income (generated via our option implementation process) is increasingly more valuable given it differentiates the portfolio's sources of return and is not reliant on a company's ability or willingness to pay dividends.

For stewards of long-term capital or savers working to achieve outcomes with their savings, the opportunity cost of our process for foregoing direct market exposure is currently low by historical standards – and we believe the income component of our return has never been relatively more valuable than now.

Stock in Focus: Bayer AG

Bayer is a global pharmaceutical and crop science business with over $40bn in revenue and $5bn free cash flow annually. Bayer's Crop Science division is the dominant market player in seeds, herbicides and pesticides globally with market shares in some instances over 50%, making it integral to the global food chain. The division spends $2.4bn p.a. on Research and Development - over $1bn more than anyone globally.

The stock fell significantly in March 2019 after a jury awarded $80m damages to a plaintiff alleging a key product (Glyphosate, manufactured by Monsanto - a Bayer company) "was a substantial factor" in the plaintiff's cancer. This was the 2nd successful claim against the company in the last 6 months, raising concerns about the level of future liabilities on the 11,200 pending cases.

There are two paths from here. Either Bayer will defend on a case by case basis and ultimately pay any costs as and when they occur, a process that will take multiple years but likely without significantly impacting the business or balance sheet in any one year. Or, a more likely scenario is that after more cases are completed and a better sense of liability emerges, Bayer will settle for a large, lump sum payment.

In assessing the potential liability for Glyphosate, we have looked at recent legal settlements with many similarities - but as importantly some differences. Asbestos settlements which arose from its carcinogenic causation (specifically Mesothelioma) was a widely used product and gave rise to many claims in the US. However this product was proven to be carcinogenic and ultimately banned, whereas Glyphosate is still legal and causation is far from proved. Asbestos claims in new cases in 2016 were settled at approximately $1.2m per case. To assess an extreme outcome we doubled Bayer's liability to $2.4m across all 11,200 pending cases and further assumed the payment is made immediately. This arrives at an implied liability of almost €25bn.

We have assessed sustainable fee cash flow as the key consideration in valuing Bayer. We have high visibility in their largest pharmaceutical drug Xarelto - for chronic coronary artery disease - and modelled this out to patent expiry in 2024. We also have confidence in the sustainability of their cash generation as the leading player in key agricultural sectors, albeit at lower margins than the company is targeting or have historically delivered.

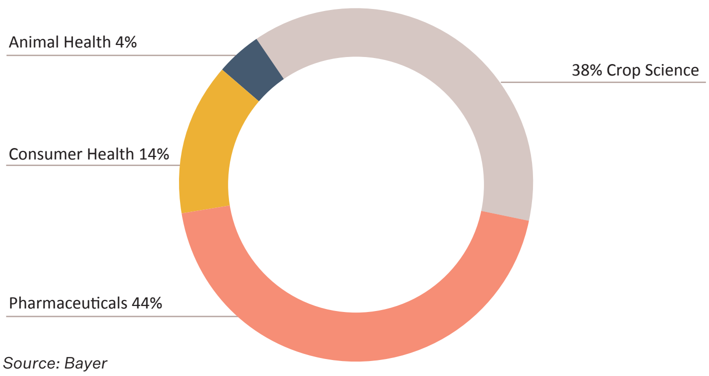
The resultant sustainable free cash flow on the Enterprise Value, which includes:

- all debt;
- no benefit going forward from the firm's expensed Research and Development spend of €5bn p.a. and
- a €25bn product liability discussed above…

…produces a FCF yield of 6%, and a dividend yield of 4% from which it should then be in a position to grow.

Should an extreme outcome eventuate, we end up with a global leader in an undeniably necessary industry paying 4% per year and growing. We hope for better, but see value in the worst.

Exhibit 3: Bayer sales by division



Source: Bayer

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Top 10 Holdings*

Company name	(% weight)
WPP	4.8%
Bayer	4.1%
Sanofi	4.0%
Hydro One	3.9%
Gilead	3.3%
McKesson	3.2%
EssilorLuxottica	3.1%
Land Securities	3.0%
Nestle	3.0%
Engie	2.9%

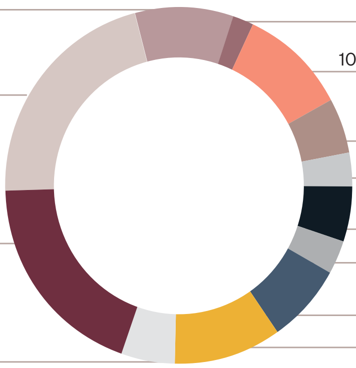
Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

Performance at 31 March 2019

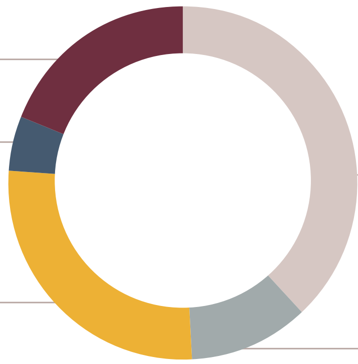
Period	Income Return	Growth Return	Total Return	Average Market Exposure
1 month	**0.00%**	0.10%	0.10%	60%
3 months	**0.00%**	5.58%	5.58%	63%
6 months	**0.00%**	-2.20%	-2.20%	64%
1 year	**4.35%**	0.33%	4.68%	64%
2 years p.a.	**5.85%**	-2.28%	3.58%	63%
3 years p.a.	**6.38%**	0.44%	6.82%	61%
5 years p.a.	**7.17%**	-2.76%	4.41%	60%
Since Inception p.a.	**6.82%**	0.20%	7.02%	61%

[1] Fund Returns are calculated after fees and expenses and assume the reinvestment of distributions
[2] Inception date for performance calculations is 18 August 2008
[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.

Quarterly distribution

Period	Cents per Units	Reinvestment price
March 2019	0.0000	n/a
December 2018	0.0000	n/a
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
June 2017	6.0226	$1.0077
March 2017	2.1000	$1.0495
December 2016	0.8000	$1.0421
September 2016	0.6000	$0.9994
June 2016	3.4538	$0.9681

Asset allocation	% weight
Global equity	57.1%
Cash – put option cover	23.5%
Cash	19.4%
Total	**100.0%**

Portfolio contributors#	Portfolio detractors#
Conagra	Centrica
Oracle	Bayer
Land Securities	EssilorLuxottica
Roche	

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

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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**	0.30% / 0.30%
Platform Availability	AMP North, Asgard, Ausmaq, BT Wrap/Panorama, CFS FirstWrap, Hub24, Macquarie, Netwealth, Powerwrap	**Distributions**	Quarterly
		Minimum Investment	$5,000