SOMERSTON
ASSET MANAGEMENT

Somerston Multi Asset Fund (the Fund)

Investment Letter No.8 – March 2019

The Somerston Multi Asset Fund (US0 class) returned +3.3% in the first quarter. The MSCI World Equity Index rose by 12.6% during the first quarter and a composite of UK, German and US Government bonds increased by +2.6%. Our Composite Benchmark rose by 9.6% in the first quarter.

During the first quarter, the fund had average equity and bond allocations of 15% and 65% respectively. The fund starts the second quarter with net exposures of 52% in equities, 58% in bonds and 18% 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**
2019	1.1	-0.6	2.8										**3.3**

Top Ten Equity Holdings

Name	% Fund
Fresenius Se & Co Kgaa	4.6%
Johnson & Johnson	4.5%
Reckitt Benckiser Group Plc	3.9%
Diageo Plc	3.5%
Thermo Fisher Scientific Inc	3.5%
Pepsico Inc	3.4%
Kerry Group Plc-A	3.1%
Danaher Corp	3.0%
Rubis	2.9%
Microsoft Corp	2.5%
Total for Top Ten	**35.0%**

Share Classes

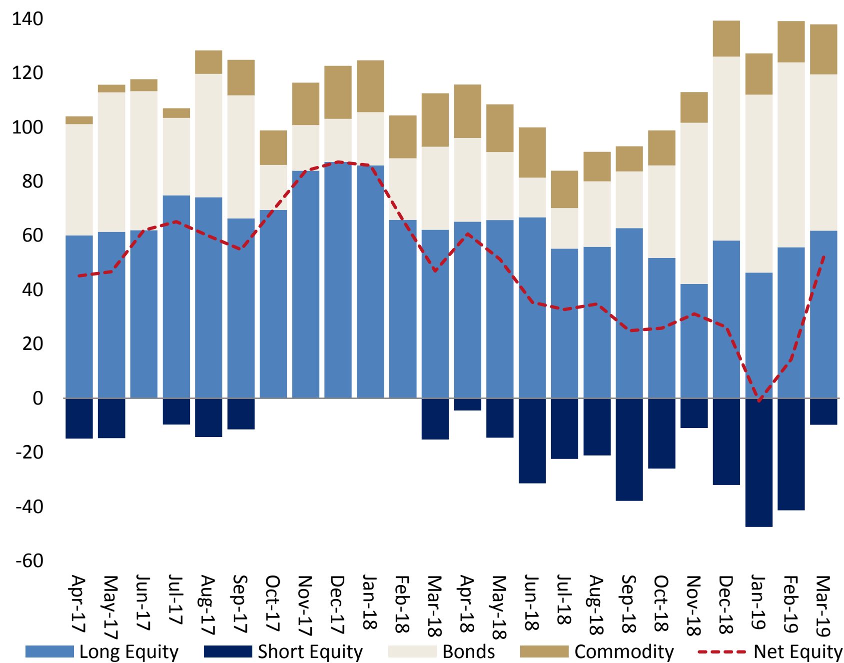
	ISIN	Ticker	NAV
US0	JE00BDRXFP25	SOMAUS0	104.5557
US1	JE00BDRXFQ32	SOMAUS1	102.8930
GB0	JE00BDRXFM93	SOMAGB0	101.1324
GB1	JE00BDRXFN01	SOMAGB1	99.5233
EU0	JE00BDRXFR49	SOMAEU0	99.0107
EU1	JE00BDRXFS55	SOMAEU1	97.4342

Asset Allocation

	Long	Short	Net
Long Equities	45.8%		45.8%
Hedged Equities*	4.4%	-4.4%	0.0%
Long Emerging Markets	6.3%		6.3%
Large Cap Long Growth/Short Value	5.4%	-5.4%	0.0%
Equities	**61.9%**	**-9.8%**	**52.1%**
US Government Bonds	2.7%		2.7%
US Govt inflation linked bonds	14.8%		14.8%
UK Government Bonds	15.3%		15.3%
UK Govt inflation linked bonds	4.9%		4.9%
Euro Government Bonds	12.4%		12.4%
PIMCO Global Inv Grade Credit Fund	7.5%		7.5%
Bonds	**57.6%**		**57.6%**
Gold Derivatives	10.1%		10.1%
Gold Miners	2.2%		2.2%
Energy Select Sector SPDR	2.9%		2.9%
Gresham TAP Fund	3.2%		3.2%
Commodities	**18.4%**		**18.4%**
Long Vol fund	2.0%		2.0%
Total All Assets	**139.9%**	**-9.8%**	**130.2%**
Cash and Equivalents			**-30.2%**

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

Evolution of Asset Allocation for Somerston Multi Asset Fund



Performance

- The fund appreciated 3.3% in the first quarter. This represents an underperformance relative to our reference point. However, during the six month hiatus where equity markets plunged and rallied just as quickly, in contrast to the market, the fund is at a new high and suffered a monthly drawdown of 2.3%.
- The largest influence on underperformance was equity allocation. We had very low allocation to equities during a vigorous equity market rally.
- Equities contributed +1.7% to total performance.
- Our stocks outperformed by +1.7% with Thermo Fisher and Danaher the largest contributors.
- Our bond book did well contributing +1.7% to total performance. We were long duration at the start of the year and switched a large part of that to inflation linked bonds earlier in March.
- Commodities contributed 0.3% with Gold lagging.
- Relative value trades added +0.2%.
- Long Volatility positions lost -0.7%

Present Strategy

We want to be long equities, growing portfolio value in a meaningful manner and our general caution over the past 12 months, and significant underweight to equities, based on a holistic

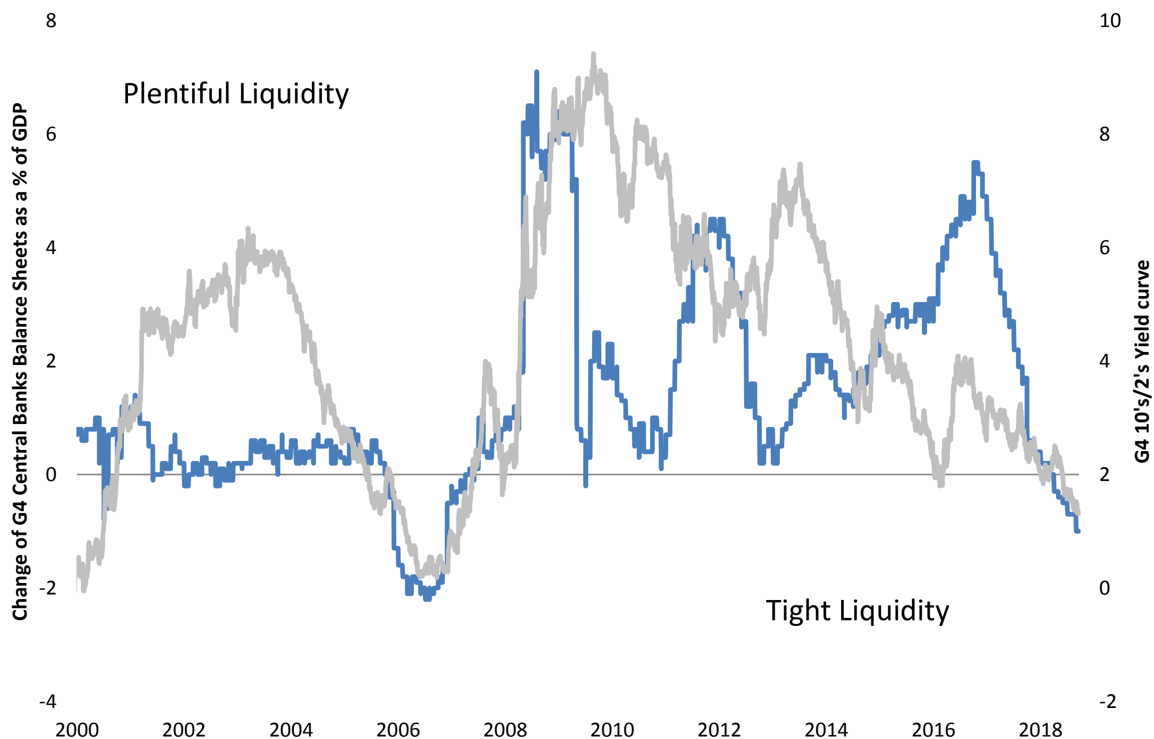
assessment of economic data has been too cautious. However, evidence is aligning that makes us more constructive.

As anticipated in our last report, economic growth has slowed rapidly in Q1 2019. In the context of this environment, US bond yields fell substantially and the US ten year bond yield fell from 2.7% to 2.3%, and after a consolidation, gold pushed higher. The fund was positioned for both outcomes. However, we were entirely unprepared for stocks rallying aggressively. On the one hand, strong government bond markets have discounted lower economic growth and on the other hand, strong equity markets have discounted much higher growth. The reality probably lies in the middle.

We expect we are in a global recession, not that this means much for investment strategy, it is merely a natural manifestation of an economic cycle. Losses in equity markets are endured as the economy slows before recession manifests such as we experienced in Q4 last year. Contrary to common belief, the best equity market returns come from the nadir of recessions, after the bad news has been discounted and recovery is 3- 6 months away. However, the US economy peaked in September, some 6-9 months after the global economy; it is slowing rapidly and it will likely continue to slow until year end. None of this matters however, because the Federal Reserve 'unleashed' the power of the proverbial 'Fed Put' which 'trumped' every bit of bad data. It has become very clear that Powell is not our ideological saviour. Like all of Greenspan's successors, Powell is clearly here to serve the market. He is not concerned with long term stability of the economy – someone else can sort that problem out when it becomes too big to ignore.

In Q4 credit markets froze, high yield bond issuance entirely dried up and leverage loan spreads moved from 5.2% to 7.0% in a matter of weeks. Without liquidity, companies are not able to roll debt obligations and a wave of defaults and bankruptcies would ensue. Since the GFC, Central Banks appear entirely unwilling to allow credit spreads to widen for long, or volatility to sustain. The 'mistake' of allowing Lehman to go to bankrupt seems to have left an indelible memory in policy makers' minds. In the first sign of trouble, Central Banks step in. This has huge and unpleasant implications long term. For now, Powell has clearly communicated: "don't worry about fundamentals – Just keep buying".

Falling interest rates in the form of lower bond yields, lower energy costs, improved financial conditions and a global cycle that is nearing maturity has sowed the seeds for a cyclical, global economic recovery that will most likely manifest at some point in the next 6-12 months. However, with US economic data unlikely to trough until the end of the year, their recovery is some 6 months further on. The extent to which markets have discounted better times ahead appears a little premature. We are somewhat concerned that the Central Banks have only voiced their 'put' option. They have not yet actually really done very much. As can be seen from the chart below, whether we look at the year over year change in G4 Central Banks Balance Sheets or the shape of the global government yield curve, liquidity conditions remain tight. If equity and credit markets march too high and labour markets remain strong, the anticipated rate cuts that investors have baked in may not come through. In the face of probable continued economic weakness, this would not be received well by financial markets.



Accordingly, while we have reduced bond weightings and duration modestly, we remain overweight government bonds. However, crucially, we have switched 19.7% into inflation linked bonds. Inflation linked bonds are a significant beneficiary from falling real yields and we see ample evidence that inflation has troughed despite real growth continuing to weaken. A period of stagflation has become more likely. Serving as a material tailwind for inflation linked bonds, gold and commodities more broadly. We remain overweight commodities and initiated an investment in the energy sector.

In equity strategy, we continue to favour high quality companies. While we believe the broad US market may finally underperform, the valuation of global high quality companies are most attractive in the US. We are also incrementally positive on emerging markets which offer far more attractive valuations from a US Dollar perspective.

We are therefore quite balanced at this stage, hedging the portfolio from potential deflationary shocks through investment in nominal government bonds, investing in commodities and inflation linked bonds will benefit from stagflation and investment in high quality companies and exposure to emerging markets should benefit from a real growth recovery.

Our mandate is to be invested in equities when the weight of evidence supports such actions. It is highly probable the fund will finally reach that position in the coming months. Many of the pieces are falling into place and the Central Banks, once again, appear to have our backs. Our conviction

will rise further once negative global economic momentum finally abates, or the markets once again become sufficiently oversold to improve our entry levels.

Equity Review

- The core equity positions had a very strong quarter in both absolute and relative terms.
- Total return of our equity book was +14.3% vs MSCI World benchmark +12.6%.
- During the quarter the core equity allocation increased to 52%.
- We tilted the holdings more defensively, increasing consumer staples allocation and reducing aggregate Beta to 0.87
- We sold two positions and added seven new investments, increasing the holding count to 19, diversifying exposure.
- Strong performance of the fund's healthcare companies was the principal contributor to outperformance.

After a difficult end to 2018, equity markets bounced back strongly in January. Global equities rallied and cyclical sectors outperformed. In contrast to strong price action, global macro data continued to disappoint, forward earnings expectations have been revised downwards and valuations look stretched once more. We used January's market strength to rebalance core equity holdings more defensively. We initiated new positons in PepsiCo and Diageo and increased our holding in Reckitt Benckiser.

Despite the broader staples industry facing disruptive pressures, **Pepsi** has delivered consistent mid-single digit revenue growth since 2012, primarily driven by its food business. Pepsi responded early to the increasing consumer preference for health and wellness oriented drinks and snacks. It is a leading innovator in all its categories, with health oriented offerings including Quaker cereals and snacks, Naked smoothies and fruit bars, Bare fruit and vegetable crisps, Tropicana juices as well as its water brands LifeWater, Aquafina and SoBe. It is a classic quality compounder, reinvesting internally generated cash and achieving high returns on invested capital.

Diageo is the World's largest spirits company with 30% share of the global premium spirits market. It benefits from enormous scale advantages, immense brand value and significant emerging market growth opportunities. A significant performance driver for the company is upselling to premium product lines. H1 2019 results demonstrated the quality of its organic growth model, with organic sales growth of 7.5% evenly driven by volume and price increases, whilst organic profits grew 12.3%. The premium spirit category has so far been relatively protected from disruption compared to other categories and we expect this trend to continue.

We sold our entire holding in Blackrock and top sliced our higher beta, more cyclically exposed positions redeploying the funds into our healthcare holdings Thermo Fisher and Fresenius. Markets

continued to drive higher in February but despite our more defensive allocation, core equity holdings outperformed.

Danaher was our top performer, rising +28.2% during the quarter on the back of excellent 4Q results across every segment and after announcing it would acquire GE's biopharma business. The acquisition (made at a distressed price) is highly strategic, extending Danaher's leading position in the fastest growing biologics market. Danaher's ability to acquire strategically beneficial, underperforming business and transform their profitability is un-paralleled. We top sliced the position into strength.

Fresenius SE rose +17.4%. The Medical Care division finally turned around in Q4 and the troubled Helios division looks to be stabilising, with better than expected top line growth last quarter driven by pricing increases. Management sound increasingly optimistic about the future and Mid-term guidance for 5-9% organic net income growth has been reassuring (inorganic growth typically drives an extra 2-4% growth a year). It is staggering that such a high quality, defensive, diversified health care company like Fresenius is trading at a discount to the market and over one standard deviation below its historic valuation levels. The share price is finally gaining momentum as investors stop focusing on last year's results, where the company failed to grow, and re-assess the significant longer term opportunities. Fresenius was our largest holding at month end after we topped up the positon early in the quarter.

We initiated a position in **Rubis**, a global energy infrastructure company that distributes LPG and bulk liquids, operates terminals and fuel distribution facilitates. Rubis operates in niche markets where it has a leading market share and controls and owns key supply chain infrastructure, creating immense barriers to entry. Issues at its Turkish and French storage facilities (part of the storage business which accounts for less than 20% of EBIT) weighed on the share price in 2018 creating an uncommonly attractive entry point and masking solid organic growth in its core distribution business and exciting inorganic opportunities. As these issues normalise we expect the share price to re-rate significantly.

We bought back our position in **Kerry** which we sold in October on valuation grounds. Since then, it has underperformed the consumer staples sector and Pepsi (the positon we initiated using the cash realised from selling Kerry) by 12%. Consumer Staples continue to face significant headwinds but Kerry is flourishing, growing revenues and margins faster than the industry on the back of occupying a niche in driving innovation in healthy convenience food and beverages.

We sold **Mckesson** which faces a plethora of headwinds that have accelerated in recent months and whilst the company is arguably a high quality dividend aristocrat trading on record low valuations, our faith in its economic moats has deteriorated and there is simply too much uncertainty facing the industry to justify holding the investment. Amazon is threatening to enter pharmaceutical distribution and recent commentary suggests its US push is accelerating. In addition

government pressure to limit pharmaceutical costs and price hikes has intensified and the threat of litigation relating to the opioid crisis will likely continue to weigh on the shares for some time.

nick.wakefield@somerston.com

alan.lemaistre@somerston.com

01534 822392

Disclaimer

Any information in this Document may not be suitable for all investors. Investors must make their own investment decisions using their own independent advisors and reviewing relevant offering material (including the Final Offering Document). Any investment decisions must be based upon an investor's specific financial situation and investment objectives and should be based solely on the information in the relevant offering material.

The Fund's manager, Somerston Asset Management Limited (the "**Manager**") believes the information contained in this Document to be reliable but does not warrant its accuracy or completeness. The information contained herein is preliminary in nature and is not and does not purport to be complete. Any estimates contained herein may be subject to change without notice. No guarantee or representation is made that the investment program set out in this Document, including, without limitation, any investment objectives, diversification strategies, or risk monitoring goals, will be successful, and investment results may vary substantially over time. Investment losses may occur from time to time. Nothing herein is intended to imply that the Manager's investment methodology may be considered "conservative", "safe", "risk free" or "risk averse".

No person, including (without limitation) any of the members, shareholders, directors, officers, partners, employees or advisers of the Manager or its associates, accepts any liability whatsoever (whether direct, indirect, incidental, special, consequential, punitive or otherwise) for any loss arising from any use of the information, opinions or other statements contained herein or otherwise arising in connection therewith (including in the case of negligence, but excluding any liability for fraud) and, accordingly, liability is disclaimed by all such persons to the maximum extent permitted by applicable law or regulation

No Investment Advice

The information contained herein does not constitute advice and should not be relied upon for any purpose. No approvals have been given by the Jersey Financial Services Commission in respect of the contents of this Document or the circulation of any offering document in relation thereto.

The information contained herein is not intended to influence you in making any investment decisions and should not be considered as advice or a recommendation to invest. This Document is for information only and provision of this Document does not in itself constitute any kind of service provided by the Manager. Furthermore, this Document does not purport to describe all of the risks associated with investment or the other matters described herein. Income from or the price or value of any financial instruments may rise or fall.

Somerston Asset Management Limited is regulated by the Jersey Financial Services Commission.

The Somerston Multi Asset Fund is regulated by the Jersey Financial Services Commission.

Warning

PAST PERFORMANCE IS NOT INDICATIVE OR A GUARANTEE OF FUTURE RESULTS. NO ASSURANCE CAN BE MADE THAT PROFITS WILL BE ACHIEVED OR THAT SUBSTANTIAL LOSSES WILL NOT BE INCURRED.