SOMERSTON
ASSET MANAGEMENT

Somerston Multi Asset Fund (the Fund)

Investment Letter No.3 – January 2018

The Somerston Multi Asset Fund (US0 class) returned 1.2% over the quarter and 4.5% for the first nine months since inception. During the 4th Quarter the MSCI World Equity Index (local currency) appreciated 5.3% and a composite of UK, German and US Government bonds rose 0.4%. Through the quarter, the fund had average equity and bond allocations of 64% and 26% respectively. During December equity weighting increased to 87.2% and bonds reduced to 15.9%. In December, the gold allocation had increased to 19.6%.

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	0.6	-1.2	1.9	4.5

Top Ten Core Equity Holdings 29 Dec 2017

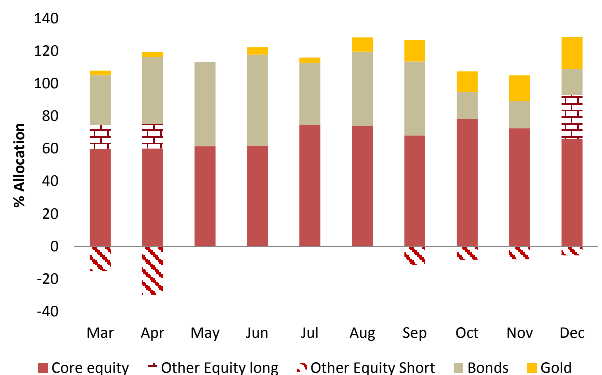
Name	**% Fund**
Sherwin Williams	5.9%
Reckitts	5.8%
Kerry Group	5.4%
MasterCard	5.4%
Blackrock	5.2%
Fresenius SE	5.1%
Danaher	5.1%
Thermo Fisher	5.0%
Johnson & Johnson	4.8%
Microsoft	4.4%
Top Ten	52.1%

Asset Allocation – 29 Dec 2017

Global Equity	87.2%
Government Bonds	15.9%
Gold	19.6%
Long Volatility	1.8%
Cash & Equivalents	-25.5%
Total	100.0%

Share Classes 29 Dec 2017

	ISIN	**Ticker**	**NAV**
US0	JE00BDRXFP25	SOMAUS0	103.71
US1	JE00BDRXFQ32	SOMAUS1	103.12
GB0	JE00BDRXFM93	SOMAGB0	102.70
GB1	JE00BDRXFN01	SOMAGB1	102.12
EU0	JE00BDRXFR49	SOMAEU0	101.98
EU1	JE00BDRXFS55	SOMAEU1	101.41



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SOMERSTON ASSET MANAGEMENT

Performance

With the MSCI North America and MSCI Europe higher for the 4th Quarter by 6.4% and 1.3% respectively, our slight underweight and caution towards equities served as a modest drag on performance. However, the main factor behind tepid performance during the quarter was stock selection with our equity book up 1.9% vs the MSCI World up 5.3%. The main detractor was our holding in satellite company SES with a negative impact of 1.3%.

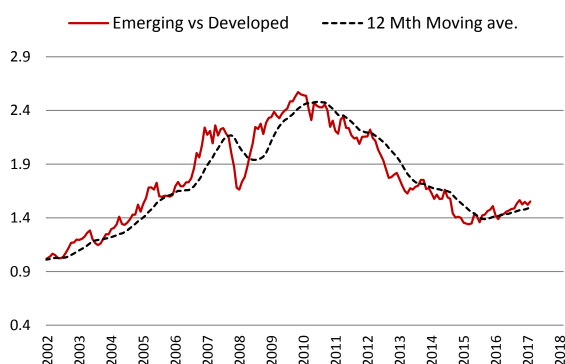
Our government bond positions had minimal impact, gold contributed 0.26% and long volatility cost 0.46%.

Present Strategy

Equity markets consistently low volatility was notable. In 2017, global equities delivered positive returns every single month. In the US this has not happened since 1958 and whilst the average equity drawdown in any given year is 14%, the maximum drawdown in the US market in 2017 was only 3%!

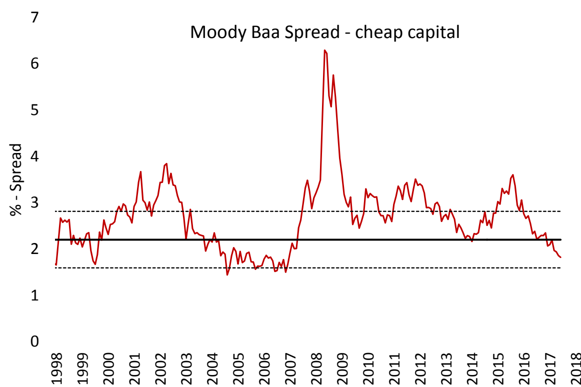
The complete absence of volatility over the past 2 -3 years has been a headwind for our strategy. The US equity market has led the way with the top 5 'mega weights' of Apple, Microsoft, Amazon, Facebook and Alphabet providing the lion share of returns. Any tactical allocation away from equities and employing underweights in the 'big 5' has been detrimental to performance. Hindsight shows being fully invested in equities with overweight's in the 'big 5' would have been both the easiest and most profitable strategy.

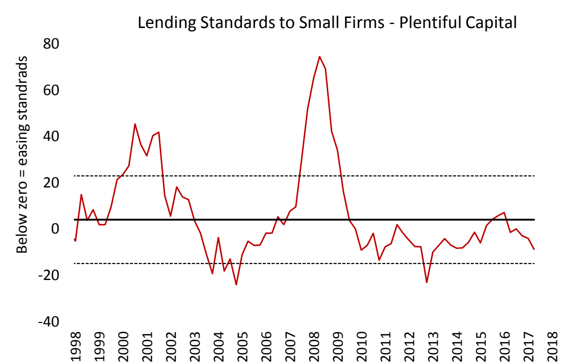
In contrast to the past 2-3 years, we see ample evidence to suggest there will be plenty of profitable opportunities outside of mega cap tech equities in the next few years. As the two charts below illustrate, we see established trends of underperformance of emerging markets vs developed markets, resources vs the market as well as value vs growth sectors, and World (ex US) vs US as very mature. A potential continuation in the rise of commodities, a more meaningful reversal higher in bond yields and a continued moderation in the US Dollar would provide ample justification for these trends to reverse.



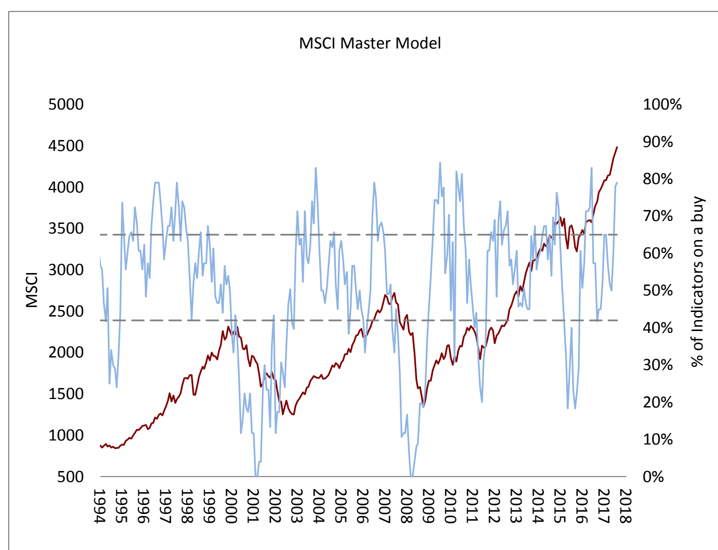
At year end, the fund was 87.2% invested in equities. We have modestly reduced the impact of stock selection which now represents 67% of the portfolio towards more macro themes of Japan (4.8%) and small caps (7.6%), we expect this transition to continue during the next few months as macro changes become more relevant for portfolio returns.

The high equity weighting reflects our thinking that conditions are in place for a positive market surprise. Many of the critical pieces for a sharp rally are in place including plentiful supply of credit, cheap capital, and accelerating economic growth around the world. It is possible to envisage strong fundamentals being extrapolated beyond all rationality driving equity valuations to true bubble levels. Typically, the greatest gains in bull markets occurs when valuations go from expensive to bubble territory and the 'cost' of missing out is often as great as the 'cost' of being too late.





Our 'master models', which combine indicators from all corners of economic theory, have historically been very good at flagging turning points. You can see from the chart below that in previous bear markets the Master Model (blue) turned down well ahead of the bear market. There is no guarantee that it will give the same early signal it has in the past but right now, the models are accelerating, and at a level consistent with impressive returns.



Our position in Gold (19.7%) reflects what we perceive to be a very constructive backdrop. Commodities strength is broad and building from a multi-year base; the US Dollar is expensive and weakening, despite monetary policy that is tightening at a far more rapid pace than other regions of the World. US Sovereign Debt continues to build, undermining the perception of the US Dollar as a store of value; emerging markets are beginning to outperform and we expect physical gold purchases to incrementally improve in these regions; financial flows show no signs of 'chasing' the recent move higher or being long the market. These fundamentals are supported by a strong technical position with prices advancing from a traditionally seasonal low in December. Should gold surpass 1,400 we might see significant renewed interest pushing the metal considerably higher. Moreover, while blockchain has its appeal from many, and may well be attracting marginal dollars away from gold, we suspect what's good for blockchain is eventually good for gold, albeit to differing degrees. We are anticipating the launch of 'RMG', a physically backed blockchain sponsored by the Royal Mint and traded on CME with great interest. We suspect it could have very positive impact for gold markets if successful.

Stock discussion

Technology is evolving at an unprecedented pace and causing wide spread disruption across several industries. As a consequence, whilst the equity market rally was relatively broad based (with every sector realising positive returns), technology was the standout winner, with the sector rising 37% during 2017. We held an overweight allocation to technology companies which positively contributed to performance.

However, when disruptors gain, incumbents suffer, and many high quality businesses, once prized for their dependable cash flows and deep economic moats, saw their competitive advantage challenged by technology, (often for the first time). The impact/threat of these disruptive forces negatively impacted a handful of our positions and weighted on stock selection during 2017. The most notable detractor was satellite operator SES.

Historically, SES had a broad client base, high recurring cash flows, generated from very long-term contracts with great order visibility. It generated solid return on capital which was far in excess of its cost of capital. SES had delivered a dependable track record of revenue and earnings growth with a steadily rising share price to match. Most importantly, companies within the industry were 'rational', competing on geography and services, rather than price. Barriers to entry were extremely high as satellite orbit positons are finite and the capex requirement is high.

More recently, on-demand and internet enabled television delivery, challenged the traditional linear satellite model. At the same time fibre optics and new satellite technology (low and middle earth orbit) challenged the fixed data business. We owned SES for a long time before these competitive challenges really took hold and before they announced their major acquisition of the middle earth orbit operator O3B. While that acquisition was highly dilutive we considered the deal strategically sensible and believed the company was actively addressing some of its challenges. The combined entity would gain significant advantages over its competitors and the dual satellite offering would position the company well to compete in the future. The subsequent purchase of RR Media

appeared congruent with this strategy, allowing the company to capitalise on the OTT revolution of media consumption. However, it became increasingly notable that the challenges facing the industry by changing consumer habits and new service providers, were greater than anticipated and the transformative deals would not be enough to offset declines in the core business. Management continued to make excuses as earnings disappointed, and communication became gradually more incomplete and opaque. The maths did not corroborate the story we were being told - management failed to acknowledge the structural pressures facing the business. We don't generally like companies that need to invest in transformational deals. Capital is often poorly allocated and the transition is never easy. We made a judgement call with SES that proved wrong. We put our faith in management for too long. We sold our position during the quarter and recognised a crucial lesson.

The equity cycle is maturing, leadership is narrowing and valuations are high. In the final stages of a bull market we generally see just a handful of stocks lead the market higher. In response, despite our positive equity outlook, (and increased overall equity allocation), we have marginally reduced our direct equity exposure at this time. We have scrutinised our positions in an effort to eliminate those which may be vulnerable to disruption.

We increased our exposure to technology by adding Alphabet to the fund in November. Some of the more dynamic, technologically innovative companies, prized by investors today, are likely to become the champions of tomorrow, but at today's valuations, that will not necessarily translate into superior stock performance. Moreover, as these companies dominate further, they will face regulatory obstacles that in many cases are not anticipated by the investing community. It is hard to believe that these companies will too face challenges much as Intel and IBM did before. Many of the disruptors are relatively young companies but investors appear to be extrapolating solid fundamentals today far into the future in a liner fashion. Alphabet has a benign valuation, relatively understandable economic moats, and a 20 year track record. More than any of the others, Alphabet knows more about our preferences, habits and secrets than our best friends. This information can be used in a highly targeted and efficient manner generating enormous excess cash flows.

In a concentrated portfolio, a small number of underperformers can quickly overshadow the performance of the remainder. Whilst we were disappointed by the impact of SES's stock fall, the vast majority of our direct equity holdings outperformed in 2017 and we expect a concentrated long term focus in high quality companies to be able to deliver superior risk adjusted returns over time.

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