Talaria Global Equity Fund (Managed Fund)

Quarterly Update June 2022

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FUND MANAGER OF THE YEAR 2018
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Investment Insights

Doing nothing is a bad choice

This has been the worst start to the year for global equity markets since before World War II. Few portfolios have come through without losses; savers are understandably nervous. Many investors in the fund have asked us what they might expect for the next year or more. The question is not unusual, but the urgency accompanying it is.

For years the default approach to global equity investing has been to buy US shares, especially US technology shares, and to buy the dips. In the decade to close of business 31 December 2021, the S&P 500 delivered a total return of 17% per annum. At that rate, it takes just over four years for money to double.

Now, however, this US-centric approach is not working. In the first half of this year, the US Tech heavy Nasdaq index was down 30% and the S&P 500 was off 21%. For investors who have been conditioned by the way markets have behaved since the Global Financial Crisis (GFC), the Pavlovian response to this weakness is to do nothing. They have been through this before and they have learned it pays to wait.

We explain why doing nothing is a bad choice by focusing on the biggest region for world equities. US shares are still expensive, US leading economic indicators are on the way down, corporate profits will head in the same direction, and inflation means monetary policy is no longer the handy lifeguard ready to rescue assets struggling underwater.

We consider what might turn the market around and when that turnaround might occur. History says that there are only two things that will do the job, and both all but coincide with, rather than run ahead of, the market low. The first of these is the bottoming of leading economic indicators. The second is a change to a supportive central bank policy. Both are a long way off, which means it is not too late to act.

Finally, we discuss risk management and rebalancing, particularly in a bear market rally. We think it is right to prefer assets with low correlation to the equity market and return your capital sooner rather than later. We also compare time-weighted returns with money weighted returns. The former shows performance over a period, the latter shows the experience of the money in aggregate during that period. The considerable difference, worse for the money in aggregate, brings home why chasing the next winner is dangerous.

Performance of global equities in context

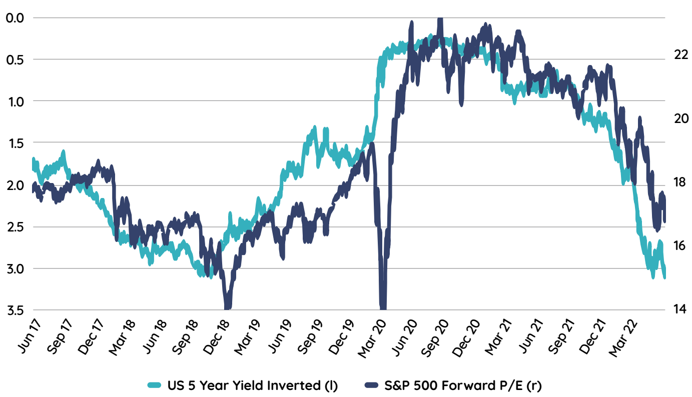
From the end of the 2007-2009 GFC, equity investors bought into a form of financial American exceptionalism. They backed the idea that US stocks are different and better than those in the rest of the world. And if they thought American shares were exceptional, they believed technology shares to be the best of them. So much capital flowed west that US shares in general and US Tech shares in particular became by far the dominant force in world equities.

The popularity of the US with investors has not saved it from this year's sell-off. US stock markets are down along with the rest of the world. In the year to the end of June, Nasdaq, the tech heavy index, was off about 30% and was the worst performing major world index. The S&P 500 did better but was still among the worst when it comes to the losers: S&P 500 -21%, Euro STOXX 50 -20%, FTSE 100 -3%, Nikkei 225 -8%, Shanghai Composite -7% (FactSet, local currency returns).

Higher interest rates the main driver to lower equities this year

What has primarily driven US share prices down so far this year is the rise in interest rates and anticipation of the Fed shrinking its balance sheet. Higher rates make cash flows far in the future less valuable and cut the amount investors will pay for them. This is particularly a problem for US indices with big tech exposure. With rates low, tech shares have been attractive because it cost little to wait for their profits to come through. With rates rising, the waiting becomes increasingly painful.

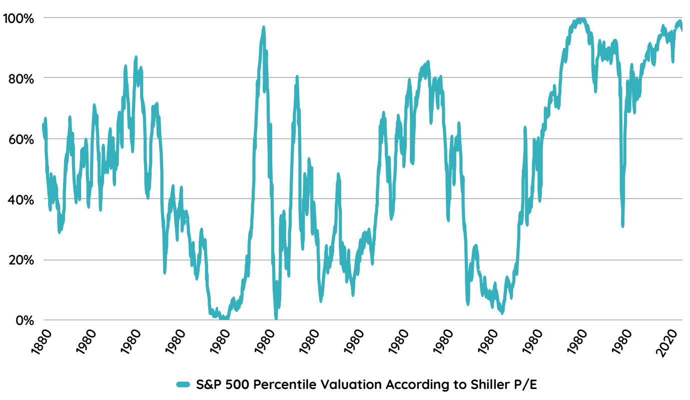
Interest rates weighing on P/E



Source: Bloomberg

Despite the weakness in stock markets, US shares are still costly. The much-watched Shiller PE, a valuation measure that adjusts earnings for inflation and smooths out cycles, was 30.8x for the S&P 500 at the end of May down from a near peak of 38.3x at the end of 2021. On its own, that fall in the earnings multiple, known as a de-rating, explains the fall in the index. But for all that the multiple has adjusted, in more than 140 years savers have rarely been more in love with the index (chart on next page). This would be a problem anyway, but it is made worse by an impending economic slowdown.

S&P has only been more expensive 4% of the time



Source: Shiller

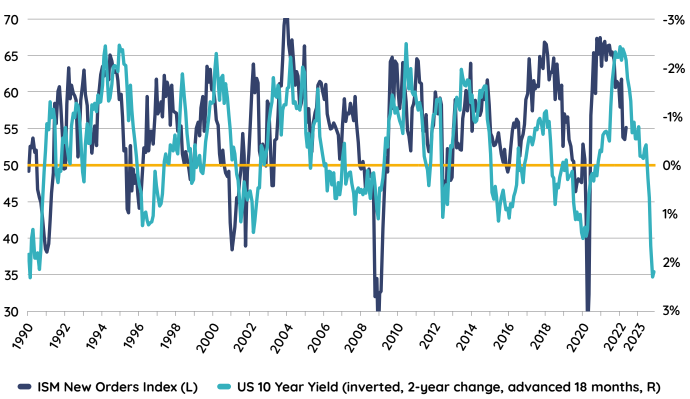
Expect an economic slowdown leading to lower corporate profitability

Unlike physics, economics is not subject to hard laws of science. If a calculator falls from a desk, we know it is heading towards the floor. Certainty in economics is not like this, it is slippery, hence the old joke: "you could lay all the economists in the world end to end and they would still not reach a conclusion".

Probabilistic thinking helps and there are relationships between different economic indicators that make events more or less likely. Some of these should make equity investors nervous because they precede an economic slowdown and the fall in corporate profitability that goes with it.

For example, the direction and level of US 10-year bond yields has meaningful predictive power when it comes to the Institute of Supply Managers' (ISM) New Orders Index (a widely followed indicator of economic health). As the chart below shows, a rise in yields precedes a fall in ISM New Orders by about 18 months. This is because cheaper money stimulates economic activity with a lag, and more costly money slows activity with a lag.

Economic slowdown ahead



Source: ISM, Bloomberg

The ISM New Orders Index itself has a relationship with the profitability of US businesses. As the chart below shows, the direction and level of the ISM tends to run ahead of moves in corporate earnings by about three months. Looking at the charts above and below together, US earnings are like a downhill skier just out of the gate and an awfully long way from the foot of the mountain. If the relationship holds, earnings could be 35 percent below current forecasts for 2023. That may sound extreme but would only take earnings back to 2019's then record level.

ISM slowdown leads to lower corporate profit growth

Source: ISM, Bloomberg

Monetary policy unlikely to come to the rescue

In previous slowdowns monetary authorities have often come to the rescue by loosening financial conditions. This has allowed investors to look past lower profits to a recovery in the business cycle. A recent example of this was the Fed pivot in December 2018 that allowed markets to rally despite the ISM not troughing until mid-2019.

But central bankers know their history. Caught, as they are, between bringing down inflation and not undermining economic growth, they will prioritise inflation. The US Federal Reserve will try to avoid out of control inflation expectations and a consequent wage spiral. They do not want a return to the 1970s and what is beginning to happen in, for example, the UK. As we write, rail workers there are striking for 10% pay rises which they say is in line with rising prices. And large accountancy firm PWC announced at the end of June that it has given at least a 7% pay rise to 70% of its workers. This sort of news raises the spectre of the corrosive cycle of higher wages, more demand, higher prices, higher wages, more demand, and so on.

And the Fed has a real fight on its hands. Its target is an average inflation rate of 2% over time. This is around four percentage points below the May core Consumer Price Index (CPI) of 6.0%. The headline CPI, which includes food and energy and is more volatile than the Core was 8.6%.

Politicians, monetary authorities, and the media have made much of the impact of disrupted supply chains and the war in Ukraine as drivers of high inflation. Unquestionably both are having a major impact, but they are far from the whole story.

Firstly, as mentioned, the core CPI excludes food and energy, two areas that have been among those most affected by supply chains and the war. Secondly, 72% of core inflation is made up of Services, which are less affected by supply chains, with Shelter (housing costs) accounting for 41% of the whole.

It is wages that drive Services, not supply chains, and with the US labour market as tight as it is, the risk is to the upside. Eventually higher rates should lead to job destruction but that looks a long way off when job openings are materially greater than the number of unemployed. The latest figures from the US Bureau of Labour Statistics shows end April 2022 job openings were 11.4 million, leaving almost two jobs for each person seeking employment.

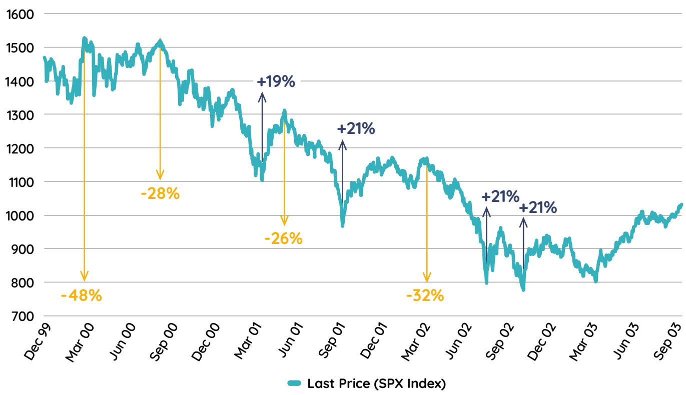
Judging when the market sell-off is over

Simple as it may sound, history says there are probably just two things that will signal a bottom in equity markets. The first is when leading economic indicators trough, allowing investors to anticipate a recovery in the economy and corporate earnings. The second is when central banks change to policies that support capital markets.

As we have discussed, neither seem to be close. If normal relationships hold, there is no reason to expect leading economic indicators to trough until the second half of 2023. And central banks need to control inflation before they can even consider changing monetary policy. We would note that every market bottom since 1950 has occurred within a month of one or both of these. In the meantime, investors need to take steps to protect capital.

What this does not rule out are occasional strong recoveries in share prices. Bear market rallies, when indices go up against the long-term downtrend, can be useful opportunities to rebalance. In the chart below we show the 1999 – 2003 bear market which saw the S&P 500 fall nearly 50% but within which there four rallies of about 20%.

Nothing goes down in a straight line



Source: Bloomberg

Rule number one, don't lose money

This year's moves in equities have rammed home the importance of risk management. In what follows we want to make three suggestions: avoid assets that magnify market moves, own assets with shorter rather than longer payback periods, and select funds that consistently deliver positive results, the key word here being consistently.

1. Avoid assets that magnify market moves

As the admittedly over-quoted Warren Buffett has said: "The first rule of investment is don't lose money, and the second rule is don't forget the first rule." He has a way of reducing wisdom to its essence.

The maths behind his rules is stark. An investor with $100 in the Nasdaq as of 1 January 2022 needs a 43% recovery to breakeven given the 30% fall year-to-date. The table below shows more examples.

The maths of losing money

Portfolio loss	Gain needed in order to break even
-10%	+11%
-20%	+25%
-30%	+43%
-40%	+67%
-50%	+100%
-60%	+150%
-70%	+233%
-80%	+400%
-90%	+900%

If you believe the market can fall further, it makes sense to avoid being in assets that move in the same direction as the market and with the same or greater magnitude. The shorthand for this is to prefer low over high beta. High beta at times has its place, but today is anything but one of those times.

2. Own assets with shorter rather than longer payback periods

In a high inflation environment, it pays to own assets that allow you to recoup your investment sooner rather than later. One of the reasons value stocks have performed well over the last year is because they do exactly that.

High yielding assets also fit the bill. As we discussed in our last quarterly, investors would be well served focusing on income as a component of returns. In our world, of course, income is not just interest on cash and dividends but also option premium.

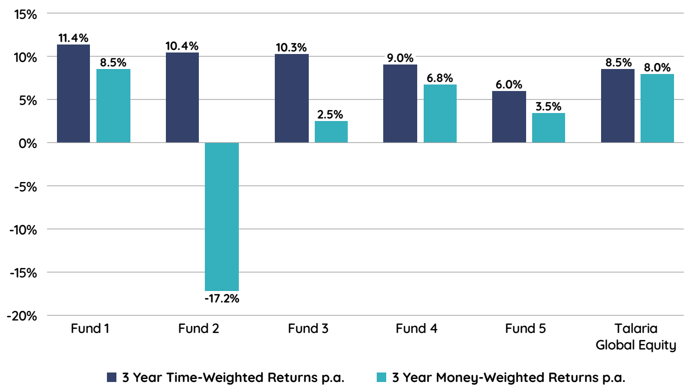
3. Do not try to pick the next fund winner

The standard way to look at a fund's performance is to calculate the average annual return over a given period assuming the money was invested at the start of the period. Looking at 1, 3, 6 months' and 1,3,5,7, and 10 years' performance gives a sense of how a fund has done in absolute terms, its trend and how it compares with competing assets.

However, this methodology fails to reflect the experience that most investors have in owning a fund. There are ways to show this. For example, the money weighted average return considers the flow of money into and out of a fund over the period and thus measures the return for the money in aggregate.

In the chart below we show the usual way of reporting performance for Talaria, and for the biggest global equity asset gatherers in Australia over the last three years. We also show the money weighted performance.

The value of consistency



Source: Morningstar

We would highlight three points:

- The second-best performer of the group in time-weighted return is the worst in money-weighted. In fact, this does not do the position justice - the bulk of money owning one of the best performers was down over 17% on their investment at the end of May. They own a fund that is up 10.4% p.a. over the last three years and yet their experience of that ownership has been to lose materially.
- Although the above example is extreme, in all cases the money-weighted performance is below the time-weighted performance. We are bound to point out that the smallest difference is Talaria's.
- These data show the importance of low volatility and consistency of returns. With a fund that consistently moves up and down a lot, timing matters so much more than with a fund that moves in a narrower range.

Conclusion

For the artistically minded, the picture we have painted is more Bacon than Da Vinci, more unsettling than beautiful.

Despite the sell-off, the world's biggest stock market is still expensive, inflation prevents a change to more accommodative monetary policies, and corporate earnings are about to head south. Until the Fed changes to a supportive stance or leading economic indicators bottom, it is hard to see an end to the downward pressure on US stocks.

The good news is that there are ways to protect and even grow capital by owning shares with low beta, short payback periods and consistent performance. Our mantra remains, prioritise regions other than the US and sectors other than tech. Focus on value and on income as a component of return. Unless you are already there, doing nothing is a bad option, but by acting you can paint a prettier picture.

June 2022 Quarterly Performance

Major equity markets entered bear market territory this quarter extending their poor start to the year. Persistently high inflation, increasingly hawkish central banks and creeping expectations of a global slowdown have weighed strongly on the most expensive and heavily owned indices. Despite the weakness, the medium-term outlook for equities continues to be challenging given still high absolute valuations and inflation-induced rate rises into a rapidly decelerating economic environment.

Weakness across most equity markets continued in the second quarter. The tech heavy NASDAQ has led the decline with a whopping 22.4% drop followed by the broader based but still expensive S&P500 with a 16.4% drop. Europe was down with both the German DAX and French CAC falling by 11.3% and 11.1%, respectively. Japan fared better in relative terms with the Nikkei falling just 5.1%, helped by the weakening yen and still accommodative central bank policy. China's Shanghai Composite was the only major index in the green, climbing 4.5% on the back of easing COVID restrictions and rumours of fiscal stimulus.

Despite these challenging market conditions Talaria's Global Equity Fund delivered a strong quarter, gaining 2.49% while maintaining substantially lower market risk.

Distributions: The Fund paid a June 2022 quarterly distribution of 11.56 cents per unit taking its 12-month income return to 7.35%.

With global equity benchmarks heavily in the red, it was no surprise to see weakness across all major market sectors. Low beta sectors performed best with Consumer Staples, Healthcare and Utilities delivering between negative 7% and 8%. At the other extreme were cyclical sectors with Consumer Discretionary delivering the largest slide of over 24% with notable profit warnings from high profile names (Tesla, Amazon, and Target all down 38%, 35% and 34% this quarter, respectively). Tech, Telcos and Materials all fell by around 20% while Financials and Industrials declined by 17%. Energy was the exception amongst cyclicals once again delivering a drop of just 5.9%, still helped by elevated oil and gas prices.

Fears of weakening global demand have weighed on commodity prices with the Bloomberg Commodity Index coming off the highs reached in May and down 5.3% for the quarter. The story is more nuanced for benchmark bond yields where inflationary pressures and hawkish central bank policy are starting to see an offset from weakening demand outlook – the US 10-yr ended at 3.01%, up 67bps since March but lower than a peak of 3.47% reached in mid-June. The AUD finished 7.7% lower than the USD on the back of softer commodities outlook and steeper US interest rates. The VIX was up 15 points to 28.7 reflecting the rising levels of uncertainty.

Our holding in Sanofi, a French drugmaker, was the biggest contributor to performance during the quarter. The company delivered a solid Q1 result, exceeded market expectations and reiterated its FY22 guidance bucking the trend of profit warnings across companies in the broader market. Steady and predictable future earnings, low beta and low valuation provide support for Sanofi shares, and we continued adding to our exposure.

Alibaba, a Chinese eCommerce giant, was another large contributor to performance. Easing pressure from the Chinese government crackdown on tech companies coupled with talks of fiscal stimulus provided respite from the heavy selloff seen throughout 2021 and early 2022. We continue to see value in Alibaba with the company delivering an 8% FCF yield even after adjusting for a conservative margin outlook.

The biggest detractor for our fund this quarter was Wheaton Precious Metals (WPM), a Canadian precious metals (gold and silver) streaming company. A sharp increase in real interest rates is the culprit with US 10-year Treasury Inflation Protected Securities (TIPS) up 116bps. If real rates rise, the relative attractiveness of gold and silver falls since both assets never yield any actual interest. That said, we still like WPM – as a streaming company it has very low capital intensity, high margins and direct exposure to the price of gold or silver.

During the quarter, the Fund exited its positions in German household and personal products manufacturer Henkel, Canadian oil producer CNQ, American apparel maker Hanesbrands, American gold miner Newmont, British real estate company Landsec and Israeli drug maker Teva. The fund also initiated new positions in American biotech Gilead, Dutch insurer NN group (see Stock in Focus) and American chipmaker Intel (see next paragraph).

Intel is a top three global chipmaker that operates in an industry with extremely high barriers to entry (the other two major players are TSMC and Samsung, both based in Asia). Intel dominated the chipmaking industry for decades but has fallen behind TSMC and Samsung in the more recent past. This is especially true for production of the most sophisticated, cutting-edge chips.

That said, Intel has seen a significant drop in its value and the shares are now offering an attractive entry point. Enterprise Value/Invested Capital (EV/IC) has dropped from a peak of over 2.5x a few years ago down to just 1x today. Heavy investment in chip manufacturing facilities ("fabs") over the next five years will see Intel's capital base grow from $160bn to $200bn by 2025 (0.8x EV/IC).

Even if Intel is unable to regain the crown of producing the most advanced chips, it can still deliver an 11% ROIC. Geopolitical pressures (TSMC is based in Taiwan, an island country under threat from China) and a structural supply chain rethink (re-shoring and near-shoring to the US and its allies) both provide further positive optionality.

The Fund initiated a position by selling puts at $32.5, 13% lower than Intel's closing price at the end of the quarter.

Stock in focus: NN Group

NN is the largest life insurer in the Netherlands and a new holding for the fund. It has a low-cost business model with limited exposure to inflation and the business cycle. We like its conservative accounting and solid capital position.

NN has delivered consistent returns to shareholders over the years and continues to promise an ongoing 8-10%per annum return through dividends and share buy-backs even before any growth or revaluation benefits.

Business overview

NN Group was spun out as an independent company in a 2014 Initial Public Offering (IPO). Prior to its listing NN was part of ING Group, a Dutch bank.

Roughly half of its EUR2bn in annual operating earnings is generated by the Dutch Life Insurance business. Another 45% is evenly split between a Dutch Non-life insurance, a European Life Insurance and a Japanese Life insurance business. NN also operates a retail bank in the Netherlands that represents just over five percent of operating earnings.

A business with advantages

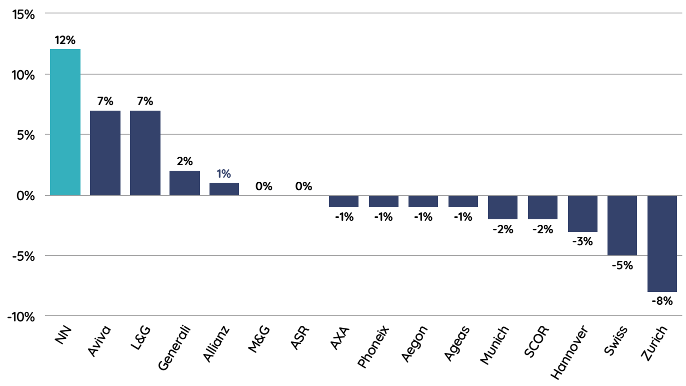
NN has long-term structural advantages over its peers and the overall market. It is particularly strong in three areas – market leadership, lower exposure to the economic cycle and effective cost control.

Take market leadership first. NN is the clear leader in Dutch life insurance with a 40% share. It has steadily increased its share over the years by both growing organically and via acquisitions. The market is concentrated now with over 90% controlled by the top five players. This is significant because the insurance business is sticky, and incumbency gives substantial advantage in exercising pricing power while maintaining market share.

NN also holds a top two position in the Dutch non-life business, growing rapidly from 10% in 2018 to over 20% currently, and a top three in European Life (with a focus on nine countries across Central and Eastern Europe and no exposure to Russia/Ukraine).

Lower exposure to the economic cycle is another structural advantage. Inflation has been a major obstacle for the global economy in 2022 but for NN it is a potential positive. Insurance premiums can quickly reprice up in line with inflation in what is a rational market. And over time, higher inflation could feed into higher nominal investment yields that drive earnings' growth. Finally, many insurance companies benefit from credit risk spreads widening which could be advantageous in a turbulent macro environment. NN group has most to gain compared to European peers, with a 50bps wider spreads contributing to a 12% increase in capital (see exhibit 1).

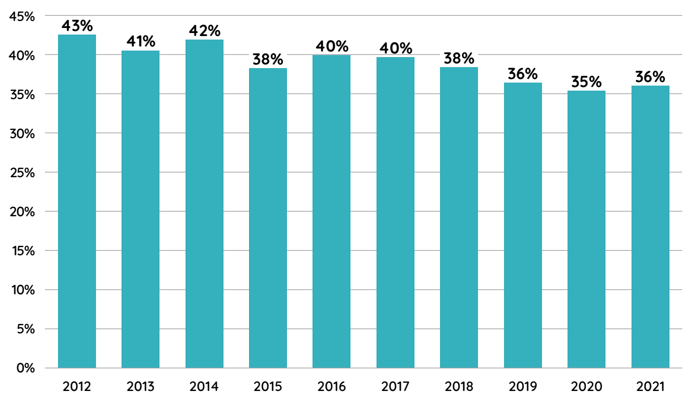
Exhibit 1: Sensitivity to 50bps credit spread widening



Source: Company Filings, Talaria

The third structural advantage is NN's ability to control costs. At 36% in its latest filing the company has one of the lowest cost-to-income ratios in the industry. Management has demonstrated its ability to improve the ratio over the years and ultimately help improve the profitability of the business (see Exhibit 2). With a ratio that low, the company is guaranteed to be profitable in most economic scenarios.

Exhibit 2: NN cost-to-income ratio



Source: Company Filings

Strong Capital Position

The aftermath of the Global Financial Crisis brought in sweeping new regulations, substantially restricting financial activities of banks and other financial companies. As a result, regulators today hold the key to how profitable a financial business is and ultimately how much capital it can return to its shareholders. Here too NN stands out favourably.

Its Solvency II (SII) ratio, the main metric that determines the amount of capital an insurance company must hold against its liabilities, is sitting at a healthy 213%. Anything over 200% is considered ideal and allows the company to carry an A+ to AA credit rating.

We have also been pleased to see NN's conservative capital accounting. It has seen positive revaluations in its portfolio in every single year since it went public with an average annual gain of EUR450m which is equivalent to 3% of market cap per annum. While our investment case does not price in any further positive revaluations, we see it as a positive signal on the company's accounting policies.

Finally, management's preferred metric to judge operating performance and potential capital return is Operating Capital Generation (OCG). This widely used insurance metric measures the capital surplus generated in a period from the operating business. Put more simply, OCG is a close approximation of the Free Cash Flow. The company has almost doubled its OCG from EUR 870m to EUR 1.6bn in the past six years. It targets EUR 1.5bn in 2023 and a mid-single digit annual growth thereafter.

Shareholder returns

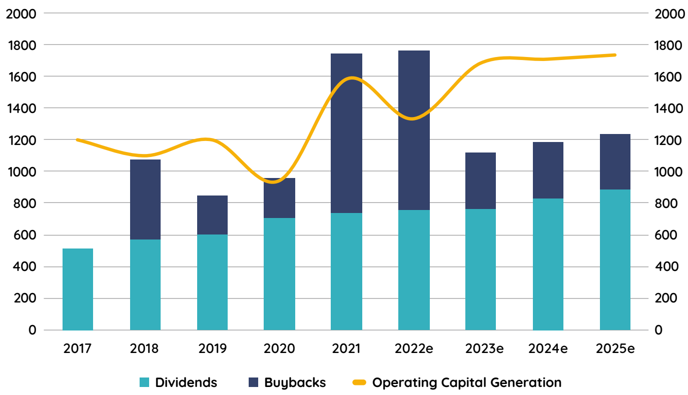
NN trades on 0.4x Price to Book (P/B) and its annual OCG is over 10% of market capitalisation with a strong commitment from management to return most of it back to shareholders. This is an attractive value proposition.

Management has demonstrated capital discipline over the years, growing the dividend per share from EUR 1.55 to EUR 2.65 (currently a ca. 5.5% yield) in the past seven years with commitment to further growth in line with annual OCG.

Management has also simplified the business by selling the Asset Management Division earlier in the year. It has returned all the excess capital generated by the disposal via share buybacks and has committed to a total of EUR 1bn this year (~7% of market cap). Thereafter it has guided to EUR350m annually (~2.5%), see exhibit 3.

When we put all this together, the company's ability to deliver 8%+ of shareholder returns per annum is not contingent on anything improving from here.

Exhibit 3: NN Operating Capital Generation (OCG) vs Dividends and Buybacks (EUR m)



Source: Company filings, Talaria estimates

Risks

There are two key risks to the business – the risk of credit losses from investments within the insurance business and low profitability from depressed interest rates.

We feel comfortable with NN's asset base as most assets held are well above investment grade, its holdings are well diversified, and the company has demonstrated a strong track record of conservative balance sheet management. This position is further strengthened with a solid SII capital ratio and an A+ to AA credit rating.

An undemanding valuation and a low-cost base provide protection to the share's downside. Even in a stress scenario of investment spreads falling from the current level of 88bps to 68bps, the dividend per share may stagnate but should not disappear. In these circumstances the dividend yield would remain close to 6% while the book value per share would still grow.

Talaria Global Equity Fund (Managed Fund)

Top 10 Holdings*

Company name	(% weight)
Alibaba	5.9%
Novartis	5.8%
Roche	5.7%
Johnson & Johnson	5.3%
Sodexo	5.1%
Everest Re	5.0%
Sanofi	5.0%
Secom	4.8%
Femsa	4.5%
Gilead	4.2%

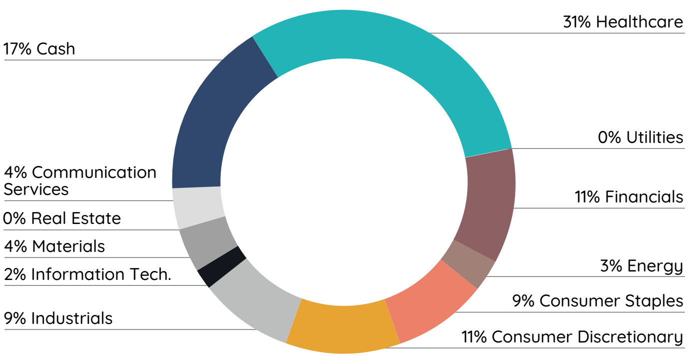
* Weightings include option positions held and cash backing put options. It assumes that put options will be exercised.

Performance at 30 June 2022

Period	Income Return	Growth Return	Total Return	Average Market Exposure
1 month	2.43%	-2.19%	0.24%	55%
3 months	2.49%	0.00%	2.49%	53%
6 months	4.03%	-1.40%	2.62%	55%
1 year	7.35%	1.76%	9.11%	57%
3 years p.a.	7.70%	0.02%	7.72%	55%
5 years p.a.	7.97%	0.17%	8.14%	58%
7 years p.a.	7.52%	-1.01%	6.51%	59%
Since Inception p.a.	7.44%	-0.53%	6.91%	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



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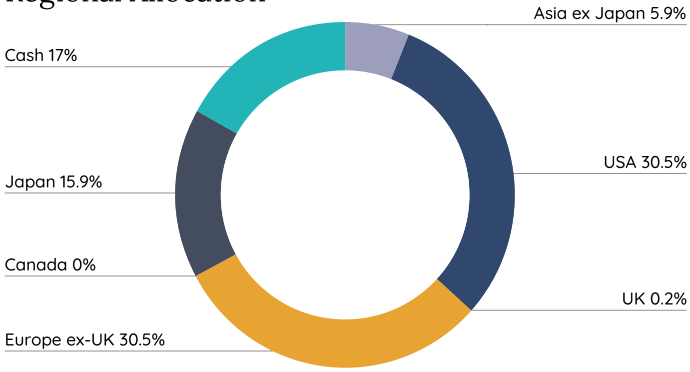
Regional Allocation



Quarterly distribution

Period	Cents per Units	Reinvestment price
June 2022	11.5642	$4.6553
March 2022	7.250	$4.6553
December 2021	7.000	$4.7216
September 2021	7.000	$4.6565
June 2021	10.766	$4.5745
March 2021	6.000	$4.427
December 2020	6.000	$4.2305
September 2020	6.250	$4.097
June 2020	18.246	$4.1645

Asset allocation	% weight
Global equity	40.5%
Cash – put option cover	42.5%
Cash	17.1%
Total	**100.0%**

Portfolio contributors	Portfolio detractors
Ali Baba	Wheaton
Johnson & Johnson	Bayer
Sumitomo Mitsui	Ambev
McKesson	Femsa

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

Talaria Global Equity Fund (Managed Fund)

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	**Exit Price**	$4.7614 (30 Jun 2022)
		Buy / Sell Spread	0.20% / 0.20%
Platform Availability	AMP North, Asgard, Ausmaq, BT Wrap/Panorama, CFS Firstwrap, CFS FirstChoice, Escala, Evans & Partners, Freedom of Choice, Hub24, IOOF, Linear, Macquarie, Mason Stevens, MLC Wrap, MLC Navigator, Morgan Stanley, Netwealth, Powerwrap, Praemium, Xplore Wealth	**Distributions**	Quarterly
		Minimum Investment	$5,000