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ASSET MANAGEMENT

Somerston Multi Asset Fund (the Fund)

Investment Letter No.4 – April 2018

The Somerston Multi Asset Fund (US0 class) returned -0.1% over the first quarter. Year to date the MSCI World Equity Index (local currency) declined -2.2% and a composite of UK, German and US Government bonds declined -1.0%. Through the quarter, the fund had average equity and bond allocations of 80% and 19% respectively. The fund starts the 2nd Quarter of 2018 with a 47.2% net equity exposure, 30.6% net bond exposure and 19.8% in Gold.

Performance (%) US0 Class

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2017				0.9	2.7	-0.9	0.6	0.6	-0.5	0.6	-1.2	1.9	**4.5**
2018	4.8	-3.7	-1.0										**-0.1**

Top Ten High Conviction Equity Holdings

Name	**% Fund**
MasterCard	6.2%
Sherwin Williams	5.7%
Blackrock	5.5%
Danaher	5.4%
Thermo Fisher	5.4%
Reckitts	5.3%
Fresenius SE	5.1%
Kerry Group	4.9%
Microsoft	4.7%
Johnson & Johnson	4.4%
Top Ten	52.6%

Share Classes

	ISIN	Ticker	NAV
US0	JE00BDRXFP25	SOMAUS0	103.64
US1	JE00BDRXFQ32	SOMAUS1	102.84
GB0	JE00BDRXFM93	SOMAGB0	101.98
GB1	JE00BDRXFN01	SOMAGB1	101.21
EU0	JE00BDRXFR49	SOMAEU0	101.15
EU1	JE00BDRXFS55	SOMAEU1	100.39

SMAF Asset Allocation

		Long	Short	Net
Equities	High Conviction	62.4%		
	Delta Adj Index Puts		-13.9%	
	ETF	11.9%	-7.3%	
	Index Futures	7.6%	-13.5%	
	Total	82.0%	-34.8%	47.2%
Bonds	US 10 yr Futures	10.4%		
	Bunds	10.6%		
	Long Gilt Future	14.8%		
	High Yield		-5.2%	
	Total	35.9%	-5.2%	30.6%
Gold	Equities			
	Futures	19.8%		
	Total	19.8%	0.0%	19.8%
Other	Long Volatility Fund	1.9%		
	Total	1.9%	0.0%	1.9%
Sub Total		139.5%	-40.0%	99.5%
Cash				0.5%
Total				**100.0%**

Performance

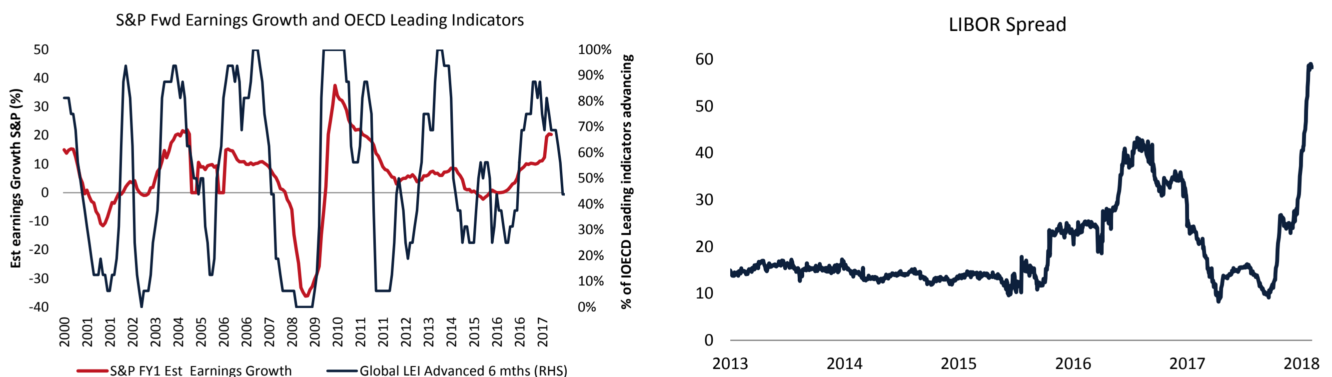
- The fund fell -0.1% vs our reference benchmark 70/30 Equity/Gov. Bonds which fell -1.8%.
- The 1.7% out performance was comprised of 1.1% from our high conviction portfolio and 0.6% from asset allocation.
- The high conviction portfolio outperformed by 1.6% during the quarter, with MasterCard, Cognizant and Thermo Fisher the largest contributors and consumer staple companies Reckitt Benckiser and Kerry the largest detractors.
- The asset allocation benefitted from being overweight equities and underweight bonds in January and reversing that position in February. Gold and currency made negligible contributions.

Present Strategy

Asset prices are primarily driven by changes in growth, credit conditions and interest rates. When growth is accelerating, credit conditions improving and interest rates falling, sentiment generally improves and investors push valuations higher. Improvements in underlying fundamentals have natural limits and when the limits are reached, the impending 'sea change' is often accompanied by extremes in both sentiment and valuations which causes the corresponding corrections to be far more exaggerated than would be warranted on fundamentals alone.

In the last few months, data is beginning to highlight a potential 'sea change'. 2 year government bond yields have moved 200 bps from a low of 0.25% to 2.25%. While the overall level of US interest rates are low compared to the most recent decades, the move is a significant change in the primary measure of the cost of capital over a short period.

Secondly, in recent weeks, we have seen evidence of a marked deterioration in the prospects for growth. The chart below left shows the S&P forward earnings growth (red line (lhs)) against a diffusion of developed economies OECD Leading Economic Index (blue line (rhs)) which is advanced 6 months. S&P earnings growth has been remarkable, largely driven by onetime gains and net margin expansion, (with sales growth contributing only 35% to overall earnings growth) but the diffusion of the OECD Leading Economic Indicator suggests this rate of growth will moderate in the months ahead.



With Interest rates rising and growth likely to slow, credit conditions offer no solace – they have taken a significant turn for the worse. The chart above right shows US LIBOR spreads widening dramatically. This is not an isolated indication of building stress. It is accompanied by widening credit default swaps and increased credit charge offs for small banks.

Good fundamentals have been extrapolated far into the future and on many measures, this potential 'sea change' is accompanied by valuations that are as high as we have ever seen.

The confluence of events has led to a series of asset allocation changes in the fund. We started the year with overweight in Equities and underweight in Bonds, this has now reversed. Compared to the start of the year we have reduced net equity exposure from 87% to 47% and increased net bond exposure from 16% to 31%.

Equity Allocation

- We are 62.5% invested in our high conviction portfolio with largest positions in MasterCard (6.2%) and Sherwin Williams (5.7%).
- We are long growth vs value through ETF's . Growth has underperformed in recent weeks which allowed us to introduce the position. In an uncertain growth environment where trade wars look increasingly likely, we would expect growth companies to fare better than value companies which are dominated by resource, financial and utility sectors.
- We are long large caps vs small caps through futures. In the event that the market lurches lower in response to slowing growth and deterioration in credit conditions, small caps would likely be most sensitive.
- We are long US vs Europe. While the US has outperformed Europe for a prolonged period, the spectre of slowing global growth, trade wars and a strong Euro serve as stiff headwinds for Europe.
- We have certain put positions that offer a large payoff in a tail event. As volatility increases, we are likely to realise the profits in these positions
- Overall our equity strategy is long 82.0% and Short 34.8% with a net exposure of 47.2%.

Bond Allocation

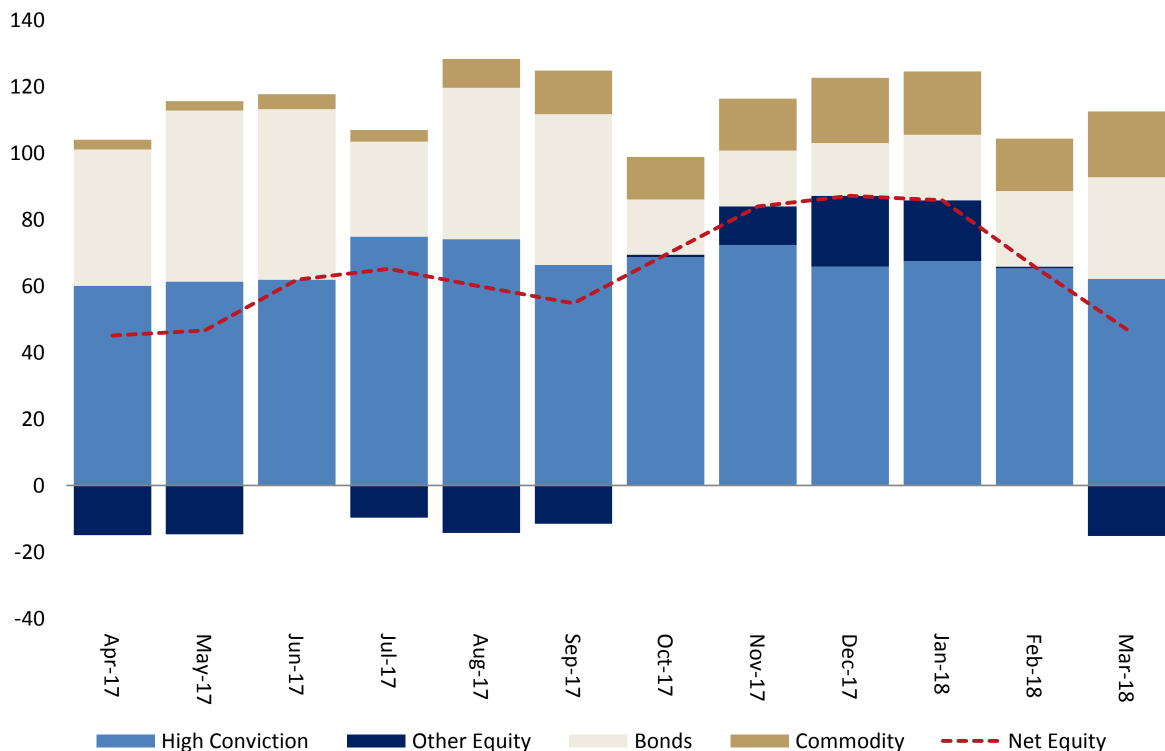
- We are long 10 year Government bonds to reflect our growing caution towards risk assets, the decline in market implied inflation expectations and peaking growth rates.
- We have a slight preference for UK Gilts. Sterling strength is having an offsetting impact on Inflation and uncertainty of Brexit is negatively impacting growth.
- We are long puts on high yield ETF's. At the time of initiation of this position, implied volatility was low and option prices were cheap. High yield often reacts badly during adversity and there is an ongoing structural consideration that the underlying investments in these ETFs are far less liquid than the ETF themselves.
- We are long 35.9% in Government bonds, short 5.2% in high yield with a net bond position of 30.6%.

Commodities & Currencies

- We do not feel resource sectors will fare well under present conditions.
- However, the negative correlation between currencies and interest rate momentum is indicative of investor preference for 'quality' versus 'carry' and there is a growing restlessness about the US fiscal positon. Accordingly, we have raised our allocation to gold bullion via futures to 19.8%.
- Gold traders have been unwinding positions since the start of the year, and we consider there is money to be invested in the gold market in the foreseeable future.
- We consider the Yen is a cheap currency with a strong net foreign asset position. Interest rate carry trades are fading and the Yen often does well in adversity. In contrast, the Euro is expensive and the underlying economy is dependent on global activity. Accordingly, we are long Yen and short Euro (7.5% of Fund).

Our asset allocation strategy aims to stay in harmony with the weight of evidence and allocation changes in a gradual fashion. We have wide allocation parameters and will use the extreme of those parameters when the evidence stacks up. While there is cause for concern, growth is still evident even if not at the same rate that it has been and the market is oversold on many measures. It is therefore premature to take an overly bearish stance.

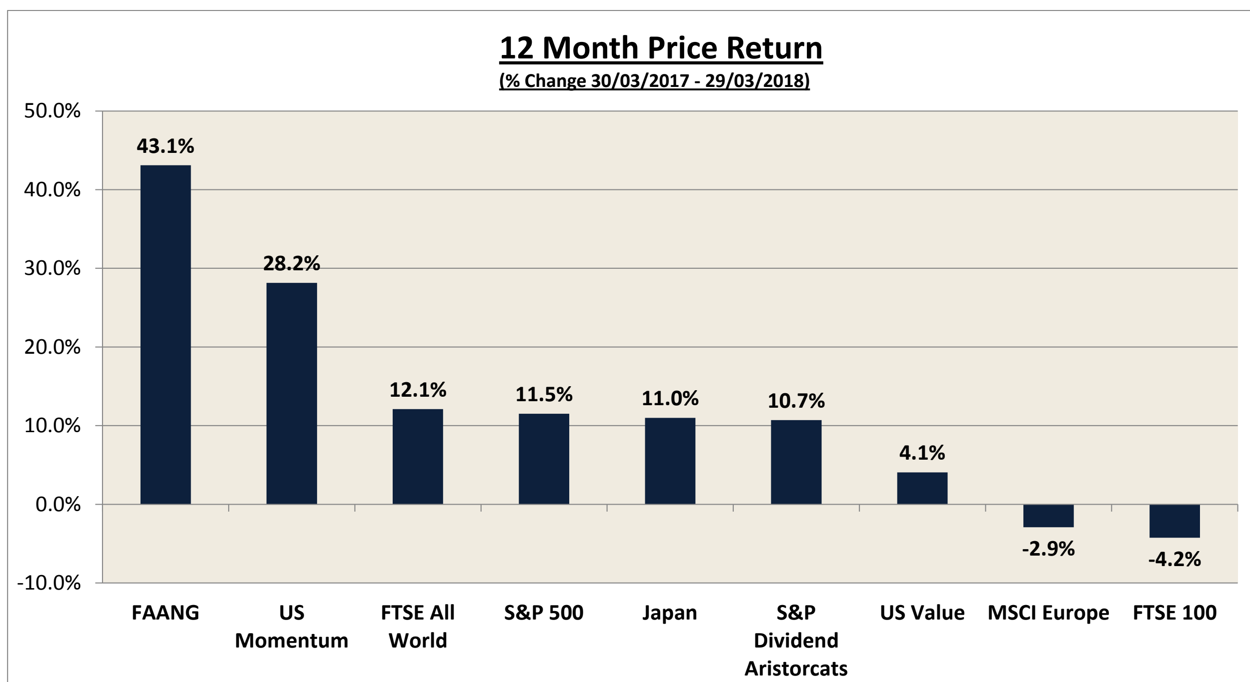
Evolution of Asset Allocation for Somerston Multi Asset Fund



High Conviction Equity

- Our high conviction equity positions performed well. Our stocks fell 0.57% whilst the benchmark fell 2.21% (1.64% outperformance).
- Our top performing holdings were Mastercard (+15.9%) and Cognizant (+13.6%).
- In local currency terms European equities underperformed North American equities by 3.2%. In USD terms, European stocks underperformed by only 0.7% owing to the strength of the Euro and Sterling. Our three worst performing stocks were all European companies. Reckitt Benckiser (-12.8%) and Kerry Group (-11.9%) have suffered from negative translation effects.
- The FAANG stocks posted another quarter of outperformance but Facebook's user data scandal and Trump's declaration of' war 'with Amazon are a warning that these investments are not without risk and we remain wary of the risk adjusted opportunity in these names.
- Technology remains the strongest sector globally and notwithstanding the absence of FAANGs we are overweight the sector.

It's been an eventful start to 2018. Global equity markets continued their Q4 2017 surge and rallied hard into early January, supported by strong Q4 earnings, larger than expected US government stimulus and robust economic momentum. The S&P posted its strongest January gain since 1997, but towards the end of the month sentiment had turned. Payroll data out of the US triggered an inflationary scare, the VIX spiked and equity markets posted their first 10% decline in nearly 2 years. The down-move was broad based, but the rebound that followed was largely technology driven and didn't last long. The prospect of a US led trade war weighed on markets and the FAANG stocks, which had led the market rally, suffered on Facebook's data scandal and Trump' declaration of 'war' with Amazon.



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The FAANG's large market caps and rapid growth has wielded a significant influence on benchmark performance. Our underweight allocations to the FANNG's were a substantial headwind in the last 12 months but our high conviction equity portfolio managed to outperform nevertheless. Prospects for the FAANG's remain broadly positive, but the recent trouble at Amazon and Facebook highlight that these investments face some unique risks that are not yet well understood.

We remain sceptical on some of the FAANGS and being entirely benchmark agnostic, we are not obliged to hold them. The technology sector remains our largest sector call but, with the exception of Alphabet (discussed in the last letter), we currently find better opportunities outside of the FANNGs.

Mastercard (+15.9%) and Cognizant (+13.6%) were our two strongest performers in Q1. Mastercard displays all the positive attributes of the FAANGS; network economics, high growth, technologically empowered but with the added advantage of a time proven, legacy business, with strong economic moats, high profitability and highly visible, recurring revenues. Solid operational performance and earnings upgrades fuelled recent outperformance. The main driver of mid-teens earnings growth is the powerful trend of cash to card conversion and whilst historic growth was driven by consumer digitisation, new opportunities are emerging in the business-to-business market. Mastercard has low capital intensity and great operational leverage, Incremental operating profit margins are +80% vs an operational base of 60%.

Cognizant is a major beneficiary of the trend towards digitisation. Its business is focused on the new generation of non-technology leaders that are becoming digital heavyweights; the blending of industrial and digital. Companies have woken up to the threats from pure digital players like Facebook, Amazon and Netflix and are investing heavily to remain relevant in the future, to get ahead of their peers and to create entirely new customer experiences. They are combining their respective industry expertise with powerful technologies like analytics, automation, Internet of things, AI, robotics and cybersecurity. They are turning to Cognizant as an enabler. Cognizant is also a leading provider of block chain technology solutions. Cognizant has experienced rapid acceleration in these opportunities over the last 6 months, and is one of only a handful of companies with the range of capabilities to help customers transform every level of their enterprise. On the back of operational improvements, Cognizant upgraded their earnings forecast for this year to +20% GAAP eps growth, which was well received by the market, but longer term margin expansion and improving industry dynamics are even more exciting prospects. Cognizant's client base is largely US financial service and healthcare companies which were also direct beneficiaries of US tax reform.

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