SOMERSTON
ASSET MANAGEMENT

Somerston Multi Asset Fund (the Fund)

Investment Letter No.6 – October 2018

The Somerston Multi Asset Fund (US0 class) returned +1.2% in the third quarter and is up +0.7% year to date. The MSCI World Equity Index increased by +5.3% during the quarter and a composite of UK, German and US Government bonds dropped by -0.9%.

Throughout the quarter, the fund had average equity and bond allocations of 36% and 19% respectively. The fund starts the 4th Quarter of 2018 with net exposures of 25% in equities, 21% in bonds and 9% 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	0.9	0.3	0.0				**0.7**

Top Ten High Conviction Equity Holdings

Name	% Fund
Sherwin-Williams Co/The	5.8%
Johnson & Johnson	5.5%
Mastercard Inc - A	5.5%
Microsoft Corp	5.5%
Cognizant Tech Solutions-A	5.1%
Reckitt Benckiser Group Plc	4.9%
Fresenius Se & Co Kgaa	4.7%
Thermo Fisher Scientific Inc	4.6%
Danaher Corp	4.4%
Blackrock Inc	4.2%
Total for Top Ten	**50.1%**

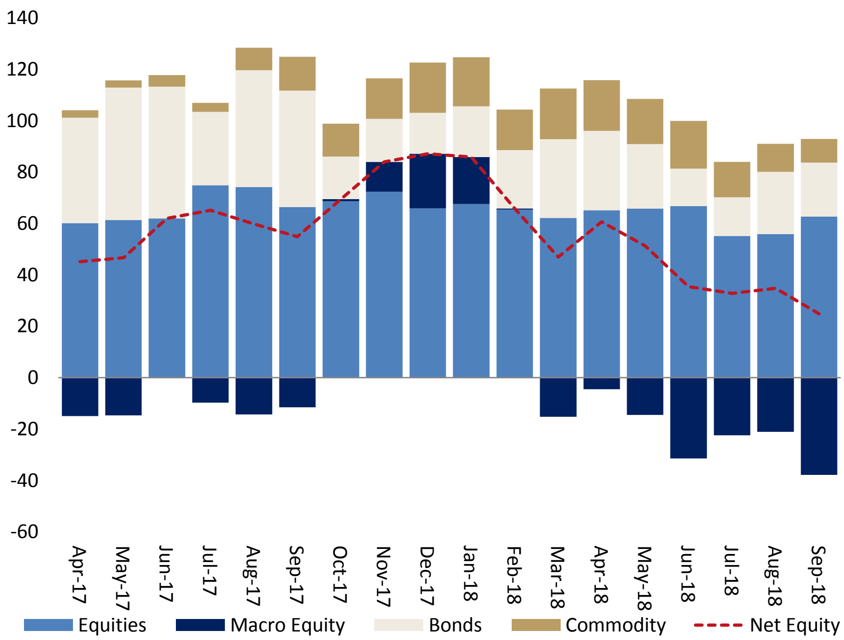
Share Classes

	ISIN	Ticker	NAV
US0	JE00BDRXFP25	SOMAUS0	102.8609
US1	JE00BDRXFQ32	SOMAUS1	101.6932
GB0	JE00BDRXFM93	SOMAGB0	100.4139
GB1	JE00BDRXFN01	SOMAGB1	99.2740
EU0	JE00BDRXFR49	SOMAEU0	98.9957
EU1	JE00BDRXFS55	SOMAEU1	97.8739

Asset Allocation

Equities	Long	Short	Net
High Conviction	62.8%		62.8%
ETF	4.8%	-4.8%	0.0%
Index Futures	0.0%	-37.8%	-37.8%
Total	**67.6%**	**-42.7%**	**24.9%**
Bonds			
US 10 yr Futures	8.3%		8.3%
Long Gilt Future	8.4%		8.4%
Euro Bund futures	5.8%		5.8%
High Yield Bonds		-1.5%	-1.5%
Total	**22.5%**	**-1.5%**	**21.0%**
Commodities			
Gold Futures	3.8%		3.8%
SPDR Gold Call option	1.9%		1.9%
Commodity Fund	3.5%		3.5%
Total	**9.2%**		**9.2%**
Other			
Long Volatility Fund	1.3%		1.3%
Sub Total	**100.5%**	**-44.2%**	**56.4%**
Cash			43.6%
Total			**100.0%**

Evolution of Asset Allocation for Somerston Multi Asset Fund



Performance

- The fund increased by +1.2% in the third quarter vs our reference benchmark 70/30 Equity/Bonds which was higher by +3.4%
- Our equities did well out performing the MSCI World Index by 0.8%. Microsoft, MasterCard and Thermo Fisher were the top contributors while AO Smith and Fresenius were the worst detractors.
- However, with a net equity exposure of 36% during a quarter when markets rose +5.3%, the decision to underweight equities was a material drag to performance.
- Our bond strategy was underweight during a falling market. The composite bond benchmark fell -0.9%.
- Our allocation to commodities cost the portfolio. In particular, Gold bullion was down -4.9% in the quarter.
- We continue to be long volatility which has been a persistent drag on performance during the quarter.

Present Strategy

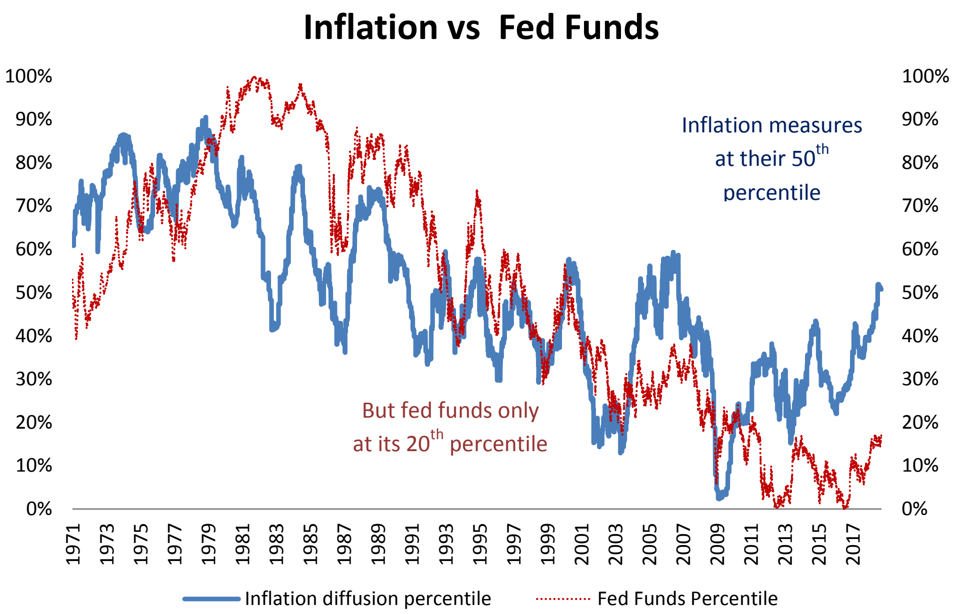
Highest Risks in a Generation?

The market is fully primed for a 'wakeup call' with record aggregate debt levels, the highest valuations on many measures and excessively optimistic sentiment. Moreover, with a global economy running at 'full' capacity, inflationary pressures are building and these may serve as the catalyst for financial excesses to be realized.

The structural trends of 'disinflation' and 'productivity growth' that has generated record profit margins and cash flow generation are being put on the table as bargaining chips in a high stakes game of 'Trade Wars'. The key negotiations are between North America and Asia. If these negotiations are drawn out, as presently appears likely, we could endure an adverse step change in inflation and productivity, reversing trends that have been favourable for equity markets for decades.

Emerging markets and cyclically sensitive sectors (Global Autos and US Housing) have had a whiff of weakness to reflect these risks, but North America represents more than 60% of the world market and the region's resilience has supported the world equity market to register positive returns for the year so far.

Even before the impact of the 'Trade War' is fully reflected in economic data many indicators are already pointing to much higher levels of inflation than most realise. US inflation measures are at their 50th percentile in aggregate for the last 40 years. The chart below illustrates the relationship between inflation and interest rates by establishing the level of both as a percentile of their historic range.



More worryingly, US inflation may be stoked further from a falling US Dollar. Not only is the US Fiscal position deteriorating significantly, thereby reducing the allure of the currency, 'redressing' the global trade imbalance that President Trump is so keen to resolve, will cause less US goods in global circulation, less US Dollars in global circulation and less incremental buying of US Dollars. Countries that run a trade surplus with America, accumulate excess US Dollars which they have traditionally recycled by acquiring US government debt, thereby funding the *budget* deficit. President Trump appears keen to reduce the trade deficit and increase the budget deficit at the same time. This is contrary to the equilibrium of the last 30 years and while not impossible, the US will need to find someone else to fund its lavish spending plans at the same time the Federal Reserve is reducing its holdings.

Furthermore, US brinkmanship has only increased the desire of the US's main trading partners to accelerate trade in currencies outside of the US Dollar. The Chinese have successfully launched Oil Futures in Shanghai settled in RMB. They are incrementally undertaking trade in RMB. The fewer Dollars in circulation, the less need to buy US paper and the more vulnerable the US will be. This is stealth 'financial war' and while the Chinese have a lot to lose, the US is vulnerable and the US Dollar is on the path to lose its status as THE world's reserve currency. The Chinese are incrementally buying real assets, diversifying their surpluses and trading in currencies other than the US Dollar.

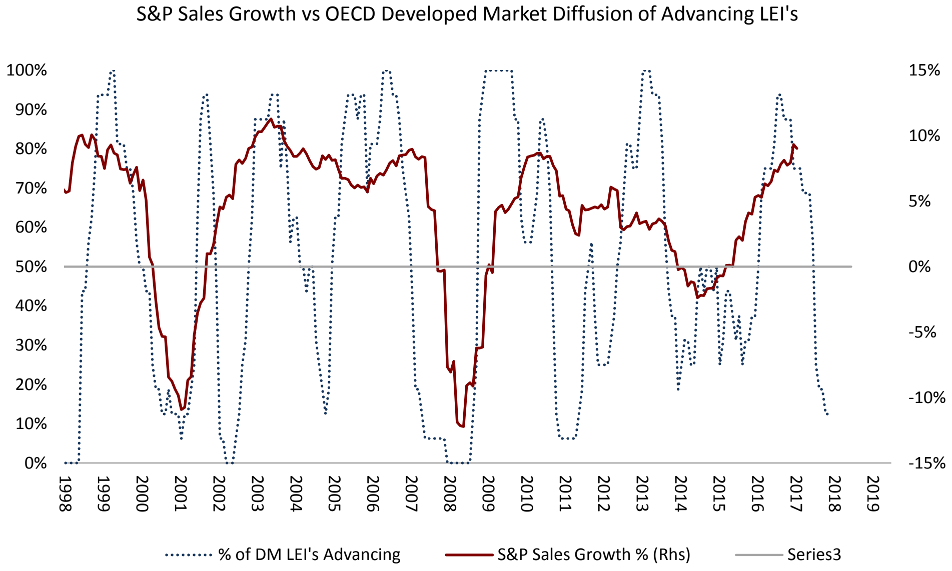
The extraordinary level of market valuations is becoming unavoidable. GMO are now forecasting negative -5% annualized real returns from US equities over 7 years just to get to equilibrium levels! Historically, high valuations have corresponded to more significant pullbacks during risk aversion when fundamentals crumble quickly and investors' fumble with whatever they can to justify holding their positions.

Since March 2009 the S&P has delivered a staggering total return of 348%. Few would have predicted such a rally at the time of the financial crisis. However, more incredible is the decomposition of that return. Aggregate revenues have only grown at 32%; operational and financial leverage have contributed 108%, and the PE has more than doubled contributing 115%:

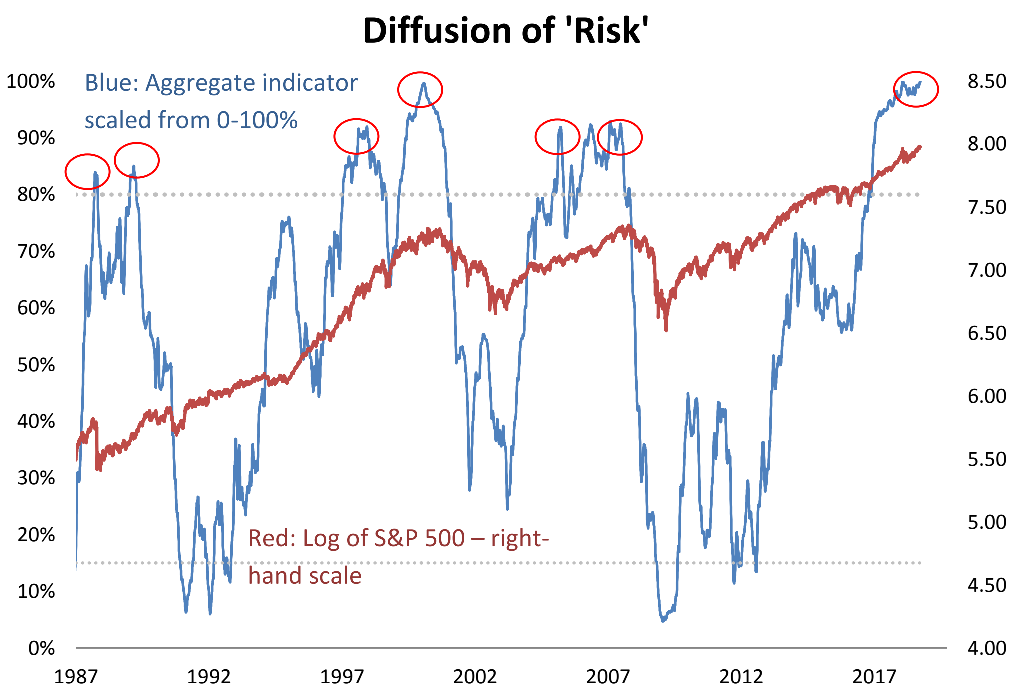
S&P Total return Attribution	Since Feb 2009 Growth Attribution
Sales growth	32%
Operational Margin expansion	86%
Interest and share count	32%
EPS growth	150%
Plus PE expansion	115%
Plus Dividend	83%
Total Return	**348%**

"There is only a certain amount of time that you can continue to fool everyone". Ultimately a company needs sales growth if they are going to continue to deliver such high rates of total shareholder return! Indeed, sales growth has never been more important as interest costs and inflationary pressures putting downward pressure on margins. However, Developed Market OECD Leading Economic Indicators have deteriorated to such an extent that sales growth also seems very unlikely in the near term.

OECD leading indicators points to lower revenue growth than forecast.



Taking account of indebtedness, valuations, inflation, interest rate, sentiment etc. we come up with the chart below that is an aggregation of 15 indicators which we have called the " Diffusion of Risk". You can see that this has done a good job of highlighing 'zones' of risk in 1987, 1990, 1998, 2000 and 2007. It also highlighted good buy zones in 1992 and 2009. This indicator is often early, but historically, it has put us 'on watch' at the right times. Worringly, this aggregate indicator is presently as high as it has ever been!



Bottom Line:

While our structural concerns are overwhelmingly bearish, we know that these can take time to manifest. Being in the high risk zone in the "Diffusion of Risk" indicator above, has often led to robust annualised gains closely followed by gut wrenching drawdowns. Presently, our cyclical indicators also warn us to be cautious on all risk assets. Accordingly, we are defensively positioned.

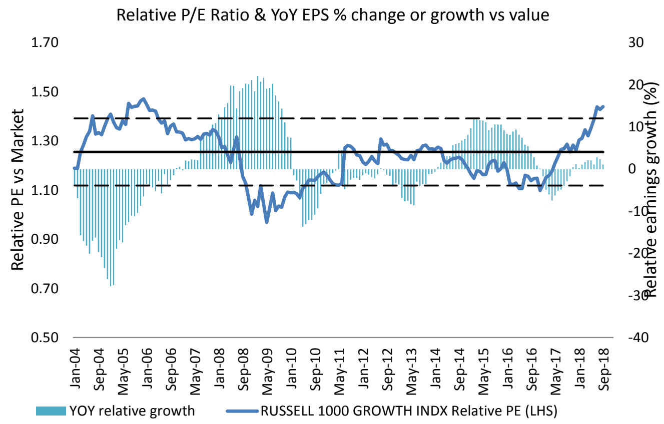
Portfolio Construction

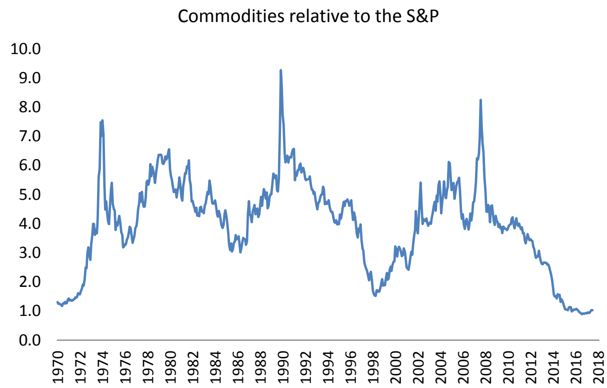
Over the last 40 years, benchmarks have become very equity and bond dominated. This has served investors really well in the disinflationary/deflationary environment of the past 35 years. However, if inflation were to feature more prominently going forward, Equity/Bond dominated benchmarks may be a disservice for investors.

In disinflationary cycles, equities tend to outperform during economic expansions and long duration, high quality government bonds tend to outperform during periods of adversity. Most investors have only ever experienced disinflationary cycles. As a result, asset allocation strategies have become fixated on the proportional allocation of bonds and equities. However, in inflationary cycles, gold, commodities, resources and inflation linked assets tend to be the strongest asset classes during economic expansions and very short duration high quality bonds tend to outperform during periods of adversity.

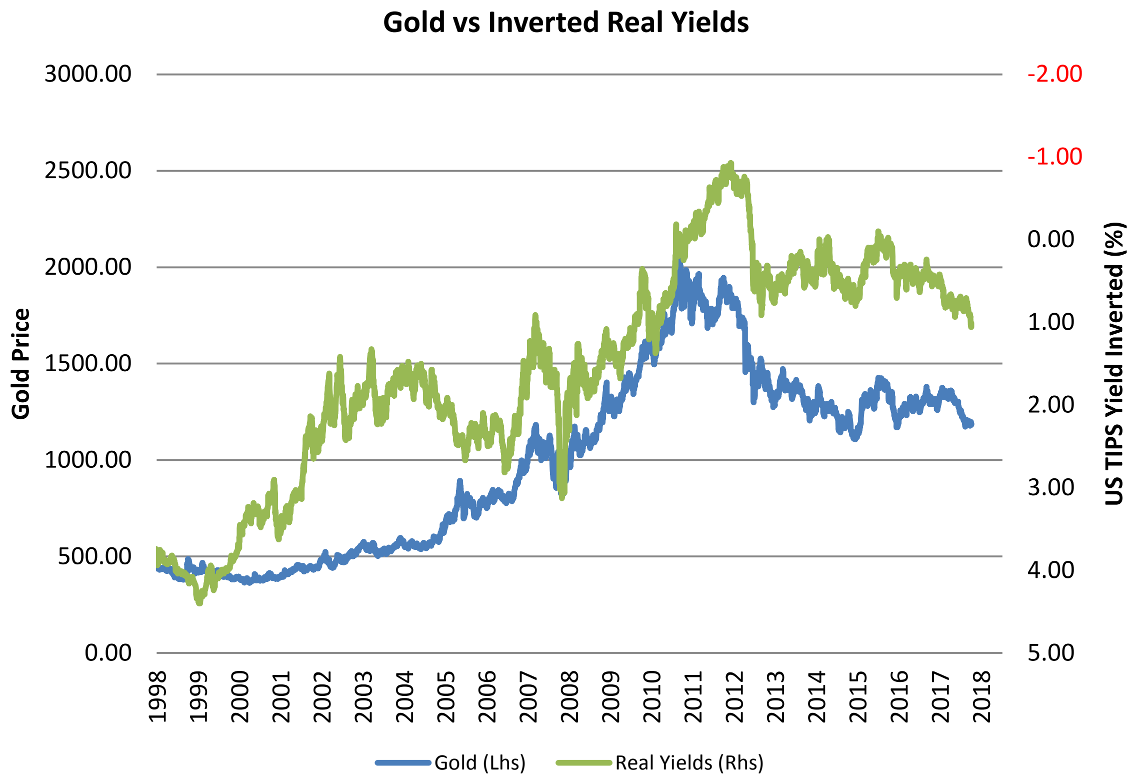
After decades of disinflation/deflation, 'Inflationary assets' have become overlooked and massively underrepresented in today's benchmarks. The probability of inflation in the years ahead may well be greater than investors are expecting, particularly if the disinflationary tailwinds of globalization are reversed. We consider it appropriate to have the latitude to allocate a significant proportion of the funds value to inflationary assets such as gold, commodities, inflation linked and other real assets if the conditions are right.

In our last letter, we showed that commodities are as cheap relative to the S&P as we have seen in 40 years (below right). In addition, we see growth stocks as expensive versus value stocks, which are largely represented by resource companies (below left). Accordingly, we have been gradually introducing commodity exposure to the fund. In addition, we have been *reducing* our equity growth exposures via short futures trades.





Gold struggles to appreciate when real yields rise, but we are very bullish of gold over the medium term, believing it is incredibly cheap relative to monetary bases and aggregate debt levels. Furthermore, the prospect of slowing growth and rising inflation might cause nominal yields to rise (to combat inflation) while real yields fall (to reflect slowing real growth). Under these circumstances, gold would forge ahead fueled by investors covering the significant speculative short position that has been accumulated.



We will maintain modest exposure to gold until the stars align but we have been acquiring gold call options which are priced with very low implied volatility. These options serve as a ‘tail hedge’, offering substantial upside if the gold price moves significantly higher following some unanticipated event.

Within our equity portfolio, our investments most exposed to growth flourished while those exposed to China languished.

Microsoft comfortably beat analyst forecasts as revenue growth accelerated to 15% driven by strength in PC's, traction in the cloud as Azure (now a $10bn revenue segment) grew 85%, and a very healthy corporate IT backdrop. **Alphabet** delivered robust quarterly sales growth and decent margin progression causing analysts to increase full year estimates. **Sherwin Williams** reported very strong results, with positive sales and volume trends in every division, a positive demand outlook for all businesses and geographies, and demonstrated its ability to pass on raw material inflation to its customers. Management raised full year guidance and the company comfortably outperformed its basic materials peers. **Thermo Fisher** was our top performer. Management reported a 3rd straight quarter of high single digit organic growth; 8% vs 5% expected. The company also comfortably beat forecasts on the bottom line and gave strong commentary on their end markets. Particular strength came from the biopharma division and China, which grew +20% during the period, un-impacted by macro-related issues. Management raised FY revenue guidance.

In contrast, **Fresenius SE** suffered during the quarter. Mylan, a US generic drug manufacturer, reported disappointing results, sparking concerns that competition in generics may spill over into the generic IV market in which Fresenius operates. New money may have been dissuaded from buying Fresenius shares until the Akorn trial is resolved - Fresenius uncovered misleading data following their bid for Akorn and are subsequently trying to withdraw from the deal. We believe generic contagion fears are overhyped and there is an asymmetric return potential if, as we expect, there is a positive resolution from the Akorn situation.

AO Smith was our worst performing holding as Chinese trade tensions escalated and the company spoke negatively about the Chinese market during a roadshow. In the short term the business will be under pressure and analysts have negatively revised their short term growth outlook for the region. The longer term outlook remains intact – energy efficiency drives demand for Smiths' products. Smith shares have de-rated to 5.5% free cash flow yield, which is over 1 standard deviation below its long term average relative to both peers and the broader benchmark.

Our equity portfolio is biased toward strong brand companies which require less capex than the overall market and are able to deliver sustainable growth in economic profits. We believe these 'high quality companies' are able to compound value through investing internally generate cash at high rates of return and they serve as the cornerstone of our portfolio.

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SOMERSTON ASSET MANAGEMENT

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