Somerston Multi Asset Fund (the Fund)

Investment Letter No.2 – September 2017

The Somerston Multi Asset Fund (US0 class) returned 0.6% over the quarter. Over the same period the MSCI World Equity Index (local currency) appreciated 3.9% and the Barclays Developed Sovereign Total Return Bond Index was 0.2% higher. Through the quarter, the Fund had average equity and bond allocations of 64% and 43% respectively.

Performance (%) US0 Class

	Jan	Feb	March	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Year
2017				0.9	2.7	-1.0	0.6	0.6	-0.5				3.2

Top Ten Core Equity Holdings 30 Sep 2017

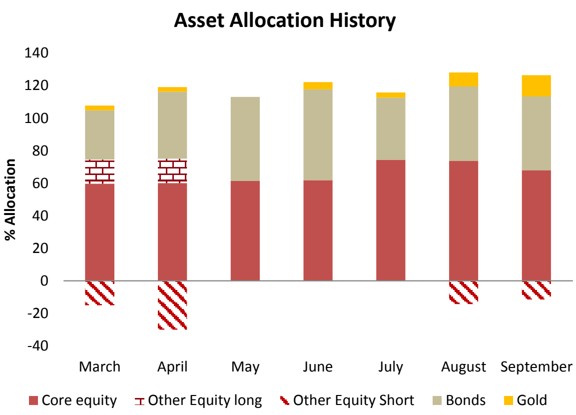
Name	% Fund
Blackrock	5.3%
Sherwin Williams	5.0%
Cognizant	4.8%
MasterCard	4.8%
Thermo Fisher	4.8%
Fresenius SE	4.6%
Danaher	4.6%
Reckitts	4.6%
Kerry Group	4.5%
Johnson & Johnson	4.3%
Top Ten	47.3%

Asset Allocation – 30 Sep 2017

Global Equity	56.6%
Government Bonds	45.4%
Gold	13.1%
Long Volatility	1.9%
Cash & Equivalents	-17.0%
Total	100.0%

Share Classes 30 Sep 2017

	ISIN	Ticker	NAV
US0	JE00BDRXFP25	SOMAUS0	103.22
US1	JE00BDRXFQ32	SOMAUS1	102.84
GB0	JE00BDRXFM93	SOMAGB0	102.58
GB1	JE00BDRXFN01	SOMAGB1	102.20
EU0	JE00BDRXFR49	SOMAEU0	102.24
EU1	JE00BDRXFS55	SOMAEU1	101.86



Performance Contribution

Our equities contributed 1.5% to the fund's performance during the quarter but underperformed during the period delivering 2.4% vs 3.9%. Underperformance was due to strong returns from emerging markets, small caps, resources and financial sectors where we have little exposure.

Government bonds negatively impacted performance by -0.25%. The negative performance was driven by the allocation effect of increasing exposure at the start September which presage a period of weakness.

Gold negatively impacted by -0.14%. This negative performance was driven by an allocation effect of increasing exposure prior to a period of weakness and owning a portion of our allocation in gold miners which underperformed bullion during the period.

Equity hedges and long volatility positions cost the portfolio - 0.32%. During the period markets advanced and the Vix (a proxy for volatility) fell 32%.

Q 3 has all the hallmarks of a classic 'risk on' market with cyclical assets doing well and safety assets doing poorly. Our caution has not paid off in relative terms though an absolute positive result was achieved.

Commentary

The Fund adopted a more cautious approach in Q3, reducing equities to 57%, and increasing government bond and gold allocations.

We manage risk in three distinct ways:

1. Careful security selection
2. Adjusting the asset allocation to reflect changes in the cycle
3. Investing in uncorrelated assets

Careful Security Selection

There are thousands of listed companies we can invest in, yet we have only 16 in the portfolio. For us, the primary set of considerations is the degree of business risk a company carries. We appraise the strength and diversity of its supply chain and its customers, regulatory and competitive threats and technological innovations, trends in the industry, capital intensity, its labour force and unions, product diversity, product relevance, product innovation, asset life expectancy and productivity of those assets. We also assess the ability of the management team, their track record and standards of corporate governance. These considerations will allow us to form an opinion about a companies' business risk. This assessment is the cornerstone of our investment approach and is considered before discussions about present operating conditions and the prospect for earnings. While we cannot immunise the portfolio from market gyrations, by investing in companies with low business risk, we are likely avoid permanent capital loss and the heart wrenching experience of seeing an investment open limit down on news that has disastrous impact for a company.

To appraise investment merit amongst the companies we consider to have low business risk, we need to see if the stock price represents attractive value. We assess the level, duration and path of future excess cash flow. Because this is a very unprecise science, we apply several assumptions to form a range of probable outcomes. More often than not, we generally find value in companies that appear expensive on a P/E basis but have an ability to deploy capital in their business earning high returns on that investment. A companies' ability to compound value in this way removes the need to constantly alter the portfolio – we let the investment do the heavy lifting for us and only when stock prices accelerate too fast or lag behind fundamentals might we consider reducing or increasing our investment.

Stock discussion

The technology sector continues to lead the market. It was the strongest sector again this quarter, rising +8.3% on the back of continued earnings momentum and an impressive Q2 earnings season supported by the structural trends of digitization, big data generation and processing, cloud computing and the shift to e-commerce. The Fund benefited from its allocation to the sector and our top 3 performers also outperformed their peer group; MasterCard +16.5%, Cognizant +9.5%, and Microsoft +8.6%.

We discussed MasterCard last quarter, but needless to say the underlying business fundamentals remain strong. In recent months, MasterCard acquired Vocalink (a leader in bank account-based payments) and Brighterion, (a software company specialising in Artificial Intelligence) and unveiled its next generation biometric card. The company is delivering high growth and profitability, investing heavily to enhance its customer experience and security, and thereby broadening its economic moats.

Cognizant is a leading provider of IT services, primarily through consultancy and outsourcing. Digital proficiency is becoming a greater necessity for all enterprises. Advances in computing technology and the growing demand for interconnectivity, and digital architecture are increasing the IT burden faced by businesses. This is creating a growing demand for IT service companies. Cognizant's competitive advantage stems from its global network, deep industry expertise and robust portfolio of industry-specific services. Last quarter the company reported better than expected underlying growth for the second quarter, with well-balanced growth in both consulting and outsourcing, and improving orders from its top 10 clients. Risks of the rumoured H-1B US immigration reforms have largely subsided and the stock has re-rated as a result. Cognizant kick started its cost cutting and capital return programs, which combined with an increased appetite for digital M&A should drive above-average earnings growth over the next few years.

Reckitt Benckiser (RB) was a laggard this quarter. RB is a European consumer staples company, focused on health and personal care. Management have done a good job of transforming the business to fast growing, high margin categories, establishing market leadership positions and highly profitable premium brands. This strategy helped drive revenue CAGR of 8.8% over the last decade, impressive margin expansion and industry leading total shareholder returns. In recent months, growth slowed as RB suffered a series of one-off issues: A South Korean product scandal, demonetisation in India causing interruption in sales, innovation failures at Scholl and a cyber-attack – culminating in a profit warning and share price underperformance. These issues do not reflect fundamental business deterioration and were largely out of current management's control. As the issues subside later this year, we are confident RB will return to strong, compounding, operating performance. Furthermore, there is potential to transform RB into a "Health and Hygiene" pure-play, where the company has a clear competitive advantage versus its pharmaceutical peers (increasing profitability and ROCE). Secondly, there appears to be significant value creation potential from the Mead Johnson acquisition (which the market now gives little credit). After the recent pullback, RB's valuations look very attractive relative to its global Health and Personal Care peers and the shares now trade at an unwarranted discount to its European competitors.

Adjusting the asset allocation to reflect changes in the cycle

We do not profess to be able to forecast accurately. The only forecast we know will be right is that any market forecast will be wrong! However, we can assess where we are in the economic cycle and the mostly likely direction of asset prices by observing data that is available today. Changes in asset allocation have the most impact on the Fund's risk and return profile. It is therefore imperative that asset allocation is carried out rigorously. We don't profess to get it right all the time or be able to time the market with any degree of accuracy, but we do consider the pursuit of preserving and enhancing capital in adversity as worthwhile. The ability to sidestep an enduring period of weakness and redeploy capital at lower levels has a profound impact on terminal wealth. There will be one or two asset allocation decisions in a decade that really matter and we have a process that gives us an edge to capture these moments.

Outlook

The global economy accelerated during 2017. Strength in industrial metal prices coincided with a long awaited resurgence in US manufacturing. Global automobile and semiconductor stocks, the most sensitive to the cycle, continue to perform very strongly, up by 18% and 30% respectively in 2017. Moreover, bank lending standards have eased and, as the tightness in the high yield spread shows, there a few signs of impending stress in the credit system.

Risk adjusted cost of capital relative to the return on capital is at steady state. The probability of recession is therefore presently low, and in its absence, the chance of enduring equity weakness is remote. However, we consider market risks are building and at a high level.

The severity of a drawdown in equity prices has historically been directly linked to starting valuation. Valuation alone does not induce weakness but once weakness begins, in the absence of good news, investors focus on valuation to try and determine when something is 'cheap', and can be bought, irrespective of the news. Presently, most valuation measures indicate very elevate levels and we consider a large drawdown could be on the cards if news flow deteriorates.

Chief amongst our concerns is the high level of optimism which appears almost universal. Several measures show complacency; most notably the realised level of volatility for US equities over a rolling 100 day period has never been lower. As we mentioned at the start of this section, so far this year, there has been plenty of good news to justify optimism but when optimism is this extreme and everyone is thinking the same, it does not take much for disappointment.

In fact, OECD leading indicators showed early signs that growth was likely to slow late in Q3 which would have disappointed elevated expectations. However, with the damage of the hurricane season adversely impacting economic data, few can tell whether poor data is hurricane induced or latent softness. Investors seem to be giving the data the benefit of the doubt for the moment.

Worryingly, an already fragile US consumer appears to be overstretching itself at the worst possible time once again. During 2017 we have seen consumer sentiment surge, causing consumption to accelerate by approximately 2% more than growth in disposable income, fuelled by a reduction in the savings rate. No doubt this activity has been somewhat induced by the 'feel good factor' of rising asset prices but this virtuous cycle of rising consumption causing rising asset prices has its limits. For one thing, the National Association of Home Builders survey shows builders optimism is at highs not seen since 2006, yet house prices appear to be slowing and in some regions already declining. No doubt, this slowdown has been induced by 30 year mortgage rates being 0.5% higher than a year earlier. While 0.5% does not sound particularly remarkable, it represents a 15% increase in the cost of servicing a new mortgage. Given the complete absence of growth of disposable income, changes in the cost of debt servicing and rising inflation have a direct impact on marginal consumption. This is a very real risk for the US economy and a source of disappointment.

Central Banks, led by the Federal Reserve, appear to be metamorphosing. For several years Central Banks have had a clear mandate to achieve stability through controlling inflation. Undoubtedly, this myopic obsession over inflation as the panacea for economic stability has been a disservice. Inflation in consumer prices is just one aspect that impacts economic stability, but as the last twenty years has amply shown, misallocation of capital through cheap and plentiful credit and asset inflation poses as much, if not more risk to economic stability than consumer prices.

Federal Reserve Chair Yellen has been most articulate, voicing a view that inflation is structurally low owing to high debt loads, challenging demographics, globalisation and technological innovation. Yellen suggests that inflation would be low irrespective of the level of rates whereas asset prices are heavily influenced by the discount rate. Low interest rates are causing asset prices to be valued higher than they should. This benefits the minority that are capital rich, and comes to the detriment of the majority who are dependent on wages and are capital poor. Moreover, elevated asset prices pose a threat to financial stability with its inseparable link to economic conditions.

This potential change in philosophy and approach may have overwhelming consequences. While we do not believe this will have any immediate impact, the sea change may herald a departure from forward guidance and high level of central bank predictability. At the most extreme, we could see egregious moves in central bank policy with little understanding of the rationale. We assign little weight to this in our present positioning but its development is something we are alive to. Not least, we will have a new Federal Chair in the not too distant future and their approach may be entirely different.

In summary, in equities we are just slightly cautious. The weight of evidence is highly unclear with good credit conditions and reasonable economic activity being balanced by high levels of optimism coinciding with a modest slowdown in growth. We look forward to clarity in the data one way or the other. We would welcome a modest pull back which would most likely provide a better risk adjusted level to increase our allocation.

We remain with a robust allocation to government bonds. Economic activity is now slowing and inflation, while present, is not overly worrying. Government bonds are likely to provide a positive pay off in equity adversity and increased deflationary concerns, but should Central Banks' approach to setting interest rates change, government bond allocations will be reduced.

Our allocation to gold will be useful in the event geopolitical risks manifest. The numerous shows of military prowess by USA, Russia, Iran and North Korea demonstrate a lingering threat.

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