TALARIA

Talaria Global Equity Fund - Wholesale

Quarterly Update | June 2019

(Formerly Wingate Global Equity Fund)

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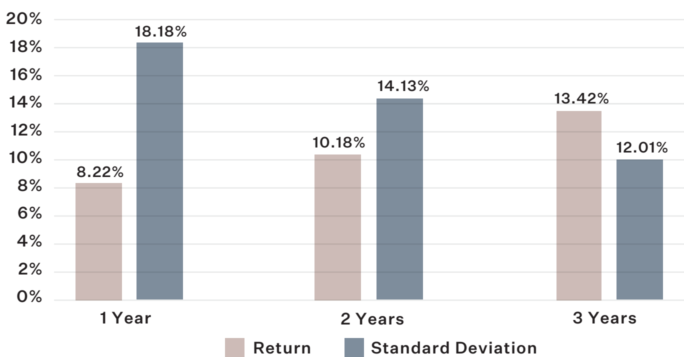
Signatory of:

Lower variability: So much more than a better night's sleep.

Despite a backdrop of lower growth and increasing geopolitical tensions, equity markets remain well supported providing double digit returns per annum over the past seven years alongside continued low volatility.

However, the last 12 months saw a partial reversal of this trend with both a slowdown of returns and an increase in the variability of returns. In fact, the S&P 500's three worst months of the last five years all occurred within this timeframe.

Exhibit 1: Lower Returns and Higher Variability

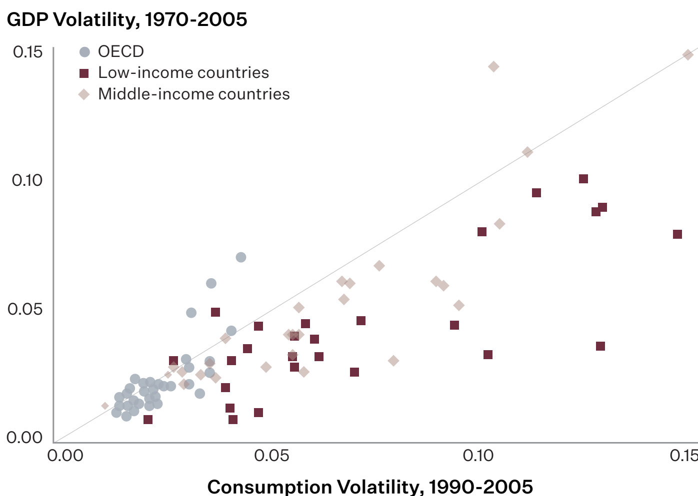


Source: Bloomberg. Based on S&P 500 as at 30 June 2019

Variability in potential outcomes - otherwise known as uncertainty - is an ever-present reality in most areas of economic and financial life. It is an integral input to the long-term outcome of GDP growth, unemployment and investment returns. In addition, it is almost universally true that lower variability - or greater certainty - generally produces significant benefits over time.

In the context of GDP growth, there is a strong correlation between lower variability of growth and the corresponding stability of consumption, while lower GDP variability leads to more stable and lower unemployment rates.

Exhibit 2: Volatility of GDP and consumption per capita by income



Source: Centre for Global Development

It is notable that Japan has averaged an anaemic 0.2% p.a. GDP growth rate over the past 25 years yet its unemployment rate has never exceeded 5.5%. In large part this is because GDP has ranged between -0.5% and +1.0% over most of that period.

Similarly, in the valuation of financial assets, earnings that are produced with lower variability, or more certainty, are valued more highly than earnings delivered with higher variability. This can be seen in the higher valuation multiples of traditionally defensive sectors like Consumer Staples and Utilities compared to the more cyclical Banks, Retailers and Auto Suppliers.

Exhibit 3: Valuation dispersion: Lower Volatility is now far more expensive

Source: Bloomberg

One of the important financial benefits of reducing variability in investment returns is the reduction of sequencing risk. This refers to the 'path' of returns and is of most concern around retirement. If there is a material draw-down in early-mid stage retirement with no chance to replenish funds through contributions, then it is very difficult to recover the initial balance – even if asset prices eventually rebound.

Aside from the economic benefits, there are considerable personal benefits to the investor from lower variability in returns. Human behavioural biases apply a higher weighting to losses than they do to gains. Said another way, even if the result over time is the same, a journey arrived at via large losses and corresponding recoveries is far less preferable to a smoother one. In fact, research by Noble prize winners Tversky and Kahneman showed empirical estimates of loss aversion are typically in the neighbourhood of 2 times, meaning the disutility of giving something up is twice as great as the utility of acquiring it.

Investors typically shift to defensive, low returning assets just when market uncertainty is at its most extreme. Unfortunately, this is often the time they should be investing in more volatile, cyclical assets.

An uncertain journey, in effect, restrains the ability to reach the desired destination.

The possibility of an increase in the variability of market returns is therefore most concerning. The paradise of the last seven years could be lost. On the returns side, as we have written about in prior commentary, the long-term prognosis is for very low returns. It is now looking increasingly likely that the journey to achieve those returns could also be more turbulent.

Historically, market volatility tends to increase in an environment of:

1. High profit margins;
2. High debt levels; and
3. High valuations.

These factors are all evident today. Economic data already point to slowing momentum in global growth. This can be seen in global PMI numbers; the fact that Central Banks are moving to easing biases; and the collapse in long term interest rates.

The solution for a low return and more uncertain world is not easy to find as these unfavourable dynamics exist across asset classes. All the easy routes have been closed.

Talaria's strategy adds a second lever to returns; namely option income which becomes more important with higher volatility as the payment for taking risk increases. Additionally, Talaria's strategy structurally decreases the variability of returns.

We remain well-placed to continue providing desired outcomes to our investors in the event of lower returns and rising uncertainty.

June 2019 Quarterly Performance

Global equity markets continued their recovery following the abrupt sell-off in late 2018. Markets responded strongly to accommodative policy stances from Central Banks globally and relative calm in the geopolitical sphere. Trade tensions continue to bubble away but to this point have not escalated significantly.

US markets rose with the S&P 500 rising 3.8% over the quarter and the tech heavy NASDAQ adding 3.6%. European shares were also firmer with the Stoxx 600 Index gaining 1.5%, led by Germany which rose 7.6%. Asian markets lagged with Japan up 0.3%, although foreign investors benefited from a stronger Yen, and the Shanghai Composite declined 3.6% retracing some ground after its remarkable 23.9% gain in the March quarter.

The Australian Dollar fell 1.1% to close at US70.2c while Gold surged 9.1% to US$1409. The US 10-year government bond yield continued to decline with the yield falling 40bps to 2.00%. Equity market volatility increased with the VIX Index increasing 1.4 points to finish the quarter at 15.1.

The Talaria Global Equity Fund returned 4.79% over the quarter having taken approximately 57% market exposure over the period. The portfolio benefited from its Health Care, Communication Services and Consumer Staples holdings and a decline in the Australian dollar. A feature of the quarter's performance was the portfolio's resilience in May when equity markets sold off sharply yet the portfolio insulated investors from most of the decline.

Distributions: The Fund paid a June quarterly distribution of 3.4313 cents per unit taking the Fund's 12 month distribution return to 8.16%.

Health Care stocks were amongst the portfolio's best performers this quarter led by gains at McKesson, Bayer, Allergan. Sanofi and Roche. McKesson, one of the largest pharmaceutical distributors in the US, rose after providing upbeat FY2020 guidance at its Q4 result. The company also completed the IPO of its Change Healthcare subsidiary. Bayer shares advanced after its internal supervisory board updated plans for addressing the Monsanto glyphosate litigation. Allergan shares surged following Abbvie's US$63bn cash and stock takeover offer for the company.

Global advertising agency WPP also performed well over the quarter. The company reiterated its full year guidance at its 1Q trading update. The second half is expected to improve as the impact of account losses in 2018 fall away from comparative organic growth numbers. WPP also provided an update on the proposed sale of its Kantar market data business with initial valuations in line with our expectations. Completion of the sale will provide considerable balance sheet flexibility and underpin the company's turnaround program.

UK utility Centrica declined after providing updated guidance. Citing the impact of the recently introduced UK tariff cap, warmer than expected weather and lower commodity prices the company cautioned that full year cash flow would be lower than expected. The company has launched additional cost cutting measures in response and continues its non-core asset disposal program. The company will provide a strategy update alongside its interim result in July at which time we expect an update on the Group's financial framework including a revised dividend policy.

Several new names were added to the portfolio over the quarter including gold miners Newmont Goldcorp and Wheaton Precious Metals, US mutual fund giant Franklin Resources, Japanese trust bank Sumitomo Mitsui Trust Bank, auto supplier Lear Corp and real estate company Brookfield Property. We also increased exposure to existing holdings in Sanofi, McKesson, Roche and Allergan. We exited several names including Engie, Oracle, ConAgra Brands, Swiss RE and Regency Centers on a mixture of valuation grounds and revised investment cases.

Our market outlook remains cautious with an expectation of lower future returns, considering current high valuations, combined with rising uncertainty. Historically, market volatility tends to increase in an environment of high profit margins, high debt levels; and high valuations. In light of this we continue to retain cash balances towards the higher end of our permitted range and remain selective on adding new money to the market.

Stock in Focus: Nestlé

We are currently exiting Nestlé following a significant appreciation in its share price. We first purchased Nestlé a little over a year ago at an average price of 80 Swiss Francs. In line with our process, it was trading in excess of 20% below our assessment of intrinsic value. When excluding its stake in L'Oreal (approx. 10% of market cap) Nestlé traded at 16 times earnings, the low point over the past five years.

Nestle's income statement was supported by an excellent balance sheet alongside a strong governance history as exhibited by its track record of 24 consecutive dividend increases. The stability of its sales profile, specifically its very low variability was additionally attractive.

The robustness of the business is supported by a diverse (albeit slow-growing) suite of businesses across multiple geographies; and its historical propensity to invest for the long-term in areas such as brand-building and distribution infrastructure, rather than focusing on short-term sales momentum.

A relatively new CEO with a renewed focus on portfolio optimisation also provided upside risk.

As the share price appreciated the embedded expectations in the price exceeded what is realistically able to be achieved. At the current price of over 100 Swiss Francs, if we demanded an 8% p.a. return (consistent with our expectations across our investment portfolio), Nestlé would need to achieve long-term EBIT margins of 25%. This compares to the current EBIT margin which is an already frothy 16%.

The implied margin of 25% is significantly higher than consensus estimates over the next three years and is the highest implied margin seen since at least 2003. Looked at another way, if margins remained the same, sales growth would need to average 8% pa compared to the recent average of 4%. A tall order considering global growth, inflation and competitive dynamics.

We believe the share price is benefiting from the market's strong preference for high ROE companies. While the valuation gap between Growth and Value factors is at extremes, this is not explained by superior growth rates, as both factors have similar earnings growth rates currently. The gap is primarily due to higher ROE companies being bid up as investors seek safety and certainty.

These are attributes Nestlé has in abundance - and in our view – investors have placed a premium on it exceeding that which is justified by company fundamentals and as such we are exiting it from the portfolio.

Exhibit 4: Nestlé Share Price

Source: Bloomberg

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Top 10 Holdings*

Company name	(% weight)
Sanofi	6.0%
WPP	5.3%
Bayer	4.4%
McKesson	4.3%
Roche	4.3%
Wheaton Precious Metals	4.0%
Hydro One	3.9%
Franklin Resources	3.0%
Land Securities	2.9%
Sumitomo Mitsui	2.9%

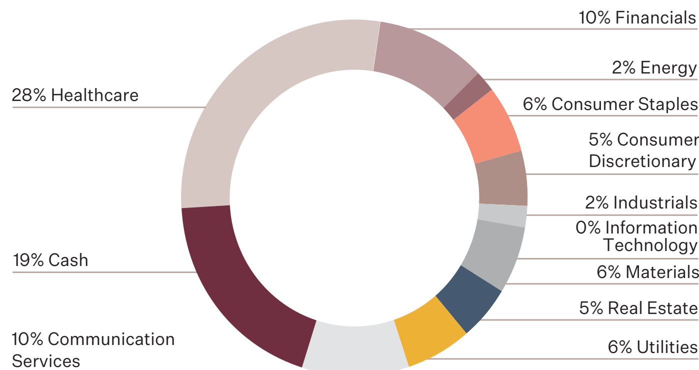
[#] Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

Performance at 30 June 2019

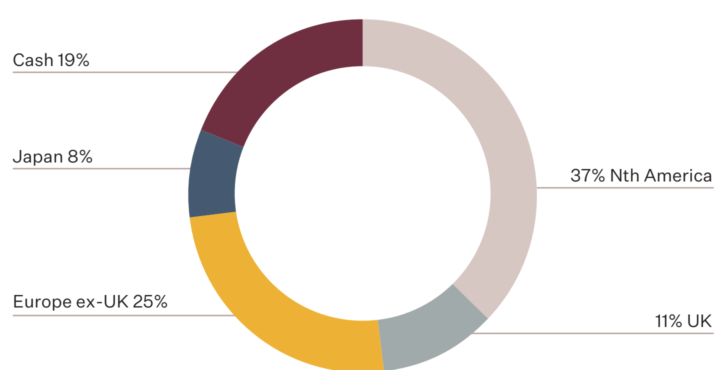
Period	Income Return	Growth Return	Total Return	Average Market Exposure
1 month	**3.68%**	-0.13%	3.55%	54%
3 months	**3.72%**	1.07%	4.79%	57%
6 months	**5.58%**	3.89%	9.47%	60%
1 year	**8.16%**	0.58%	8.74%	62%
3 years p.a.	**8.05%**	1.24%	9.29%	60%
5 years p.a.	**8.82%**	0.05%	8.86%	61%
7 years p.a.	**9.80%**	2.34%	12.15%	60%
Since Inception p.a.	**7.37%**	-0.68%	6.69%	62%

[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
June 2019	3.4313	$0.9311
March 2019	1.5000	$0.9212
December 2018	1.2000	$0.8961
September 2018	1.2000	$0.9643
June 2018	4.6235	$0.9258
March 2018	1.3000	$0.9214
December 2017	1.0000	$0.9286
September 2017	0.8000	$0.9145
June 2017	3.8802	$0.9235
March 2017	1.0369	$0.9349

Asset allocation	% weight
Global equity	51.7%
Cash – put option cover	28.8%
Cash	19.5%
Total	**100.0%**

Portfolio contributors[#]	Portfolio detractors[#]
WPP	Centrica
McKesson	Cognizant
Bayer	Land Securities
Hydro One	Teva

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

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Fund Snapshot

APIR Code	AUS0035AU	**Inception Date**	18 August 2008
Management Fee	1.16% 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, Freedom of Choice, Hub24, Linear, Macquarie, Netwealth, Powerwrap, Praemium, IOOF Pursuit	**Distributions**	Quarterly
		Minimum Investment	$5,000
Fund Size	$316m	**Strategy assets under management**	$422m

Important Information

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