SOMERSTON ASSET MANAGEMENT

Somerston Multi Asset Fund (the Fund)

Investment Letter No.5 – July 2018

The Somerston Multi Asset Fund (USO class) returned -0.5% in the second quarter and is down -0.5% year to date. The MSCI World Equity Index increased by 3.6% during the quarter and a composite of UK, German and US Government bonds was 0.8% higher.

Throughout the quarter, the fund had average equity and bond allocations of 54% and 29% respectively. The fund starts the 3rd Quarter of 2018 with net exposures of 35% in equities, 15% in bonds and 19% in commodities.

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	-1.0	0.8	-0.2							**-0.5**

Top Ten High Conviction Equity Holdings

Name	% Fund
Fresenius SE	5.9%
MasterCard	5.8%
Cognizant Tech Solutions	5.6%
Sherwin-Williams	5.6%
Alphabet Inc – Class A	5.3%
Blackrock	5.0%
Microsoft	5.0%
Reckitt Benckiser	4.9%
Smith (A.O.) Corp	4.3%
Thermo Fisher Scientific	4.3%
Top Ten	**51.6%**

Share Classes

	ISIN	Ticker	NAV
US0	JE00BDRXFP25	SOMAUS0	102.38
US1	JE00BDRXFQ32	SOMAUS1	101.41
GB0	JE00BDRXFM93	SOMAGB0	100.35
GB1	JE00BDRXFN01	SOMAGB1	99.39
EU0	JE00BDRXFR49	SOMAEU0	99.21
EU1	JE00BDRXFS55	SOMAEU1	98.27

Asset Allocation

		Long	Short	Net
Equities	High Conviction	66.7%		66.7%
	Delta Adj e-mini Puts		-6.5%	-6.5%
	ETF	14.4%	-14.4%	0.0%
	Index Futures	0.0%	-24.9%	-24.9%
	Total	**81.1%**	**-45.8%**	**35.3%**
Bonds	US 10 yr Futures	7.9%		7.9%
	Long Gilt Future	7.0%		7.0%
	Euro Bund futures	4.4%		4.4%
	High Yield Bonds		-4.6%	-4.6%
	Total	**19.3%**	**-4.6%**	**14.6%**
Commodities	Gold Futures	14.4%		14.4%
	Commodity Fund	4.2%		4.2%
		18.6%		**18.6%**
Other	Long Volatility Fund	1.7%		1.7%
	Sub Total	**120.7%**	**-50.5%**	**70.3%**
	Cash			29.7%
Total				**100.0%**

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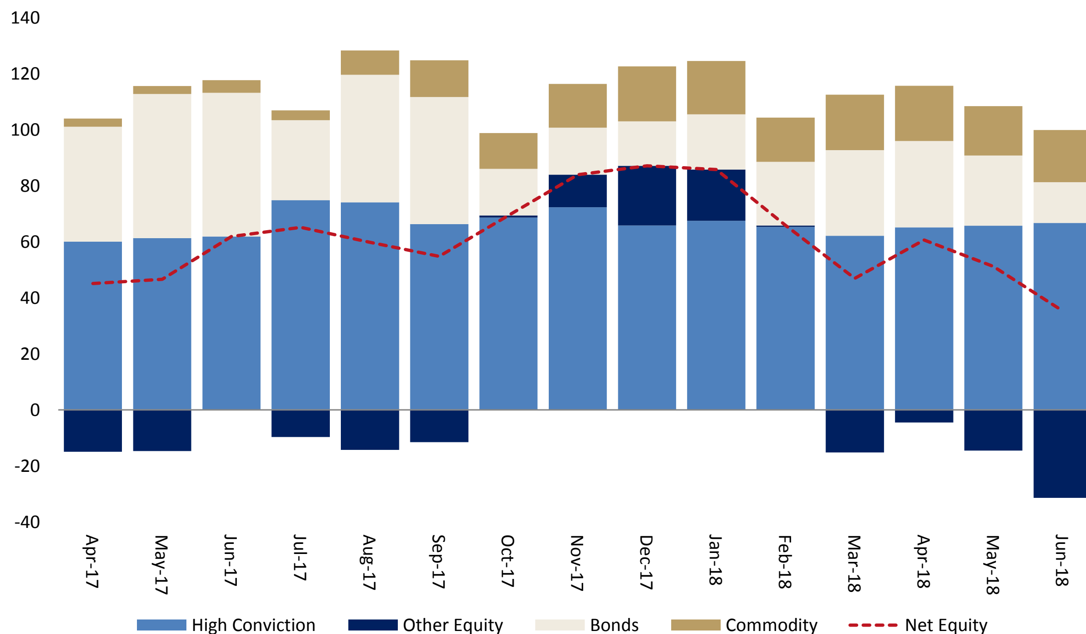
ASSET MANAGEMENT

Evolution of Asset Allocation for Somerston Multi Asset Fund



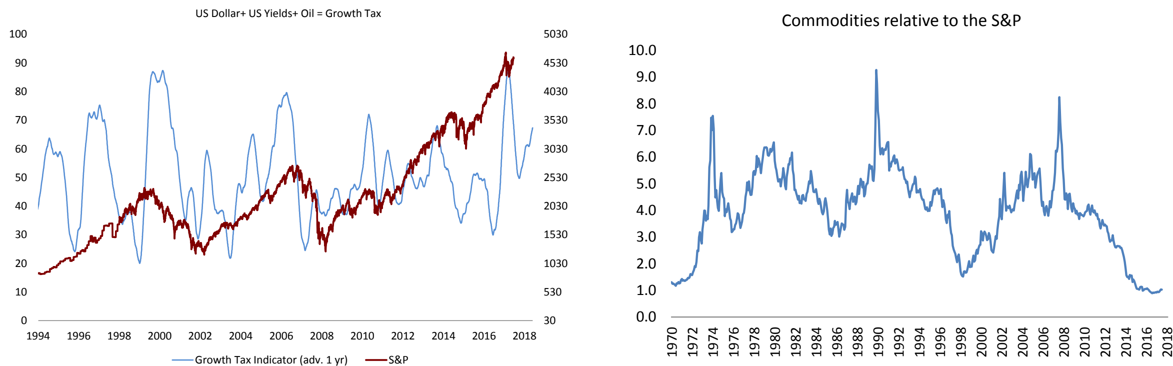
Performance

- The fund fell -0.5% vs our reference benchmark 70/30 Equity/Bonds which was higher by 2.7%.
- Much of the underperformance was a consequence of our caution: long gold (-1.2%), long volatility (-0.9%) and short equity futures (-0.8%).
- Our equity portfolio underperformed by -0.7% during the quarter. Blackrock, AO Smith and McKesson were the largest detractors, while MasterCard, Fresenius SE and Kerry were the largest contributors.

Present Strategy

We have been gradually reducing equity exposure for the past 5 months. It feels that the proverbial sponge is being wrung dry to get the last drop out of this bull market, doing what it can to get every bear to capitulate before turning lower. Equity short covering is evident and it appears that hedges are being abandoned.

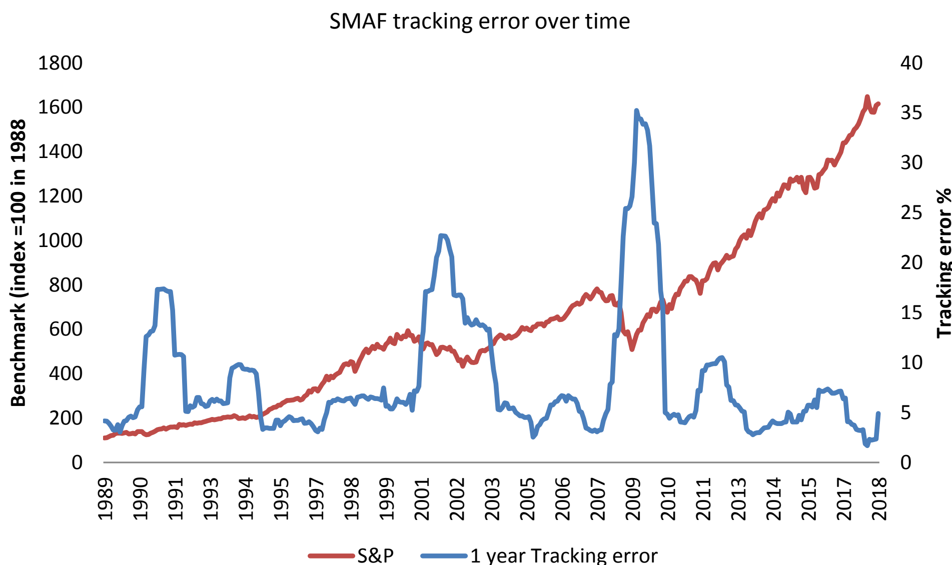
Investors face an environment of slowing growth, rising inflationary pressures, worsening credit conditions and tighter monetary policies. Whilst none of these headwinds are particularly stiff by themselves, their confluence makes it notable. Below, we show the 'Growth Tax Indicator' that combines the rolling 12 month increase in energy, debt and US Dollar funding costs. The headwind of higher costs has historically coincided with market softness and/or recessions twelve months later. We appear close to choking point.



While valuations look fair, that assessment is based on unsustainable profit margins and low discount rates. Any normalisation of these cyclical factors shows equities as very overvalued. Yet the marginal new investor outweighs the marginal seller with markets on an upward path.

We try and act on the weight of evidence in an objective and proportionate manner. This approach pays dividends over the medium term but often, a good deal of patience is required before the weight of evidence manifests itself in market returns. Cracks are however appearing. Emerging Market equities, debt and currencies have been under considerable pressure in recent weeks. More recently, the most cyclically sensitive sectors of Financials and Industrials have started to underperform.

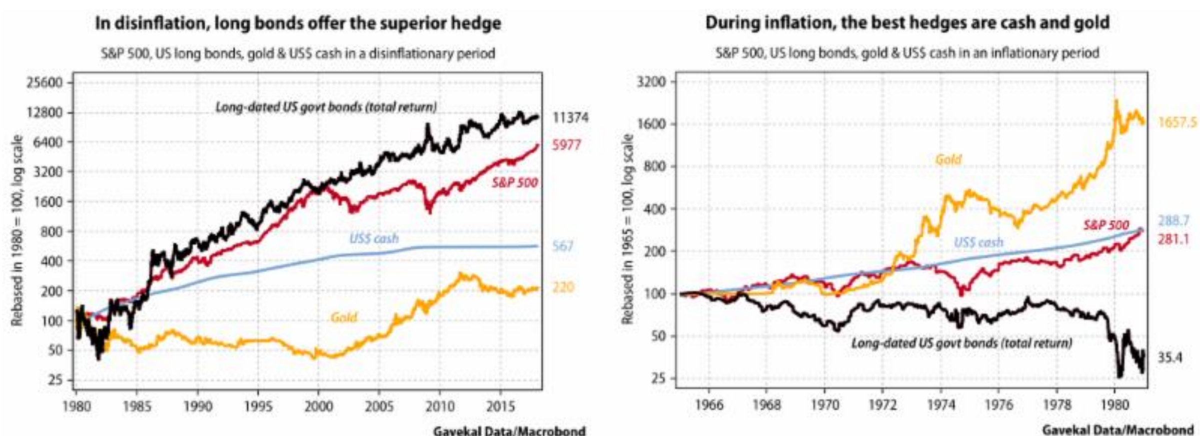
Unlike many funds in our sector, we have wide latitude to change allocation in an effort to take advantage of both bull and bear markets. Accordingly, while our average tracking error is 8%, it is highly variable over time. The chart below compares the strategy's rolling one year tracking error with the S&P. The tracking error tends to rise during bear markets when the strategy often takes a very different position to the benchmark. We cannot deliver differentiated results in adversity unless we act accordingly when the risks appear high. Presently, the range of probable outcomes is wide and our tracking error is accordingly likely to rise.



While government bonds are the usual hiding place during adversity, we are concerned their safe haven status may not provide the same returns as it has done historically. Inflationary pressures appear on the rise (even if only temporarily) and while its ascent is controlled, we feel there is a risk that inflation may accelerate faster than anyone has experienced for several years.

As a corollary to our underweight bond position, one of the notable changes at the end of the quarter was to obtain broad commodity exposure through a US mutual fund that invests in commodity futures.

For the past 30 years it has been prudent to back 'disinflationary' assets. Several secular trends have benefitted equities and bonds to the detriment of commodities and gold. These trends have been incredibly persistent and benchmarks now have very little exposure to either gold or commodities more broadly. If the disinflationary trends begin to reverse, there could be significant investment flows into commodities and the relationship between asset classes that has persisted for the last 30 years will turn on its head, with yesterday's winners becoming tomorrow's losers. For illustration purposes, the two charts below show the stark contrast between asset class returns from the disinflationary period from 1980 to date and the inflationary period from 1965 to 1980.



Globalisation has been an important factor behind tame inflation. A reversal of international cooperation increases the odds that we may endure more inflation than we have become accustomed to. Moreover, after 8 years of chronic underperformance, the valuation of commodities versus equities is at very favourable levels offering a good risk adjusted entry level.

In summary, our asset allocation has been too cautious in recent months. We do not see any evidence that this stance should change. We are underweight both equities and bonds and we are growing more constructive on commodities.

Equity Allocation

- We are 66.8% invested in our high conviction equity portfolio with largest positions in Fresenius SE (+5.9%) which we added to during the quarter in a timely manner, MasterCard (5.8%) and Cognizant (5.6%).
- We have hedged 24.9% of the portfolio using large and small cap US futures.

- We remain long growth vs value through ETF's . This position has worked well and although we are alive to a change in fortunes, technology continues to exhibit good strength.
- We have certain put positions that offer a large payoff in a tail event. If/As volatility increases, we are likely to realise the profits in these positions
- Overall our equity strategy is long 81.1% and short 45.8% with a net exposure of 35.3%.

Bond Allocation

- We are long 10 year government bonds but underweight our benchmark.
- We have a slight preference for US 10 year bonds.
- 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 19.3% in Government bonds, short 4.6% in high yield with a net bond position of 14.6%.

Commodities & Currencies

- We reduced gold slightly from 19.5% to 14.4%.
- We introduced 4.2% in broad commodity exposure that we expect to broadly follow the Bloomberg Commodity Index.
- We have no currency exposure at this time.

High Conviction Equity

Our high conviction equity portfolio rose 2.9% during the quarter, underperforming the benchmark that rose 3.6%. Markets were supported by strong corporate earnings growth and record unemployment in both the US (lowest since 1969) and UK (lowest since 1975) but the movement in currency markets and the 'Trade War' had the most notable impact on stock specifics.

Divergent monetary policy influenced the forex markets. The Dollar rallied strongly and European based dollar earners were beneficiaries. Our European holdings in **Reckitt Benckiser**, **Kerry Group** and **Fresenius SE**, all benefited.

Technology appears largely immune from the trade war and outperformed. MasterCard was again our top performer but Cognizant and Microsoft were also at the top of the leader board.

Energy was the strongest sector during the quarter, as declining production in Venezuela and Libya coincided with Iranian sanctions, creating a dearth of supply and sending oil prices higher. We do not hold any energy related stocks and our underweight allocation to energy companies detracted from relative performance.

Industrials were severely impacted by the trade war rhetoric and created some decent opportunities. We initiated a new positon in **AO Smith.**

Smith is the Global leader in water heater and boiler systems. The majority of Smith's business serves the US replacement water heater market, which is a stable, highly profitable (+50% ROCE) business that generates a lot of cash. Free cash flow is reinvested to stimulate growth in faster growing geographic regions, particularly in China (growing +20% annually) and more recently in India (growing +40% annually). China now accounts for 35% of Smith's revenues. Investors perceived this exposure within the scope of the trade war and its share price declined as a result. This created an opportunity.

Smith's success in China was built on its premium brand, technology leadership and extensive distribution and service network (+9,000 retail outlets, in Tier 1/2/3 cities). More importantly, it has developed world class Chinese manufacturing facilities, a specific product set managed by a local Chinese executive team. Smith employs +10'000 Chinese workers and its global R&D centre is based in Nanjing. The US and Chinese businesses are essentially separate, local entities. As such, Smith's products should be immune from border tariffs and the main risk faced by the company is translational currency effects from a weakening renminbi. Regardless of the outcomes of the trade war, major structural tailwinds will continue to support the Chinese business; rising Chinese affluence, urbanisation, middle class expansion, improving energy infrastructure and growing environmental regulations. China badly needs Smith's products - most Chinese citizens still have third world living standards and the country does not yet have universal plumbing.

Smith has delivered consecutive dividend increases for the last 26 years and appears able to continue to grow EPS at a consistent 20% CAGR. It offers investors exposure to major structural trends within China, via a US listed company with exemplary corporate governance, now trading at a discounted price.

During the quarter we sold our positions in Nielsen and Eurofins Scientific.

We halved our position in Nielsen in November 2017 following disappointing developments. We held off from selling entirely as the share price had fallen excessively versus earnings and valuations looked supportive. We hoped to see evidence of a turnaround (or at least stabilisation). Unfortunately, this has not happened. Nielsen's core client base, large cap consumer goods companies, remain under persistent pressure (increasing competition, increasing costs, lack of pricing power, distribution challenges).

Nielsen management hosted an investor day at the end of April, which gave us a deeper understanding of the challenges it faces. The rate of change faced by the industry and uncertainty over Nielsen's leadership remains a cause for concern. We exited the position in early May.

We also sold our entire position in Eurofins Scientific in early May. Eurofins is the World leader in food, environmental and pharmaceutical products testing. The company runs an international network of over 400 laboratories across 44 countries. Eurofins has performed exceptionally well over the past few years, growing phenomenally, however, Eurofins is heavily acquisition dependent. The rapid pace of growth and commensurate increase in both size and number of acquisitions has made it very difficult to assess return on capital. The investment has become

more opaque, heavily dependent on management and the stock's valuation offers no comfort. As such, the risk profile no longer suited and we can find better risk adjusted opportunities elsewhere.

The prospect of an escalating trade war is a major concern for equity markets. There is very little visibility on how the trade war might develop, let alone its economic consequences. Markets are subject to unpredictable government action and a capricious US president with unprecedented influence. The globalisation megatrend, which has supported capital markets for decades, is under threat. Yet despite this lack of visibility, global equities are just 2% shy of their all-time highs. There is inevitably a degree of posturing and bargaining taking place on both sides, but it certainly feels like there is room for this trade war to escalate much further, we continue to follow developments closely and we are ready to take advantage of opportunities that are likely to emerge.

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