TALARIA

Talaria Global Equity Fund - Hedged
Quarterly Update | December 2019

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: Heads I win; Tails I lose very little.

Investors enjoyed exceptionally strong calendar 2019 returns with every major asset class increasing in value above the rate of inflation for the first time in a decade. World stock prices increased 28% with the tech heavy Nasdaq index up close to 40% and Global credit up double digits. Making money when everything is going up isn't a big deal so to laud our returns seems disingenuous as simply put - everything went up.

We follow a process managing money in which outcomes take care of themselves. Outcomes as a barometer of decision-making quality presents several problems though. E.g. Playing Russian Roulette with a loaded pistol and avoiding the bullet would hardly qualify as an example of a good decision, despite the positive outcome.

Focusing on how we make decisions has allowed us to consistently deliver for investors three outcomes necessary for superior risk adjusted and absolute returns, namely;

- lose less when the market goes down;
- generate a significant level of differentiated income,
- and enjoy a smoother equity market ride.

In any one year the opportunity cost of our process can be greater than the benefits and 2019 was such a year. Take the income component of return for example. In 2019, the income return was 7.7%, with the payment for committing to buy shares we deemed undervalued amounting to 4.6% of this source of return.

This significant income generation in 2019 however came with a near 20-year high opportunity cost given the strength of equity markets. Here's a reminder why.

When our investment process identifies a share we wish to purchase we commit "today" to buy the share at a fixed price on a set date in the future. We move the cash "today" into a bank account to fund our potential purchase. While we got paid 4.6% upfront in 2019 to hopefully own the share – we want to own the share – the cash earmarked for the purchase is not in the equity market until we own the company.

So, in exceptionally strong years such as 2019, the payment over the year is lower than if were to simply buy the shares we want to own. In calendar year 2019 we calculate this opportunity cost to be 3%.

Likewise given expensive markets, we were at the upper level of uncommitted cash we will hold, which lowered our absolute returns. Our estimate of prospective 12-year equity market returns moved from being mildly negative at the start of 2019 to the lowest ever by year end. We are never "Bullish" or 'Bearish" we are in the words of renowned investor Seth Klarman "Value-ish" and the reality today is many equities are priced to give very low long-term returns.

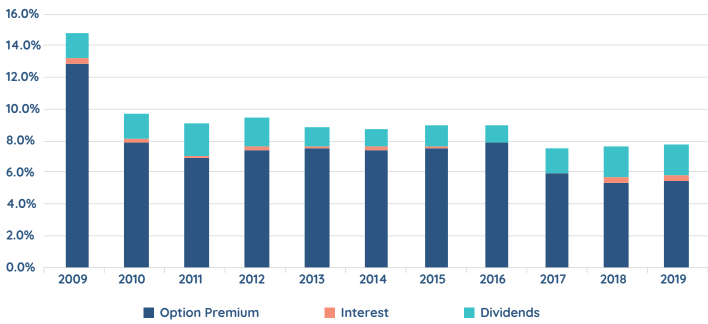
Cash provides optionality and reduces the risk of permanent capital impairment by buying companies at the wrong price and locking in sub-par returns. How we manage money is designed around reducing risk – the prices paid, the way stocks are bought, the strong component of our returns from income and the willingness to hold cash when stock prices are expensive. These are all tools within our process to reduce the risk of a permanent impairment of capital.

Assuming we are in a new era of higher stock prices and lower returns involves the risk of significant capital impairment. Likewise,thinking prices will fall at some point involves an opportunity cost of an uncertain amount - which as it happens in 2019 was near a 20-year high. We don't subscribe to "buying the best of a bad lot" and are comfortable saying no if we feel the investment odds are not in our favour. Following one's process and having the patience to hold cash when prospective returns are low is only prudent.

We firmly believe that managing money via our process, gives us and our investors the highest probability of growing absolute wealth over time, though years like 2019 seen in isolation would argue otherwise. So why have we managed money like this for 15 years?

Firstly, consider that in the last 20 years the best performing developed market stock index has generated less than 6% pa nominal total return and even that required the median stock on several measures to end the period at the most expensive in history. Having around 25% of our portfolio earning a contracted 15% per annum must be beneficial to returns over the long term as this is higher than the equity market returns forgone from not being always directly exposed. As you would expect this is exactly what our 15-year history demonstrates.

Exhibit 1: Income Chart



Source: Talaria. Reflects sources of return generated by the portfolio per calendar year

Secondly, financial wellbeing doesn't live by a calendar as anyone who has suffered significant financial losses or uncertainty in life well knows. Agents in the asset gathering industry champion short, discrete periods of time because their objective is to sell – a Principal most certainly doesn't because they know the winning strategy is a long term one.

Losing less when prices go down matters because you have more absolute dollars benefitting in the good times irrespective of where on the calendar they occur - meaning more absolute dollars in your account over time.

As important to one's absolute wealth come year end 2019 was how one faired in 2018 when all major asset classes underperformed inflation.

Thanks to the benefits of our process in 2018 we generated a 5.4% total return versus the index return of 1.5%. So, assuming $100 invested 1 January 2018, we started 2019 with $105.40 not $101.50. Despite producing less than the market's return in 2019, over the course of 2 years we provided a smoother journey, assumed only 60% market risk and our investors enjoyed double digit per annum returns.

Thirdly – the range of outcomes against expectations can be surprisingly large so making sure you have more working for you in the ups is so very important to meeting your long-term financial goals.

Smoothing returns matters. Not being forced to sell at depressed prices matters. Preserving enough capital to fund retirement matters. And perhaps most importantly - the fact that the route taken to wealth counts for long term wellbeing more than the destination of wealth itself matters. Uncertainty – which is what volatility reflects – for most people is unpleasant and stressful. It can make a temporary loss permanent for emotional reasons. As people we don't cope well with uncertainty as a rule, making it more likely to sell when stocks are falling and buy when stocks are rising. To paraphrase Mike Tyson – everyone has a plan until they are punched in the mouth.

Consider the experience of the average investor in Peter Lynch's fund at Fidelity. Between 1977 and 1990 the fund returned 29% annually – more than double the S&P 500 stock index (great job Peter!) – and yet as Lynch himself shockingly calculated, the average investor in his fund made only around 7% per annum during the period. The reason? Volatility in stock prices meant money would flow out when stocks went down only to flow back in when stocks recovered.

The behavioural impact of volatility on long term returns is exactly what we have seen over the last 2 years. Only now after an exceptionally strong year of gains are investors putting money into the market after selling equities for the last 24 months.

Smoother returns are an underappreciated necessity to wealth creation over time and an outcome of our process – they allow you to preserve capital, stick to the plan and enjoy the journey.

What gives us confidence that how we manage money, provides us and our investors, the highest probability of growing absolute wealth over time? Our delivery.

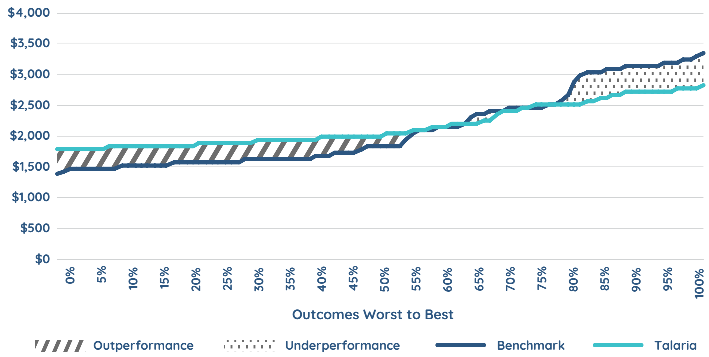
(The following analysis refers to the underlying unhedged portfolio which commenced in Oct 2005). The blue lines in this graph represent the range of outcomes of "wealth" after ten year periods of time invested in the benchmark and Talaria, respectively, with a starting value of $1,000. The ten year periods are rolling by month and begin on 1 October 2005 (such that the first ten year period ended on 30 September 2015, and the second ended on 31 October 2015, etc).

The outcomes are sorted on the graph from worst to best as you go from left to right, with the 0th percentile referring to the worst outcome and the 100th percentile referring to the best.

For the benchmark, the very worst ten year period over this timeframe produced a tepid 3% p.a. return, whereas the very best ten year period delivered a gain in wealth of over $2,300 – a 13% p.a. return.

For investors in Talaria, the very worst ten year period produced a still-respectable 6% p.a. return, whereas the very best ten year period delivered a gain in wealth of over $1,800 – an 11% p.a. return. Importantly, Talaria outperformed in all of the weaker periods. Except for a brief window, the benchmark only outperformed Talaria in its strongest quintile; the top 20% of ten year time periods.

Exhibit 2: Range of Wealth Outcomes



Our process encourages us to temper our enthusiasm during good times, become more optimistic and own more shares when things look bad and explicitly takes advantage of the fact that the "average' market return masks a materially more volatile journey on the path to those "average" returns. While there is a cost to this process – the long-term rewards are greater than the cost borne in any one year.

Investors are always taking risks. The key is understanding what risks you are taking, when you are taking them and having a process to profit from, eliminate or temper them.

December 2019 Quarterly Performance

Global equity markets finished the quarter higher as dovish interest rate policy and hopes for a phase 1 US-China trade deal boosted sentiment. The US Federal Reserve cut US rates a further 0.25% during the quarter to provide additional stimulus to a slowing US economy. In the UK, Boris Johnson was returned as Prime Minister in a December election victory that paved the way for Brexit to be finalised.

US markets rose with the S&P 500 up 8.5% over the quarter while the tech heavy NASDAQ surged 12.7%. European shares also rose with the Stoxx 600 Index adding 5.8%, led by Germany which rose 6.6%. Despite a post-election bounce, the UK lagged the broader rise in European shares with a 1.8% gain. Asian markets were stronger with Japan's Nikkei increasing 8.7% and China's Shanghai Composite Index gaining 5.0%. At a sector level IT, Health Care and Financials were the best performing sectors globally. Sectors that underperformed included Consumer Staples, Real Estate and Utilities.

The Australian Dollar rose 4.0% to close at US70.2c as the US dollar weakened. Commodities firmed with Gold rising 3.0% to US$1,517 and WTI Oil gaining 12.9% to US$61 per barrel. US 10-year government bond yields rose 25bps to 1.92% as the Federal Reserve said it would leave rates on hold for an extended period after the recent cuts. Equity market volatility declined with the VIX Index falling 2.5 points to finish the quarter at 13.8 points.

The Talaria Global Equity Fund – Hedged returned 4.32% for the December quarter and 15.82% over 12 months with ~58% market exposure.

The portfolio benefitted from its Utility, Real Estate and Materials holdings and the rising Australian dollar.

A Conservative Party election victory and subsequent rally in the British Pound benefitted our UK shares. Centrica was a notable beneficiary of the election result as it removed the threat of renationalisation outlined in the Labour Manifesto. In addition, Centrica reported a robust 3Q trading update in November. Stable customer numbers and the reaffirmation of full year guidance suggests that recent pressures on the business may be abating. Landsec, the UK landowner and developer, and global advertiser, WPP, also rallied on the back of the election result.

Bayer shares performed strongly over the quarter. The company announced 3Q results with improving sales results across its Crop, Pharmaceutical and Consumer Health businesses. The divestment of non-core assets including Currenta and the Animal Health businesses helped to firm up the balance sheet ahead of further news flow in 2020 on a potential Monsanto resolution.

French advertising agency Publicis was the main laggard for the quarter. The company reported a disappointing Q3 organic growth number of -2.7% and lowered its earnings outlook due to continued pressure on the organic growth outlook for its North American business. On the plus side the company maintained good momentum in key account wins.

During the quarter we increased exposure to Johnson & Johnson, Publicis, Centrica, Newmont Goldcorp, Brookfield Property and Sony. In addition, we wrote puts to gain exposure to Bunzl, Cisco, Eaton, Kingfisher, Prudential Financial and Schneider Electric. We exited several names including NTT Docomo, Biogen, Henkel, Everest Re and Kohls on a mixture of valuation grounds and revised investment cases.

Our expectations for long term returns, at a market level, remain subdued given the current starting point for valuations. In this context, we retain a cautious outlook, observing that Q3 corporate earnings declined 3.8% year over year for the S&P500. We expect a continuing deceleration in economic growth and as such believe that the outlook for corporate profits is deteriorating. This compares to Wall Street expectations for more than 10% EPS growth for the S&P 500 (ex-Financials) in 2020. We are focussed on a small subset of opportunities that continue to represent value in an expensive market and retain cash levels towards our upper limit. Patience is a virtue and a key asset for long term investment, and we prefer to wait for better valuations in order to substantially increase our market exposure.

Stock in Focus: Centrica

UK utility Centrica provides energy to consumers and businesses in the UK, Ireland and the United States with over 25 million customer accounts.

Centrica shares have struggled over the last two years as the company has faced a combination of internal and external pressures which have impacted earnings. Below we outline some of these pertinent issues, but more importantly, discuss the recent corporate initiatives and valuation measures that support our investment case.

What we estimate the company can earn off its current asset base has fallen around 20% compared to what we thought 2 years ago for 3 primary reasons. Firstly, following a review of energy tariffs in the UK, the regulator ordered a lower level of Tariff caps affecting around 3m of the company's UK customer accounts reducing profits by a gross 27% in the firm's largest division. These caps will be removed in 2023 at the earliest. Secondly the North American business has been affected by lower levels of energy price volatility, weather and a more competitive market. In time we think this can largely recover. And thirdly the firm's oil and gas reserves have been downgraded and the volume and price realisations have been lower than forecast. Despite a well-executed cost saving program this was insufficient to offset the earnings headwinds and the decision was taken by management to conduct a strategic review of the business.

Following the review, Centrica announced in July it intends to dispose of its Oil and Gas assets, sell its equity stake in UK Nuclear reactors and announced a significant further restructuring of the business. In addition, the Pension trustees ordered the company to increase payments into the pension by £175m per year for the next 6 years despite a year end 2018 pension deficit of only £28 million.

The magnitude of the payments was materially higher than our forecast and was particularly disappointing as we use a 2.5% discount rate and return on plan assets across all listed equities so had been using an adjustment as per our standard methodology but this proved less conservative than that of the Trustees.

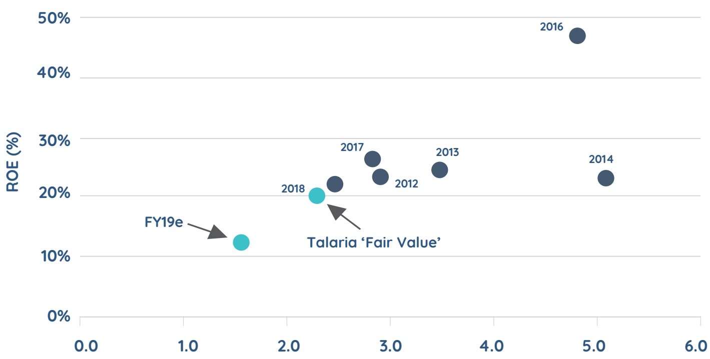
This order highlights the ongoing concern we have for many listed equities given current pension fund deficits and to our mind overly optimistic return assumptions – many of which are still in the region of 5-7%. The deficits are not debts that can be rolled over, nor are they at the discretion of a company. Rather all decisions around pension funding are taken by fully independent pension trustees answerable only to the pension fund members.

Despite Centrica shares falling sharply over the last two years, our process of staggering our entries and our lower-risk investment proess has significantly cushioned the loss on the position. This has been via a combination of option premium received for committing to buy the share, the buffer against loss embedded in our option strategy and company dividends received.

Looking forward we see value in Centrica shares amidst the strategic changes being undertaken by management which we view favourably. The business will be less capital intensive, largely eliminate off balance sheet liabilities, have a lower exposure to commodity price fluctuations and can resume growing the dividend which currently stands at a peer high 5.6%.

Our estimate of normalised earnings implies an operating margin of 3.6% which is 140bsp lower than the median of the last 10 years, and a return on equity of 20%. For this 20% return we are currently paying 20c over the book value of the companies' assets. Put another way equity holders on completion of the strategic program will have a less than a 6-year payback to own the entire equity of the firm.

Exhibit 3: Centrica: Return on Equity vs. Price/Book Value



Source: Company Data and Talaria

We think that the share can give a total return of over 100% from here and have been adding to the position.

Talaria Global Equity Fund - Hedged

Top 10 Holdings*

Company name	(% weight)
Johnson & Johnson	5.8%
Sanofi	4.7%
WPP	4.4%
Roche	4.2%
Bayer	4.2%
Centrica	4.0%
Land Securities	3.7%
McKesson	3.6%
Publicis	3.4%
Sumitomo Mitsui	3.4%

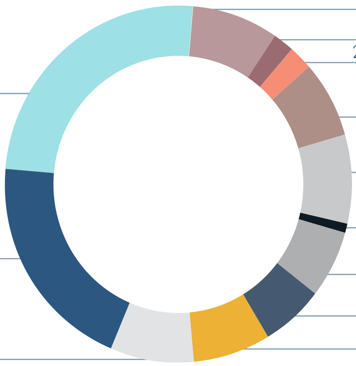
*Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

Performance at 31 December 2019

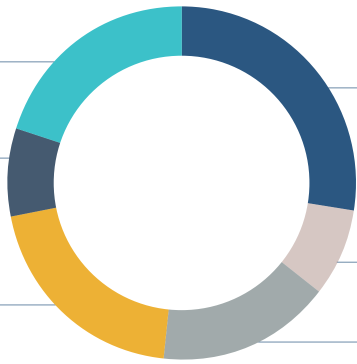
Period	Income Return	Growth Return	Total Return	Average Market Exposure
1 month	**0.00%**	1.87%	1.87%	58%
3 months	**0.00%**	4.32%	4.32%	57%
6 months	**0.00%**	6.45%	6.45%	56%
1 year	**0.00%**	15.82%	15.82%	58%
2 years p.a.	**2.48%**	3.27%	5.75%	61%
3 years p.a.	**4.73%**	1.81%	6.53%	60%
5 years p.a.	**5.04%**	0.43%	5.47%	61%
Since Inception p.a.	**6.14%**	1.51%	7.66%	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.

Quarterly distribution

Period	Cents per Units	Reinvestment price
December 2019	0.0000	n/a
September 2019	0.0000	n/a
June 2019	0.0000	n/a
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

Asset allocation	% weight
Global equity	53.4%
Cash – put option cover	27.0%
Cash	19.6%
Total	**100.0%**

Portfolio contributors#	Portfolio detractors#
Centrica	Publicis
Land Securities	Franklin Resources
Bayer	Brookfield
WPP	Asahi

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

Talaria Global Equity Fund - Wholesale

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, Hub24, Macquarie, Netwealth, Powerwrap	Distributions	Quarterly
		Minimum Investment	$5,000