SOMERSTON ASSET MANAGEMENT

Somerston Multi Asset Fund (the Fund)

Investment Letter No.10 – September 2019

The Somerston Multi Asset Fund (US0 class) returned +0.7% in the third quarter. The MSCI World Equity Index rose by +1.5% during Q3 and a composite of UK, German and US Government bonds increased by +2.6%. Our Composite Benchmark rose by +1.9% in the third quarter.

During Q3, the fund had average net equity and bond allocations of 86% and 52% respectively. The fund starts the fourth quarter with net exposures of 91% in equities, 43% in bonds and 17% 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	1.3	-1.8	5.6	0.7	0.6	-0.6				**9.3**

Top Ten Equity Holdings

Name	% Fund
Fresenius Se & Co Kgaa	4.1%
Rubis	4.0%
Alphabet Inc-Cl A	3.9%
Johnson & Johnson	3.4%
Thermo Fisher Scientific Inc	2.9%
Sherwin-Williams Co/The	2.6%
Microsoft Corp	2.5%
Ashtead Group Plc	2.4%
Walt Disney Co/The	2.3%
Danaher Corp	2.0%
Total for Top Ten	**30.1%**

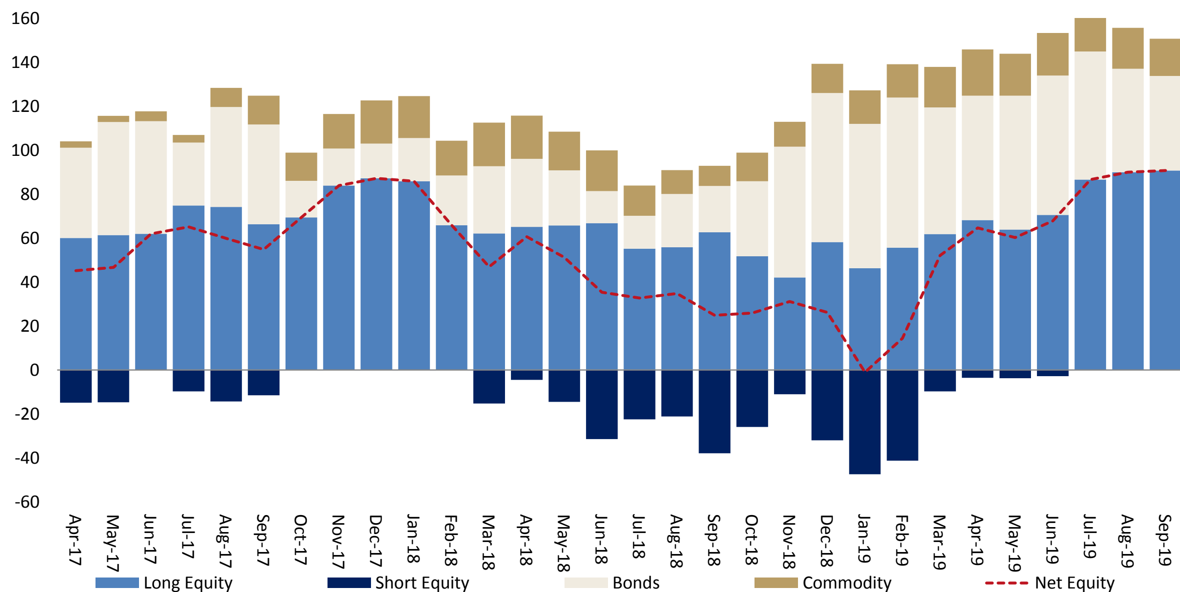
Share Classes

	ISIN	Ticker	NAV
US0	JE00BDRXFP25	SOMAUS0	110.5471
US1	JE00BDRXFQ32	SOMAUS1	108.3806
GB0	JE00BDRXFM93	SOMAGB0	105.7936
GB1	JE00BDRXFN01	SOMAGB1	103.7146
EU0	JE00BDRXFR49	SOMAEU0	103.0840
EU1	JE00BDRXFS55	SOMAEU1	101.0588

Asset Allocation

	Long	Short	Net
Core Equities	48.0%		48.0%
Equity Index futures	29.3%		29.3%
Long Small Cap Value	7.4%		7.4%
S&P 500 High Beta Equity ETF	3.1%		3.1%
Emerging Market Equity Index futures	3.0%		3.0%
Equities	**90.8%**		**90.8%**
US Government 2 year bonds	12.9%		12.9%
US Govt inflation linked bonds	8.5%		8.5%
US Government 10 year bonds	3.9%		3.9%
Euro Government Bonds	6.3%		6.3%
UK Govt inflation linked bonds	6.1%		6.1%
PIMCO Global Inv Grade Credit Fund	5.5%		5.5%
Bonds	**43.1%**		**43.1%**
Gold Derivatives	12.4%		12.4%
Gresham TAP Fund	2.6%		2.6%
Gold Miners	2.0%		2.0%
Commodities	**16.9%**		**16.9%**
Long Vol fund	1.9%		1.9%
Total All Assets	**152.6%**	**0.0%**	**152.6%**
Cash and Equivalents			**-52.6%**

Evolution of Asset Allocation for Somerston Multi Asset Fund



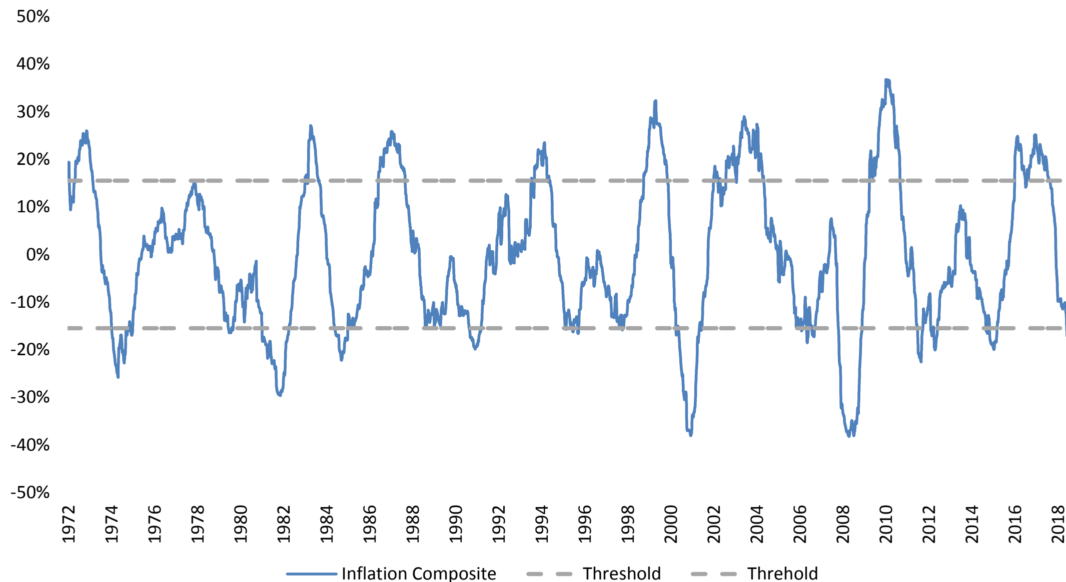
Performance

- The fund appreciated +0.7% in the third quarter underperforming its benchmark that rose 1.9%.
- Most of our underperformance came from equity selection. This reverses a trend of several months of outperformance from stock selection. Our stock picking struggled with the 'churn' within markets that we presently endure.
- Our allocation to gold added +0.7%.
- Our allocation to long volatility added +0.1%.
- Sherwin and Alphabet were top contributors; Fresenius, Johnson & Johnson and Adobe were our worst performers.

Outlook

Throughout the second half of 2018, investors were celebrating record earnings growth and justifying bullish positions. However, we warned that US Growth and Inflation was on the precipice and we were employing caution. Macro data now shows the extent of the deterioration in US economic conditions. In contrast, to investor jubilance in the summer of 2018, now pessimism abounds and investors are huddled into the safety of government bonds, defensive stocks and precious metals.

This chart shows the aggregate deterioration in a composite of 27 US growth indicators and 10 US inflation indicators.



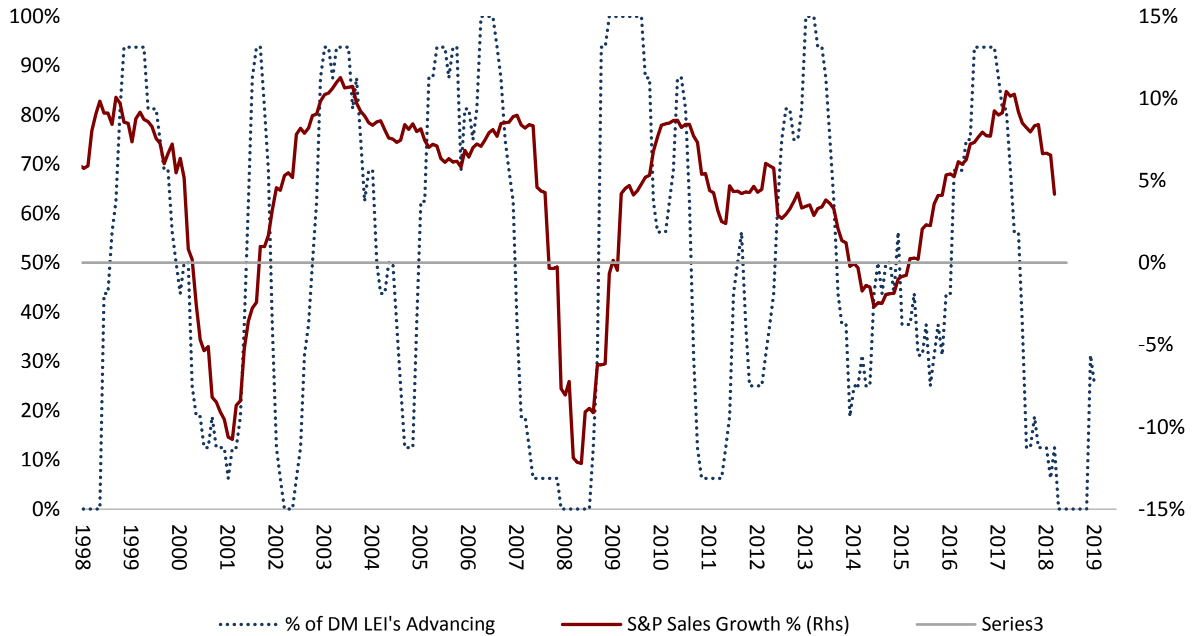
Historically, when Growth and Inflation are slowing to this extent, over the next 6-12 months, equity markets have registered their best returns, cyclicals outperformed defensives, Emerging markets outperformed Developed markets, corporate bonds and Inflation linked bonds outperformed government bonds, the US Dollar falls and oil rallies. Unless there is a manifestation of 'unknown' or long term secular risks, we believe history is a good guide for today, yet very few (if any) investors are positioned for such a positive outcome.

The equity market is churning as stocks that were leaders begin to lag, and laggards show leadership. Though very difficult to navigate month by month, this is a natural development at transition points.

Our bullish conviction is not just predicated on depressed economic data *'hoping'* the cycle is nearing a low, we believe this thesis is supported by:

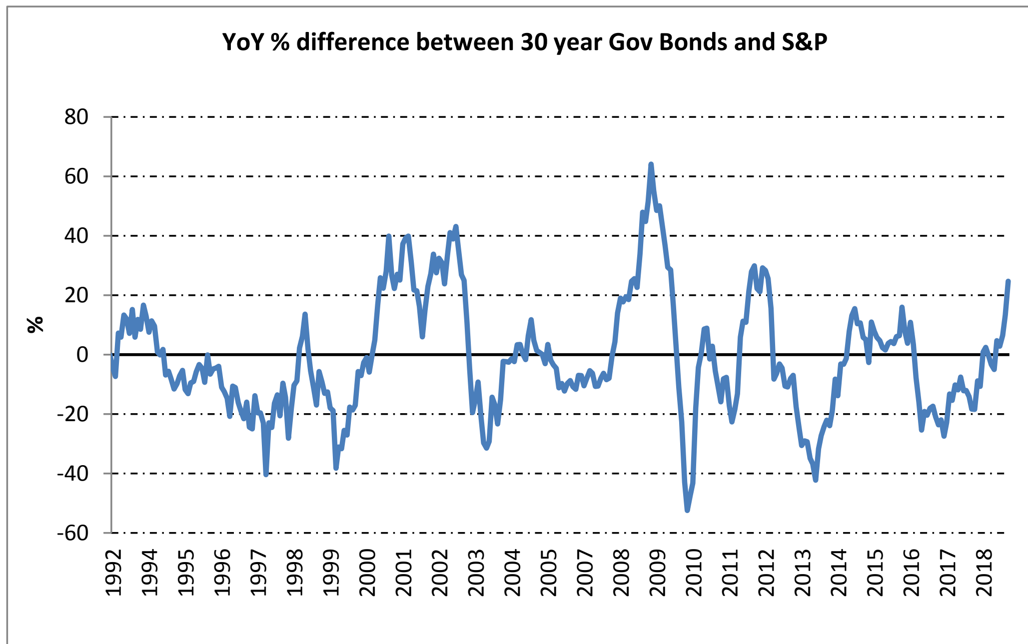
1. Early signs that global economic data is becoming less bad.
2. Significant improvement in global monetary policy.
3. Excessive investor crowding in 'safe assets'.
4. Well behaved credit markets.

The next chart shows the percentage of global OECD leading indicators advancing as a dotted series and US S&P sales growth in red. In 2017, the leading indicator gave an early warning signal that revenue growth was set to slow. Today this indicator is giving an early warning that sales deceleration is nearing an end. We are entering a tough reporting season, but growth comparisons will become lot easier from therein.

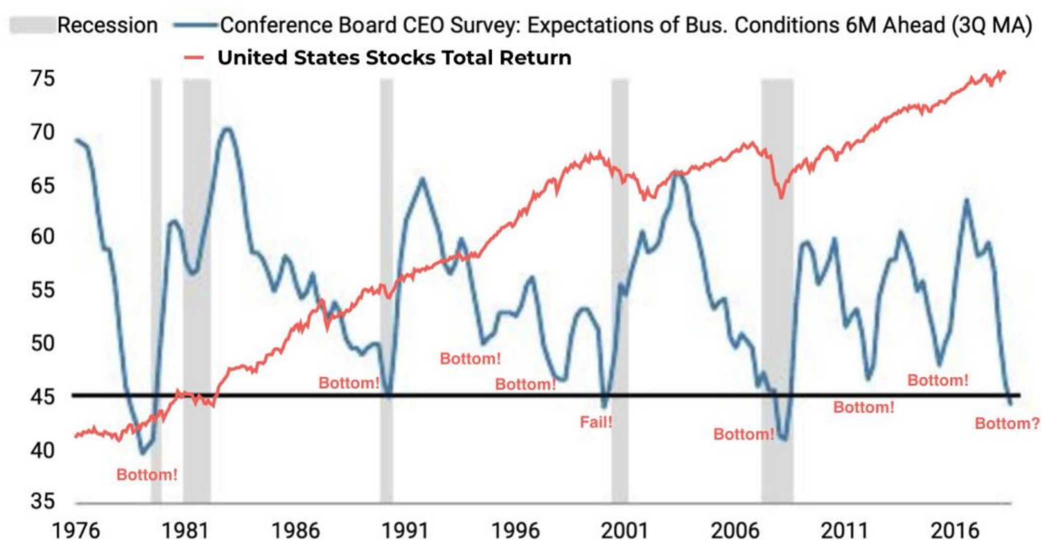


Whether you look at the collapse in bond yields or, as in the chart below, the number of Central Banks cutting interest rates, global monetary policy has become very easy. This chart shows the now much cited ISM manufacturing survey (black line) that recently came out very weak with the number of Central Banks that are cutting interest rates. ‘Monetary Policy’ leads by 8 months and a positive inflection in the Ism Manufacturing survey is likely in the near future.

Despite positive fundamental evidence, investors are huddled in 'safe assets'. Long term Government bonds have outperformed the S&P by 24% in the last year! The S&P Low Volatile Equities Index has outperformed the S&P High Beta Index by 27%. When investors realise that Armageddon has been avoided and these safety assets are actually quite vulnerable, the flow from these assets into 'catch up' high beta/cyclical equities will be notable.



It is no surprise that these distortions also show up in sentiment and fund flow data. This chart shows that CEO sentiment towards future business conditions are at lows seen in 2008, 2000, 1989 and 1979.



Finally, credit conditions remain reasonable. Banks are easing lending standards, and although credit spreads have widened marginally, they are generally well behaved. The disruption in the repo market is likely a consequence of regulation, capital adequacy requirements and significant risk aversion following the GFC. It is pleasing, and symptomatic of the environment post GFC, that the Central Bank fulfilled their role as lender of last resort swiftly and meaningfully.

Presently, we believe investors have the opportunity to employ an attractive convex asset allocation, namely to be long risk assets that traditionally do well in these economic conditions yet no-one owns. We therefore have an aggressive bullish stance to equities, we have reduced Gold and Silver and while we remain overweight government bonds, we reduced duration and see opportunities in US two year government bonds and US inflation linked bonds. We have reduced defensiveness and have made further allocations to small cap growth and high beta that are likely to benefit from recovery. We appreciate this is a non- consensus view but consensus is often wrong. We will not go against our time tested process. Should our analysis prove incorrect, our process has inbuilt risk management characteristics that will force us to the sidelines if the market does not corroborate our positioning.

When gold enters a secular bull market it can surprise even the most bullish. The most recent gold bull market started in 2001 and ran for 10 years rising 550%. The early 1970’s gold market, post Bretton Woods, incurred a 500% rally followed by three years of decline before pushing on again from 1976 to rise 475% in four years.

Gold has risen 33% in the past year. This might be just the start. However, I have some concerns in the short term. Firstly, speculators have flocked to gold. Both derivative and ETF flows have been enormous and it looks a little crowded. Secondly, the fundamental driver appears to be falling real yields. As discussed above, should the cycle turn, real yields will rise, potentially undermining a crucial fundamental pillar for gold’s recent ascent.

Nonetheless, we believe the US Dollar could peak in the coming months, if, as has been suggested, The Federal Reserve aggressively buys treasuries with freshly minted US Dollars. We have reduced gold but maintain a core position at the moment.

In summary, we are inclined positively. We believe there is likely some volatility during the forthcoming reporting period but many are positioned for a crisis and we do not see evidence to that effect.

Equity Review

- It was a challenging quarter for our core equity book which fell -0.3% relative the World Equity market that rose 1.5%.
- Stock selection has been the primary driver of returns in recent quarters but it reversed course this quarter.
- Quality and Momentum stocks outperformed in August, but there was a major leadership shift in September to traditional value stocks.

- Major shifts in factor leadership are often a sign of a market in transition.
- We reduced the scale of our factor tilts and increased our Value and Beta exposure.
- We reduced our core equity allocation as a proportion of our total equity book

Global equities rose 1.5% during the quarter, but markets were not benign. Our stock picking struggled with market 'churn', particularly the sharp reversal in market leadership in September; Value stocks rallied whilst momentum stocks capitulated (companies with the greatest 1 year price gains were sold indiscriminately). Most of our underperformance came from stock selection during this period, reversing a trend of several months of outperformance.

We favour high quality companies that benefit from structural growth. In recent years we have maintained low exposures to cyclical companies. This tilt has benefitted performance and as long as the low inflation, low growth environment persists, we expect this trend to continue. However, our major factor exposures have become increasingly crowded. The valuation gap between Growth and Value has reached extreme levels. Cyclical companies have underperformed and capital has flooded away from high beta into safety and quality. Investors are overwhelmingly pessimistic about the global economy, concerned we face a sharp deterioration in economic growth or potentially a global recession. Such extremes in sentiment and positioning create risk. Major shifts in factor leadership are a sign of markets in transition and any positive surprise in macro data or sentiment could cause under-loved cyclical and value stocks to rally further.

In sympathy with our increasingly bullish equity view, we reduced the scale of our factor tilt during the quarter, adding to value and cyclical companies. Following a strong run, our consumer staples holdings looked particularly expensive relative to their growth and profitability, so we reduced our allocation to the sector from 30% to 15%. We topped up the value side of our equity book and added new holdings in the Energy, Materials, Industrial and Technology sectors to increase cyclicality and Beta. This reduced our factor and sectoral skews at a time when market leadership is less certain. In addition we reduced the proportion of our overall equity book invested in core equity, diversifying our overall equity exposure.

Notable performers

Sherwin Williams (Mkt Cap $48 Bln): +20.2% Sherwin's share price rose 7.8% following its quarterly earnings release. Sherwin continues to execute impressively in a challenging macro environment, earnings beat expectations by 3% driven by higher volumes in its Americas division. Whilst Sherwin reduced full year sales guidance, margins expanded across all business segments as the company posted price increases well ahead of raw material inflation. Sherwin's pricing power, geographic dominance and brand strength drove US same store sales +5.3%, in spite of challenging weather conditions throughout the quarter, which likely delayed a number of projects. Customer backlogs have strengthened, raw materials have begun to deflate, pricing and cost synergies continue, putting Sherwin in a strong position for the remainder of the year. The company re-affirmed its full year earnings guidance, positively surprising investors.

Alphabet (Mkt Cap $70 Bln): +12.8% Last Quarter Alphabet was a laggard, weighed down by decelerating sales growth (albeit 19 %!) which we speculated was due to short term pricing mechanics rather than anything more sinister; we added to our position. This quarter revenue growth reaccelerated to 22%, in line with 2018 levels restoring investor confidence. We continue to believe that Investors are incorrectly focused on a negative mid-term outlook for the advertising business, overlooking the inherent stability of the franchise and the embedded value of the other businesses. Subsidiary Waymo is creating the go-to operating system for driverless vehicle technology; it has more miles driven than all other companies combined. Youtube and Google Maps are two of the worlds most visited apps with billions of users, but they are virtually un-monetised. Google Cloud is part of a Triopoly critical to the future of business and computing. Alphabet is the global leader in AI with access to more data than virtually any other company in the World and huge barriers to entry, its portfolio of other bets may well prove to be one of the greatest private equity companies in the World. The company is more profitable and growing faster than its peers but trades on just 19x P/E and 3.5x P/Book.

Estee Lauder (Mkt Cap $70 Bln): +8.9% Whilst US/China trade tensions weighed on exporters, Estee demonstrated remarkable resilience with management commenting that China and travel retail (largely Chinese) continue to be its best performing markets. The company is yet to experience any deterioration in trends in either China (where market share expanded and Estee is now the country's largest beauty manufacturer) or Hong Kong (despite the protests). Emerging markets, ex China have also experienced notable acceleration. Management expressed confidence in its 7-8% forward sales guidance (versus its 6-8% long term targets). Estée's leading positon in the rapidly growing prestige beauty market, its pivot away from department stores and towards fast growing, highly profitable, direct to consumer and e-commerce sales position it well going forwards.

Lowlights

Fresenius SE (Mkt Cap 25 Bln): -10.0% Fresenius shares continue to be lacklustre at best. A number of separate issues coupled with end market uncertainty caused the de-rating in 2018, from which the share price is yet to recover. Fundamentally little changed over the last quarter, but the company lacked the positive catalysts required to rebuild investor confidence. 2019 is a year of investment, but the story is not broken, Fresenius benefits from a highly diverse set of businesses driven by structural tailwinds. Both the German hospital business and US generic drug business face some headwinds but nothing of the magnitude that is now being priced into the shares. As we move through the second half of 2019 we expect both businesses to stabilise and return to growth. Timing a reversion in investor confidence is difficult, but when the company starts to deliver against expectations there is material upside from a re-rating toward historic multiples. Long-term investors willing to put up with the short term uncertainty have an opportunity to make significant gains. Fresenius is now one of our cheapest holding, 1.4x P/Book, 12.5x P/E and at least 50% undervalued relative to its profitability.

Johnson and Johnson (mkt Cap 341 Bln): -6.4% Litigation risk has been the main driver of share price weakness in 2019 and legal catalysts will likely linger and weigh on sentiment for some time. However, the company has an industry leading litigation track record and has historically

demonstrated great pragmatism in settling cases when they believe the odds are stacked against them. Fines are likely to be large but they will probably settle over many decades (as with tobacco litigation) and ultimately they are unlikely to be more punitive than the share price currently reflects. We continue to monitor the situation closely and take these risks seriously. However, as a consequence of these risks, whilst the fundamental business is going from strength to strength, the J&J share price has de-rated significantly since December; to a 20% discount to its peer group (the steepest discount in over 30 years). Typically, J&J trades at a premium valuation to its peers and it has seldom traded at a discount of more than 10%. These periods of relative undervaluation have historically represented the best times to buy the shares. JNJ benefits from a bountiful pipeline and four major new drugs, which are expected to accelerate pharma business growth materially into 2020 and beyond. Investors are blinkered by litigation and failing to recognise the strength and quality of the underlying business.

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