TALARIA

Talaria Global Equity Fund - Hedged
Quarterly Update | December 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

The Reset

When it comes to investor psychology, the Ancient Greeks knew what they were talking about.

They categorised people as either hedgehogs or foxes. Foxes, they said, know many things whereas hedgehogs know one big thing.

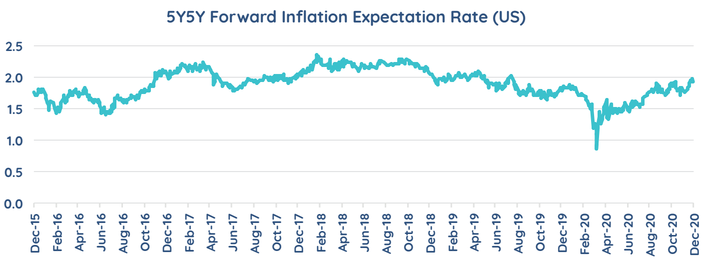
Early last year equity investors were all hedgehogs with the Coronavirus being the one big thing they knew.

As a result, between 20 February and 23 March, major indices went down by a third in the steepest decline of its size on record and the VIX index, a volatility measure of the S&P 500 known as the 'fear index', blew out to an all-time high.

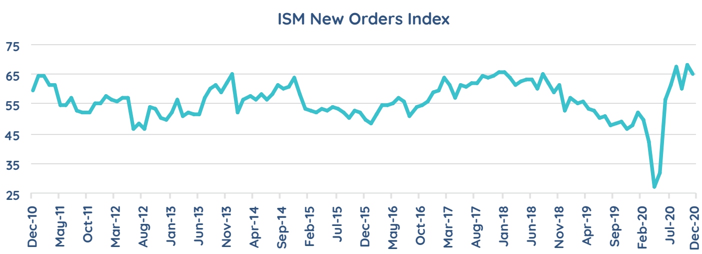
However, from the March market low there was a gradual transformation from hedgehog to fox culminating in Q4. Throughout this time many stocks rallied significantly and equity indices in the US went to all-time highs driven by a historic imbalance between a very small number of mega cap technology stocks and the rest. Investors woke up from the pandemic being the only thing that mattered, to it being one of many factors.

Of those that we would highlight, three were general and should persist into 2021:

- Monetary and fiscal stimulus was of unprecedented scale and accompanied by clear 'whatever it takes' commitments from authorities worldwide.
- The development of vaccines in record time meant it was possible to look through the disturbing short-term COVID data.
- As shown on the below charts, economic data began to recover and drove sentiment: showing investors arguably care less about current levels and more about changes of direction.



Source: Talaria, St Louis Federal Reserve



Source: Talaria, Bloomberg

The US election was a specific factor:

- Biden becoming President-elect eliminated one uncertainty, and markets hate uncertainty,
- While by the end of December there was no 'blue sweep', the early January elections have now given the Democrats control of the Senate, which will likely be more stimulatory for the US economy.

Most importantly, for all the terrible consequences of the pandemic, it had a major positive effect in ending a long running economic cycle while kicking off a new one.

While monetary and fiscal measures prevented economies completely falling off a cliff, they also offer an opportunity to invest in this year's early cycle economic growth and future expansion.

The equity advantage

In our view equities are a good way to approach this reset.

Cash and bonds as significant parts of a retirement portfolio are probably non-starters. Both have their places but interest rates on cash are very low and it would take an unusual view of the world to justify a heavy weighting. More importantly, as we discussed in our last quarterly, government bonds in developed markets are unattractive in that they:

- Tend to be expensive, offering little, no or negative yields to maturity.
- They are unlikely to offer the traditional hedging characteristics upon which the classic 60:40 portfolio (60% equities: 40% bonds) is based - on current valuations, investors cannot expect government bonds to provide positive returns when stock markets fall.
- And are vulnerable to inflation, the threat of which is the most credible since the early eighties.

Equities on the other hand represent regions, sectors, industries and companies that will, in many cases, see their cash flows grow with economic recovery.

Moreover, although it is a complicated dynamic, equities (particularly those valued as shorter duration ie shorter time to make back your investment or those representing companies with a degree of pricing power) can also benefit from inflation picking up.

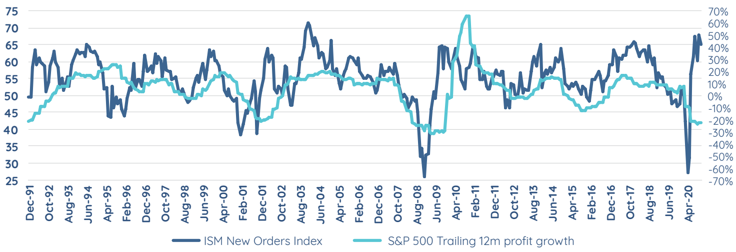
This means while an investor knows that growing inflation will reduce her real return from bonds, she might see an improvement in her return from shares if the companies the shares represent can grow cashflows in the inflationary environment.

Which equities?

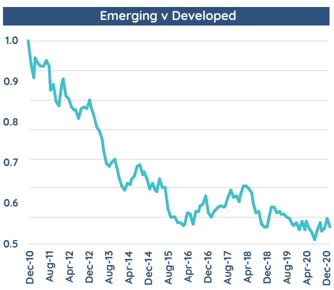
The problem for investors is working out which equities they should invest in when headline valuations are high, particularly in the US.

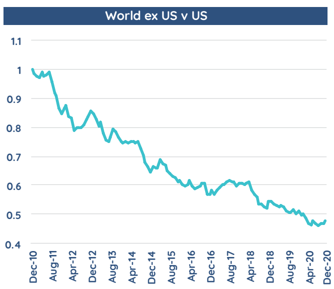
One answer might be found in returning to long established investment principles.

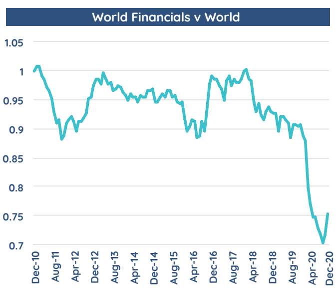
For example, one rule is to buy growth when growth is scarce and to buy value when there is growth for all. A variation on this theme is invest in value when there is a wide spread between value and growth, and invest in growth when that spread is narrow.

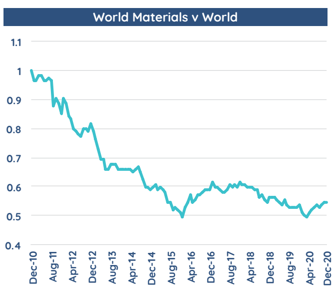


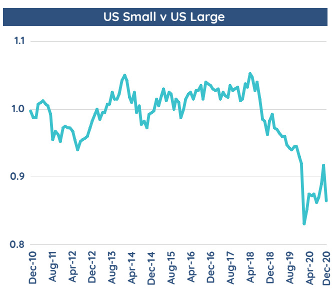
This arbitrage lens provides a guide to which areas of the market are interesting. Strictly speaking, arbitrage is a value-based strategy but relative performance is useful shorthand, with areas that have been weak for an extended period worthy of consideration as the below charts demonstrate (all charts below are 10-year price relative):

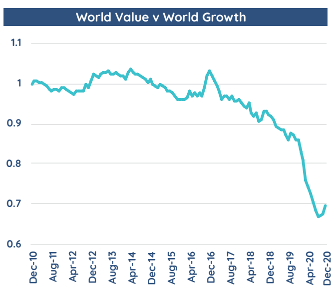












Sources: S&P Dow Jones Indices

As the charts show, one class of shares can underperform another for years: While in themselves these relationships are not timing tools, they are powerful indicators of when there are changes in economic and market cycles. In view of the reset, they are worth taking seriously.

Talaria and the reset

For much of the last decade, two main interconnected trends have been against global portfolio managers such as Talaria.

The first has been the outperformance of US equities versus the rest of the world. The second has been the outperformance of long duration equities given the tailwind of falling rates, particularly those of the US tech giants comprising the (in)famous FANMAGs.

Despite this, managing to our mandate we have consistently produced higher income, lower volatility and lower drawdowns and we have achieved this without concentrating our holdings in any one geography or in any one sector.

Given the variety of our holdings and as Q4 demonstrated, any change in the dominant US and tech equity outperformance trends can be materially positive for the portfolio.

It is also worth emphasising that these positives come from our bottom-up investment process - the portfolio is an outcome of the individual stocks our analysis identifies as attractive, rather than through any strategic convictions.

As this analysis is consistent regardless of region or sector, we tend towards broad exposure and towards those areas of the market that have been out of favour. Therefore we can benefit from reversals in any or all those relationships shown in the previous charts.

Since the March low we have expressed confidence in our holdings by committing high levels of cash to the market (table below):

2020	Maximum Total Cash Committed
April	85.32%
May	85.74%
June	97.20%
July	90.81%
August	85.54%
September	86.84%
October	92.00%
November	91.29%
December	90.31%

Source: Talaria

As we report delta (market exposure) at period ends, the degree to which we are making funds work for our investors often appears lower than it is. This is because of the way put options behave when the underlying equity is rising: as the price of the stock moves further above the strike at which we have sold the option, the less the theoretical exposure. Using options as tools for implementation of investment ideas has not stopped us managing the portfolio to be heavily committed to the market.

An upbeat outlook

We are excited about the year ahead because there are several things that seem to be falling into place;

- Our analysis has identified holdings across a broad range of regions and sectors; we believe the portfolio offers material upside.
- The pandemic has prompted an economic reset and there are signs that this could feed through into a change in the market cycle.
- We are exposed to several areas that have been out of favour, such a change may drive rotation that would work in our favour.
- Although volatility may continue to fall, we are still operating in an environment that is constructive when using options for implementation, which means we can offer a significant income component to total return, something that proves even more valuable if the capital return element of the asset class is lower than it has been in recent years.

As 2020 reminded us, there can be extraordinary, unexpected and unwelcome events that dominate everything. Even as we share our excitement about the portfolio in the year ahead, our investors should know that we take nothing for granted.

They should also know that we appreciate their support as we wish them a happy 2021.

December 2020 Quarterly Performance

The fourth quarter of 2020 was strong for global equity indices, with strong performances in previously out of favour sectors such as Energy and Financials. Although the near-term pandemic news was negative and questions remained unanswered after the US elections, investors looked ahead to what they saw as the bright side with vaccines and a Biden Presidency. Consensus at the end of the period seemed to be that 2021 would be a great year for stock markets; having been around for many market cycles, we take this as a reason to be cautious.

US stocks rose, with the S&P 500 up 11.7% over the quarter. The NASDAQ again outperformed the broader index, up 15.4%. US small caps stood out with a breathtaking increase of 30.8% in the S&P 600 Small Cap Index. Performance in Europe was better in Q4 after an anaemic year, with the Stoxx 600 up 10.5%. The best major European Index was France's CAC 40 up 15.6%. In Asia, Japan was the standout, with the Nikkei 225 rising 18.4% whilst China's Shanghai Composite was up 7.9%.

Energy, Financials and Consumer Discretionary were the best performing sectors globally. Sectors that underperformed were dominated by defensive areas of the market such as Consumer Staples, Healthcare and Utilities. Despite the strong quarter Energy had a very poor year, down 34.4%, with Financials the only other sector with 12-month negative performance, down 5.0%. As both sectors are value heavy, they are sectors that should be closely observed in the year ahead if the rotation really takes off.

The Australian Dollar was strong again this quarter, up 7.4% against the US Dollar, closing at US 76.9c. Crude oil prices were also strong over the period with the US benchmark WTI up more than 13% to USD 48.52. The broad Bloomberg commodities index was up some 10.0%, while US 10-Year government bond yields rose notably to 0.92% at the end of December versus 0.68% at the end of September 2020. Equity market volatility fell, with the VIX Index finishing the quarter at 22.8 having been 26.4 at the end of Q3.

Distributions: The Fund paid a December 2020 quarterly distribution of 1.40 cents per unit taking its 12-month income return to 6.71%.

The biggest stock contribution to the portfolio came from Ambev, which we focus on in the following section, followed by the oil and natural gas producer Canadian Natural Resources (CNQ). Since the mid-2014 oil price downturn, CNQ's management have proved themselves able to cut unit costs through efficiency and expansion. This has allowed the company to continue to pay their dividend, leaving the share on a prospective dividend yield of 5.5% at the end of a quarter when the stock rose some 50%. Given the strong reserve position the capex requirement is limited, and the majority of free cash flow should remain available for shareholder distributions or debt paydown.

Apart from CNQ, we have not had direct exposure to the energy sector for a considerable time. However, in Q4 we sold puts in French integrated oil major Total, which we think is the most attractive of those companies comprising Big Oil. With a relatively strong balance sheet offering security, based on conservative assumptions including zero dividend growth in perpetuity, the share's risk reward is attractive at current levels.

Another positive contributor to performance in the period was US commercial property owner Brookfield Property Partners (BPY). As we write, BPY has received a takeover offer from parent company Brookfield Asset Management (BAM), valuing each BPY share at $16.50. This is a 15% premium to the last traded price and values the group at 0.61x Book Value. We note that the shares are currently trading above the offer price at ~$17, which may indicate that investors believe BAM will have to provide a 'bump' for shareholders to accept the offer. We will study the proposal closely, though bids such as this are a mixed blessing. On the one hand they deliver a short sharp boost to the share price, on the other hand they may not fully realise what we believe should be the upside.

As well as gaining exposure to Total, we sold puts in Mexican holding company Femsa and Italian Bank Intesa Sanpaulo.

Femsa has an attractive set of assets including material holdings in listed entities Coca-Cola, Femsa and Heineken NV. Given that there is a market value for these holdings, we can calculate an implied value for the national chain of small format retail stores that it also owns. This retail unit has headroom to grow for a number of years and can thus deploy capital on which it earns attractive rates of return. Taking this into account, we believe the share to be materially undervalued.

Intesa's share is attractive for the diversified revenues which the bank generates through asset management and insurance in addition to its more traditional banking. The group has good provisions cover for the loan book and the balance sheet is well capitalised. Our analysis is that future dividends will on their own come close to or even exceed our required rate of return, with the potential of a narrowing in the discount to book value an added potential upside.

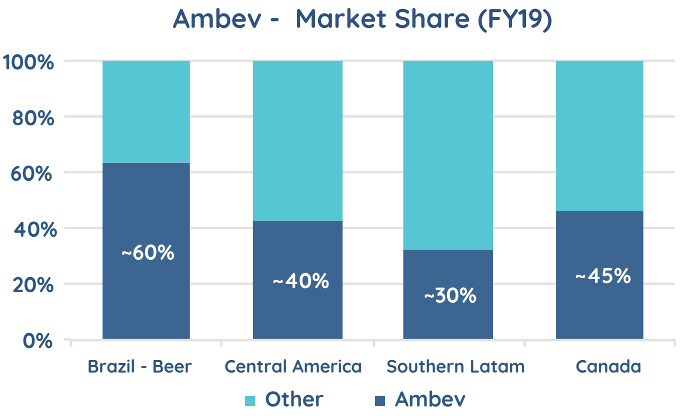
2020 has been a year for superlatives in relation to financial markets, culminating in the so-called 'everything rally'. For our part, we especially note that consensus across global equity markets going into 2021 is as tight and uniformly positive as we can remember heading into a new year. As such it's worth repeating our earlier statement that for those of us that have been through many market cycles, this is a reason to be cautious.

Stock in Focus – Ambev

Ambev is one of the largest beer producers worldwide and Latin America's biggest brewer. It will generate more than 90% of its 2020 forecast USD 11.2bn of sales from beer, with the balance from non-alcoholic beverages. Brazil accounts for some 55% of revenues, with the rest from Latin America – South (19%), Central America and the Caribbean (13%) and Canada (13%). Roughly speaking, the geographical breakdown of profits mirrors the revenue split.

Ambev has leading or near leading market positions wherever it operates, underpinned through a diversified number of products such as Skol, Brahma, Antarctica, and Bohemia.

Scale has helped Ambev to generate high returns (2019 ROE 20%), but it is not a case of scale alone. Management have also proved themselves adept at defending margins (2019 operating margin 29.6%) in the face of structural and cyclical challenges and in efficiently allocating capital without underinvesting. The balance sheet is strong, and the group will report net cash again this year.

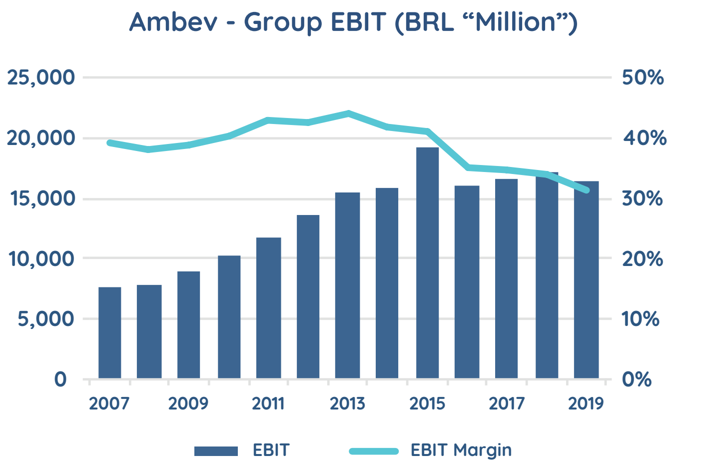


Source: Company Reports, Talaria est.

With more than half of Ambev's domestic sales generated through the on-trade like restaurants, bars and hotels the negative impact of the pandemic has resulted at times in the shutdown of its outlets and in a sharp reduction in the mobility of its customers.

However, it has not been all bad news. Volumes in the last two quarters have surprised on the upside as the recently appointed CEO has led a pragmatic approach to pricing, while capitalising on the breadth of their offerings including the newly launched, market share winning Skol Duplo Malte. Scale and brand recognition have also worked in the group's favour, as the vast logistics operation has proved reliable despite the COVID-related challenges, and customers have sought the comfort of big-name products.

If Ambev can maintain volume growth then operating leverage and an increasingly favourable product mix can deliver margin expansion and a sharp recovery in earnings. Risks to this scenario include the reduction in consumer support by the Brazilian government and a return to greater competitiveness by number three brewer Petropolis (ca. 10% market share).



Source: Company Reports, MS

Looking at normalised earnings based on conservative assumptions, we consider the valuation attractive with downside of perhaps as little as 10% and upside of as much as 30%. However, if our investment thesis proves correct, the stock should compound up in our favour for a number of years and deliver much greater returns.

Talaria Global Equity Fund - Hedged

Top 10 Holdings*

Company name	(% weight)
Total	5.0%
Prudential	4.5%
McKesson	4.3%
Ambev	4.3%
Roche	4.1%
Intesa Sanpaolo	4.0%
Bayer	3.9%
Asahi Group	3.7%
Canadian Natural Resources	3.1%
Sanofi	2.9%

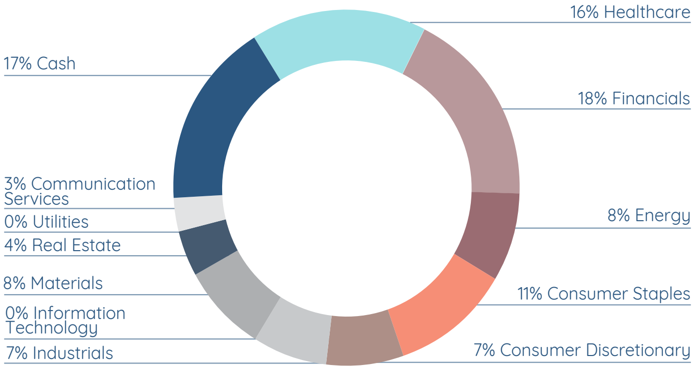
*Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

Performance at 31 December 2020

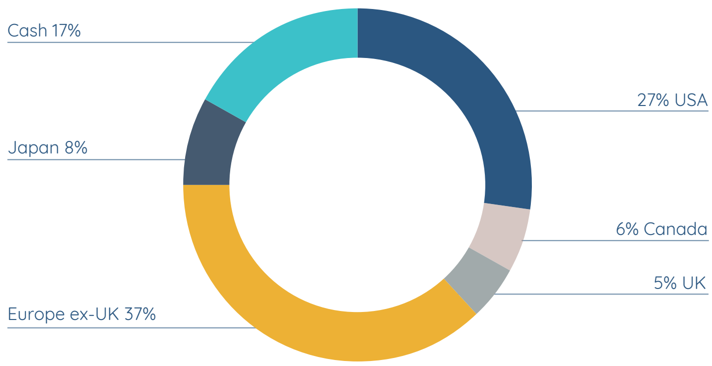
Period	Income Return	Growth Return	Total Return	Average Market Exposure
1 month	**1.39%**	0.93%	2.32%	53%
3 months	**1.50%**	8.73%	10.23%	53%
6 months	**3.15%**	8.80%	11.94%	50%
1 year	**6.71%**	-7.45%	-0.73%	53%
2 years p.a.	**3.97%**	-0.43%	3.54%	58%
3 years p.a.	**5.48%**	-0.22%	5.26%	59%
5 years p.a.	**6.43%**	-1.55%	4.88%	59%
7 years p.a.	**6.22%**	0.35%	6.57%	60%
Since Inception p.a.	**6.17%**	-0.72%	5.46%	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
December 2020	1.4000	$1.0177
September 2020	1.4000	$0.9359
June 2020	3.9668	$0.9354
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	45.0%
Cash – put option cover	37.7%
Cash	17.3%
Total	**100.0%**

Portfolio contributors#	Portfolio detractors#
Ambev	Bayer
Canadian Natural Resources	Kingfisher
Lear	Sanofi
Prudential	

[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	Asgard, Ausmaq, BT Wrap, BT Panorama, Hub24, Linear, Netwealth, Powerwrap, Praemium	**Distributions**	Quarterly
		Minimum Investment	$5,000