SOMERSTON ASSET MANAGEMENT

Somerston Multi Asset Fund (the Fund)

Investment Letter No.7 – December 2018

The Somerston Multi Asset Fund (US0 class) returned -0.9% in the fourth quarter and -0.2% for the year. The MSCI World Equity Index fell by -13.1% during the fourth quarter and a composite of UK, German and US Government bonds increased by +2.8%. Our Composite Benchmark fell by -8.5% in the fourth quarter and fell by -4.5% during the year.

Throughout the quarter, the fund had average equity and bond allocations of 27% and 41% respectively. The fund increased its bond allocation to 60% at the end of November and starts 2019 with net exposures of 26% in equities, 68% in bonds and 13% 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	-2.3	1.8	-0.4	**-0.2**

Top Ten Equity Holdings

Name	% Fund
Johnson & Johnson	3.8%
Reckitt Benckiser Group Plc	3.5%
Walt Disney Co/The	3.2%
Cognizant Tech Solutions-A	3.1%
Danaher Corp	3.0%
Fresenius Se & Co Kgaa	2.8%
Mckesson Corp	2.5%
Sherwin-Williams Co/The	2.5%
Alphabet Inc-Cl A	2.4%
Microsoft Corp	2.4%
Total for Top Ten	**29.2%**

Share Classes

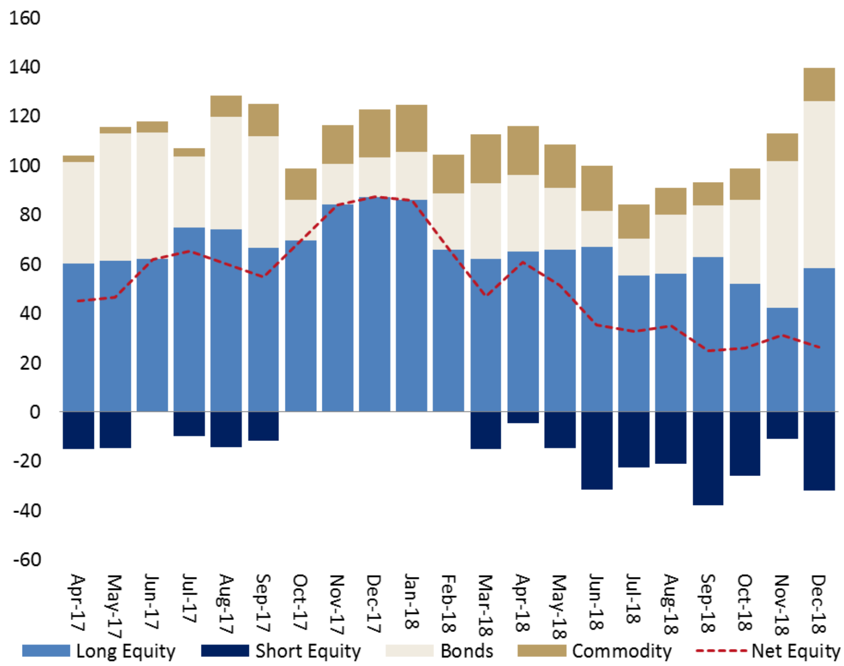
	ISIN	Ticker	NAV
US0	JE00BDRXFP25	SOMAUS0	101.9135
US1	JE00BDRXFQ32	SOMAUS1	100.5457
GB0	JE00BDRXFM93	SOMAGB0	98.9817
GB1	JE00BDRXFN01	SOMAGB1	97.6514
EU0	JE00BDRXFR49	SOMAEU0	97.2222
EU1	JE00BDRXFS55	SOMAEU1	95.9179

Asset Allocation

	Long	Short	Net
Long Equities	17.1%		17.1%
Hedged Equities*	21.4%	-21.5%	-0.1%
Long Emerging Markets	7.2%		7.2%
Long US Hombuilders ETF	1.9%		1.9%
Large Cap Long Growth/Short Value	5.1%	-5.0%	0.1%
Small Cap Long Growth/Short Value	2.7%	-2.7%	0.0%
Long Low Vol / Short High Vol	2.8%	-2.8%	0.0%
Equities	**58.2%**	**-32.0%**	**26.2%**
US Government Bonds	26.3%		26.3%
UK Government Bonds	25.5%		25.5%
Euro Government Bonds	16.1%		16.1%
Bonds	**67.9%**		**67.9%**
Gold Derivatives	8.0%		8.0%
Gold Miners	2.2%		2.2%
Comodities	3.1%		3.1%
Commodities	**13.3%**		**13.3%**
Long Vol fund	2.2%		2.2%
Total All Assets	**141.5%**	**-32.0%**	**109.6%**
Cash and Equivalents			**-9.6%**

**Long Equities/Short US and European index futures*

Evolution of Asset Allocation for Somerston Multi Asset Fund



Performance

- The fund fell by -0.9% in the fourth quarter outperforming our reference benchmark by +7.6%.
- The largest factor driving outperformance was our significant underweight to equities, which fell 13.1% during the quarter. Our average net equity position was 27% vs the benchmark allocation of 70%. Moreover, 28% of our net equity exposure was allocated to emerging markets during November and December. EM equity performance was flat during this period, materially outperforming world markets. The fund outperformed the benchmark by +7.6%, of which +6.6% was attributed to equity allocation decisions.
- We held long exposures in interest rate sensitive/ defensive/ low volatility sectors while being short the market. This strategy delivered +0.3% during the quarter.
- Our bond strategy avoided credit entirely and focussed on mid to long term government bonds. We maintained an overweight bond allocation and significantly increased exposures in October. This positively contributed to performance. In aggregate our bond strategy generated +0.8% outperformance versus the benchmark.
- We have held a long volatility position for some time. This had cost us before the 4th Quarter, but delivered +0.5% at a crucial time.
- Within our commodity strategy, our exposure to Gold Calls and Gold Royalty companies more than offset losses to resources and general industrial commodities. In aggregate, our Commodity positions added 0.1%. Our equity book underperformed by 1.4% in the quarter, negatively impacting both our net long exposure and our hedged exposure. Given our present macro bias for quality that we would expect to outperform in adversity, this

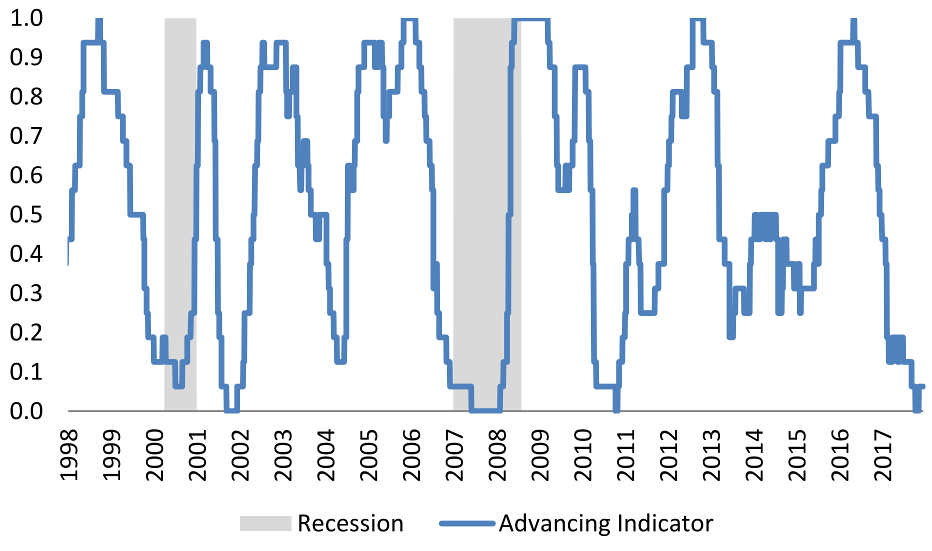
outcome was disappointing. Thermo Fisher, Danaher and Disney outperformed while company specific issues at Fresenius SE caused the stock to fall dramatically - it was the standout detractor, with Blackrock and Cognizant underperforming as well.

Present Strategy

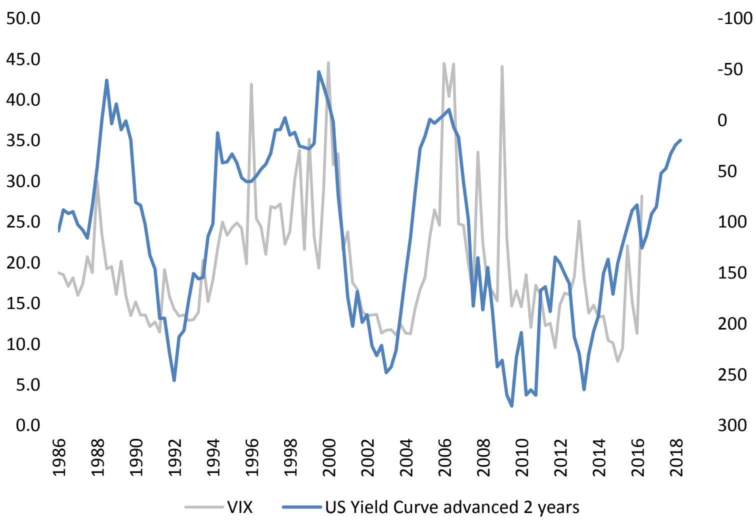
We started our September report as follows:

"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."

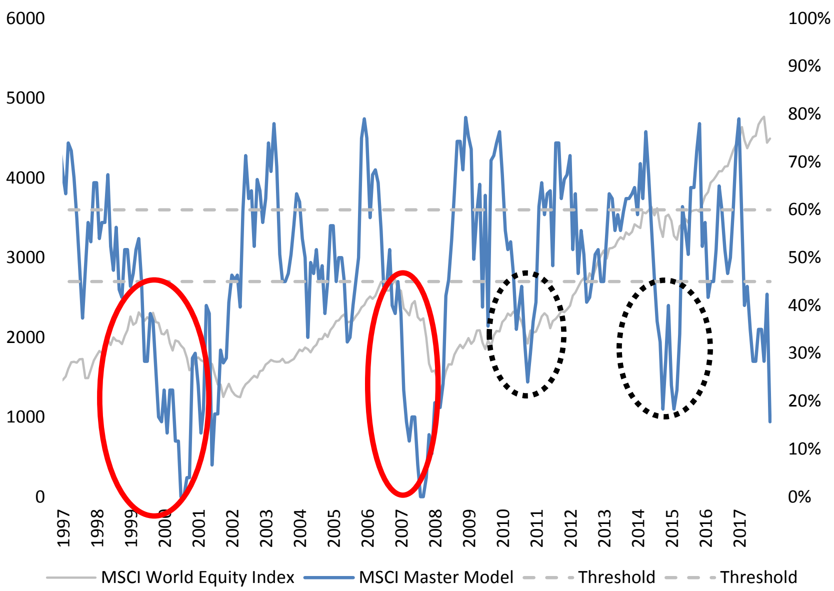
This opening comment could not have been more prescient. The markets have sold off aggressively with the US markets down -13.7% in the 4th Quarter. In recent weeks 'hard economic data' is rolling in weaker than 'most' expected, vindicating the bears. Commentators and strategists who told everyone that 'growth is strong and the economy was fine, to hold firm and not panic', are eating their words. When the economy is strong and starts to **decelerate** historical market returns have been terrible **–** as we have now. Conversely, market returns are generally strong when growth has slowed but is starting to **accelerate** from a low level. You don't need a crystal ball to anticipate these decelerations and accelerations. There are several indictors that are hyper sensitive to the cycle and lead the overall market. GDP, Consumer Confidence and Employment, while often cited, are merely coincident with the cycle with very little valuable information for investment strategy. We again show our breadth of developed market Leading Economic Indicators (LEI) as published by the OECD. This indicator shows the percentage of developed market LEI's advancing from 6 months earlier. As can be seen below, it tops out well ahead of a US recession and while this indicator does give some false warnings, it suggests we are now in a global recession if not a US one.



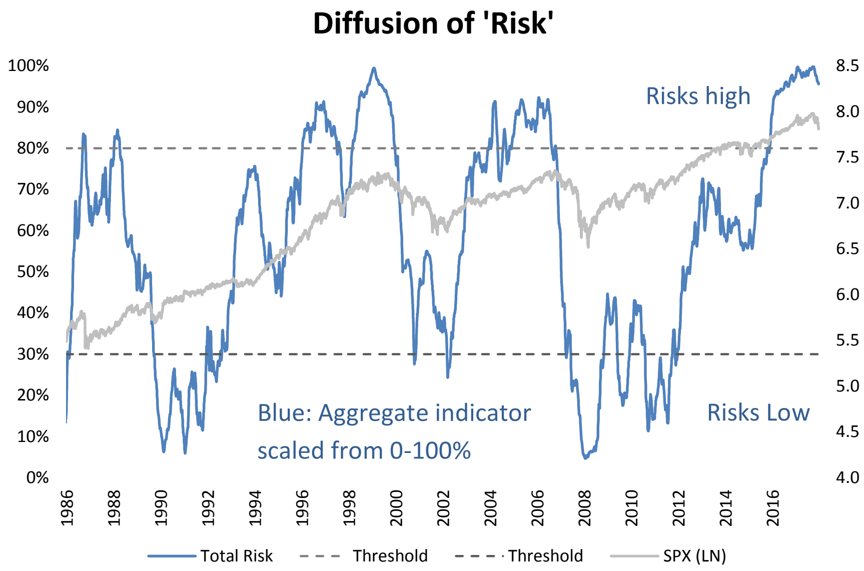
The much berated yield curve has once again proven itself an exceptional leading indicator. The chart below shows the 2's/10's US yield curve in blue which we advance 2 years with the Vix in grey. The curve was warning of much higher levels of volatility for over a year before the market finally got it.



As ever, credit also gave us a decent early warning signal, with Investment grade spreads widening from the end of January 2018. **Indicators which have a long and persistent record of giving early warning signals <u>had been on red alert for at least six months prior to the start of this quarter</u>.** Our Master Model for the MSCI World Equity Market entered its most bearish zone in March 2018 and has remained in this zone pushing lower again at the end of December.



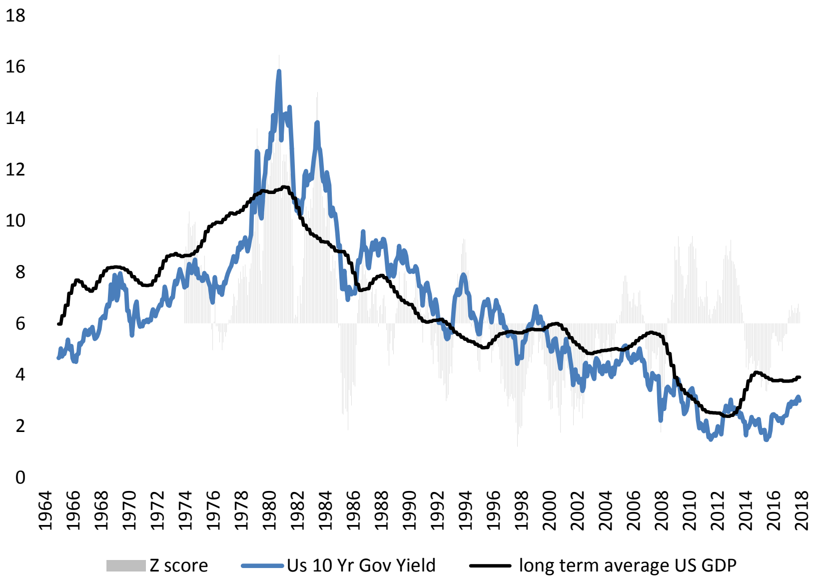
Is our MSCI World Equity Master Model signaling a bear market like 2001 and 2008 or will it be a false warning in an ongoing bull market, much like 2011 and 2015? We consider 2011 and 2015 would have been far worse market events were it not for Central Bank Intervention. In essence QE deferred the inevitable and allowed excesses to build up. Prevailing risks are now as high as we have ever seen, surpassing both 2000 and 2007. It stands to reason that if you price the risk free at zero for long enough, money will bid other assets up until they are also priced for zero returns. The chart below is updated from September's report showing our Diffusion of Risks Indicator which is an aggregation of 16 different indicators representing valuation, leverage, credit conditions, sentiment and business activity for the US market. While the selloff has been aggressive, and we see short term indicators such as the number of stocks making 52 week lows and very steep volatility term structures flashing 'get ready to buy' signals, the aggregate level of risk remains extremely elevated. High aggregate risks together with our tactical Master Models firmly in negative territory, put us in a 'sell the rallies' mode.



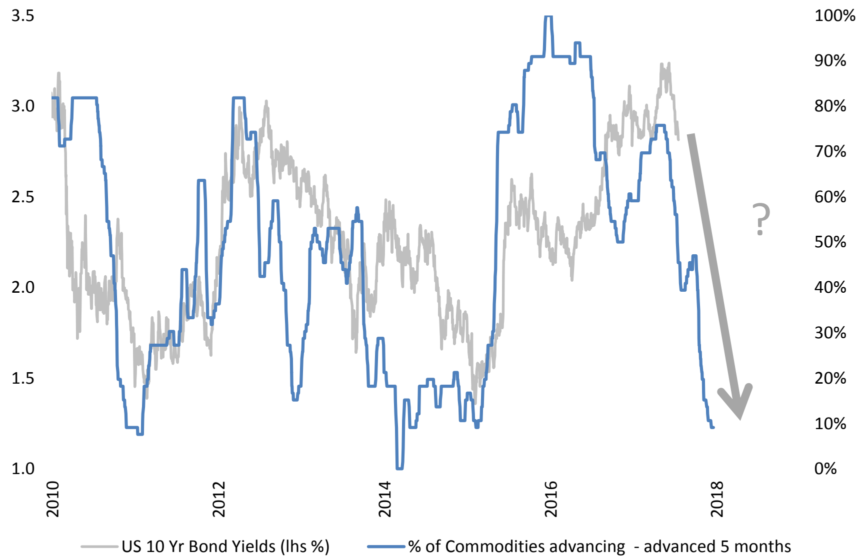
We continue to favour defensive, interest rate sensitive, dividend payers in our long equity book, avoiding high beta and momentum factors. We consider this *might* be the beginning of a much larger unravelling, or as some have dubbed it, the bursting of the 'Everything Bubble'. However, we are not dogmatic and we are certainly not hinging our strategy on any specific forecast. If our tactical indicators change we will act to stay in harmony with the weight of evidence.

There has been growing consensus that Government bonds are a 'bubble'. We were not particularly keen on Government bonds for over two years but equally, we were never in the 'bubble camp' as we did not consider valuations anywhere near 'bubble' levels.

Nominal Bond yields are a combination of **real yields** and **inflation expectations**. Real yields are inextricably related to long term real growth. In the US, long term trend growth is restrained by adverse demographics in the form of working age population as a percentage of dependents, falling labor participation and stale productivity trends, equating to relatively stable real growth trends of a little under 2% at best. More difficult to ascertain and far more variable, are long term inflation expectations. Over recent years US Inflation has been running at 1.7% on average which when combined with real growth of 2%, equates to trend nominal GDP of around 3.7% on average. As the chart below shows, cost of capital (bond yields) have broadly equaled the return on capital (nominal GDP) over long periods (as we would expect). So a 10 year yield at 3% vs 3.7% does not seem radically bubble like.



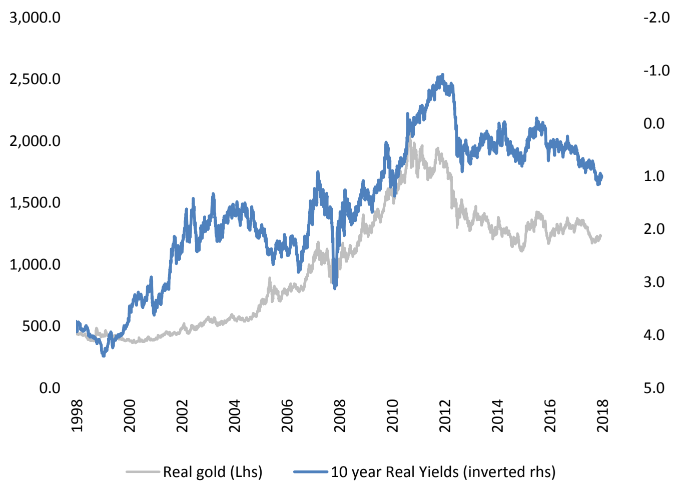
Admittedly, in 2016, bond yields appeared too low relative to trend growth. They have somewhat closed this valuation gap in the last two years. While it appears there is still a ways to go until the gap is totally closed, we consider historic trend nominal GDP growth to be elevated, the result of a ten year economic expansion that is coming to an end, and not wholly representative of what future nominal GDP will be. Crucially, inflation is presently suffering material headwinds with long term inflation expectations plummeting on the back of very soft commodity prices.

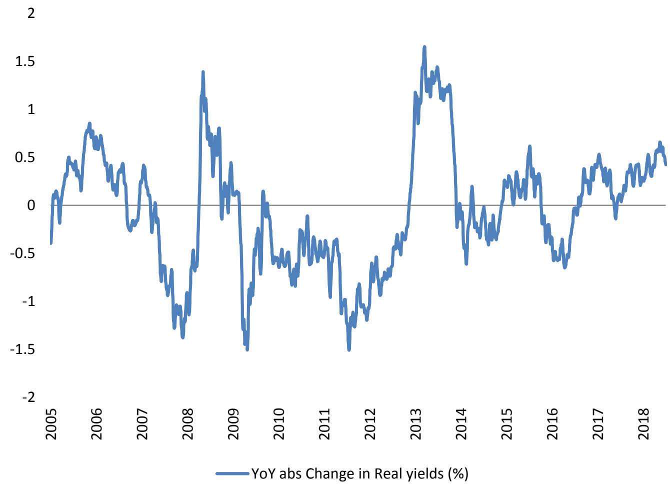


Commodities are very weak. Bond yields can fall substantially

The last time the percentage of commodities rising from 6 months earlier was as weak as it is today, US ten year bonds yielded less than 1.5%. At the end of 2018, they yielded 2.7%. As the chart above shows, yields could have much further to fall to catch up to commodity weakness. If the equity rout continues, as we expect, we think the US ten year could be between 2.25% and 2.5% at a minimum. Accordingly, given market adversity and deterioration in inflation expectations we continue to hold overweight government bond exposures with an average duration of 9.0 years and no credit at all.

Gold performed very well in the 4th Quarter and we expect much higher gold prices in the medium term. Gold is the ultimate **risk free**, **zero coupon**, **inflation protected, ultra-long duration** asset. Like all unproductive assets, the primary driver of its fair value is the change in the discount rate, which is approximated by real yields or long term US Inflation protected government bond yields (TIPS). As the discount rate moves higher, gold falls and vice versa. The chart below left shows the gold price in grey and the yield on US TIPs, inverted in blue to show the negative relationship. The chart right shows the year-over- year change in TIPs yields beginning to roll over, lowering the discount rate and pushing gold's fair value higher.





The majority of our gold position is through Gold calls that are 20% out of the money and continue to be priced with a low implied volatility. In the event of an unexpected shock, we see gold calls as one of the best tail hedges. However, we do consider gold is in store for a pullback in the coming weeks, retracing some of its initial move and we will look to add on any weakness.

In summary, the market has accumulated a raft of heavy excesses predicated on cheap money and Quantitative Easing. The economic cycle is mature with peak GDP, peak employment and peak consumer confidence. The data is only just rolling over from lofty levels. In short, we consider we are in the early stages of this down cycle. While the market will have violent swings in both directions, we are sellers of equities and credit on rallies and buyer of gold on weakness. While too early to say for sure, but I suspect adversity will only abate once the Central Banks about turn and start easing. That prospect is several months away.

Our equity holdings underperformed their benchmark by 1.4% in Q4. Performance was negatively impacted by stock selection and reflected a reversal of the outperformance generated earlier in the year. Calendar year 2018 performance was a more respectable outperforming by 0.14%.

Our overall allocation to defensive sectors was broadly beneficial. ‘Dividend aristocrats’ and classic defensive sectors outperformed. However, disappointingly, our healthcare stocks were the largest “defensive” allocation, and they materially underperformed the other defensive sectors utilities and REITS. Moreover, two of our healthcare stocks suffered specific issues and were amongst our worst performers. The most damaging was Fresenius SE that fell 33% during the quarter.

The drivers of equity performance during Q4 are **fascinating**. Stock selection was not materially driven by a preference to sectors, or growth over value or high quality vs low quality as might be expected, but the dominant factor was **beta/volatility**.

Factor	Relative performance (1Q/4Q)
Size (Large cap outperformance)	5.3%
1 Year P/E Expansion	5.1%
Nearest to 52 week price high (high out)	4.1%
1 year Price Momentum	1.2%
ROE	1.2%
ROCE	-0.7%
Earnings Volatility (High Vol vs Low)	-2.0%
Forward EPS Growth	-7.9%
VOLATILITY	-21.8%
BETA	-27.0%

Simply put, **the top quartile of Russell 1000 stocks by beta underperformed the lowest quartile of beta stocks by 27%!** No other factors exhibited such complete dominance. We expected high quality to outperform low quality, but the spread was only 0.25% and within our preferred high quality universe, the spread between the lowest beta and highest beta stock was 35.6%!

In the initial stages of market corrections, short term price moves can be poorly correlated with fundamentals. In the short term it can be painful but in the fullness of time, this disequilibrium should moderate. Indeed, many of our holdings have now de-rated to very attractive relative valuations, whilst their business prospects remain fundamentally unchanged, leaving us more optimistic for the future.

Quality is a subjective measure and we spend a great deal of time assessing both qualitative and quantitative aspects to identify quality companies that have low business and financial risk. Our investment strategy skews us towards such businesses, but a quality business may have low beta and be defensive of may have a higher beta and exhibit moderate cyclicality.

Outperformance in falling markets is a key aspiration. When macro conditions deem it wise, we will ere on the side of caution. But should the right economic conditions prevail, our capacity to skew exposure to perform well in rising markets is also vitally important. For now we remain cautious.

Recent Developments and Notable movers

As the quarter progressed, we tilted the direct equity exposure more defensively; increasing exposure to Healthcare companies and more defensive, value oriented positions. We reduced exposure to more highly valued, higher growth companies following strong performance and our more defensive/bearish equity outlook.

Early in the Quarter we sold our position in Kerry on valuation grounds, following strong Performance. **Kerry** remains a highly attractive consumer staples company, occupying a key niche in delivering innovative taste, nutritional and functional ingredients to the food, beverage (and to a lesser degree) pharmaceutical industries. At a time when large swathes of the consumer staples sector are coming under pressure from greater competition and new distribution models, Kerry is able to remain a leader in its industry. Kerry's business remains attractive and it is a company we continue to follow, but the premium valuation simply became too excessive in the short term.

We initiated a position in **Walt Disney** which is launching its own direct to consumer OTT streaming service called 'Disney plus'. With brands like Pixar, Marvel, LucasFilm, Disney and now the 21st Century Fox family, Disney has the World's richest Film and TV content library. Its Studio division is experiencing record productivity and profitability, so its library continues to strengthen. Disney generates c. $10bn of free cash flow annually to invest in growth opportunities, new content and the OTT platform. Disney shares trade on 16x earnings. In contrast Netflix had a cash burn rate of c. -$2bn over the last 12 months and its shares trade on 110x earnings. In addition, Disney has the opportunity to revolutionise sports broadcasting with its sports streaming platform ESPN plus, and its parks division appears primed for strong growth following major capital developments which vastly broaden its demographic appeal.

Fresenius SE was our worst position in Q4, falling 33% during the month. Fresenius is a unique, highly diversified German health care company with market leading operations in renal dialysis, German hospitals, clinical nutrition, and generic intravenous drugs. In mid 2017, Fresenius began to underperform. The market became concerned that its North American drug business faced pricing pressure and litigation pertaining to its $4.3bn merger with Akorn was open ended. The pricing issue never materialised and in early December the Akorn issue was fully resolved in Fresenius's favour. Shortly thereafter, management revised down their mid-term guidance. The shares were already down -35% from their 2017 highs, but investors capitulated and the share price dived another 10%. The pullback has been excessive in our view. Whilst the German hospital business will slow marginally over the next 5 years, it is in a transition period that will position it well for the future, the dialysis unit is already in recovery and the other business units look strong. Healthcare businesses like Fresenius do not die overnight. Fresenius has behaved like a highly cyclical tech stock, not one of Europe's most defensive and diversified healthcare companies, with 25 years of steady double digit earnings growth and consecutive dividend increases. Fresenius is expected to achieve mid-single digit sales growth and low double-digit earnings growth CAGR over the next 5 years. It is highly profitable and defensive yet the shares are now trading at record low relative valuations at 11.4x P/E and 7.5x EV/EBITDA. As a leading analyst covering the stock summarised; "There is no plausible scenario we can envisage for Helios Germany that justifies the current share price – modelling a decade of severe losses in this business would not reduce our valuation to the current share price".

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