SOMERSTON
ASSET MANAGEMENT

Somerston Multi Asset Fund (the Fund)

Investment Letter No.10 – December 2019

The Somerston Multi Asset Fund (US0 class) returned +8.4% in the fourth quarter. The MSCI World Equity Index rose by +7.5% during Q4 and a composite of UK, German and US Government bonds fell by -2.2%. Our Composite Benchmark rose by +4.5% in the fourth quarter.

During Q4, the fund had average net equity and bond allocations of 84% and 28% respectively. The fund starts 2020 with net exposures of 82% in equities, 12% in bonds and 26% in resources/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	2.1	2.8	3.3	**18.5**

Top Ten Equity Holdings

Name	% Fund
Fresenius Se & Co Kgaa	4.4%
Rubis	3.8%
Johnson & Johnson	3.4%
Alphabet Inc-Cl A	2.9%
Thermo Fisher Scientific Inc	2.4%
Intuit Inc	2.1%
Ashtead Group Plc	2.1%
Roper Technologies Inc	2.1%
Microsoft Corp	2.0%
Enbridge Inc	2.0%
Total for Top Ten	**27.3%**

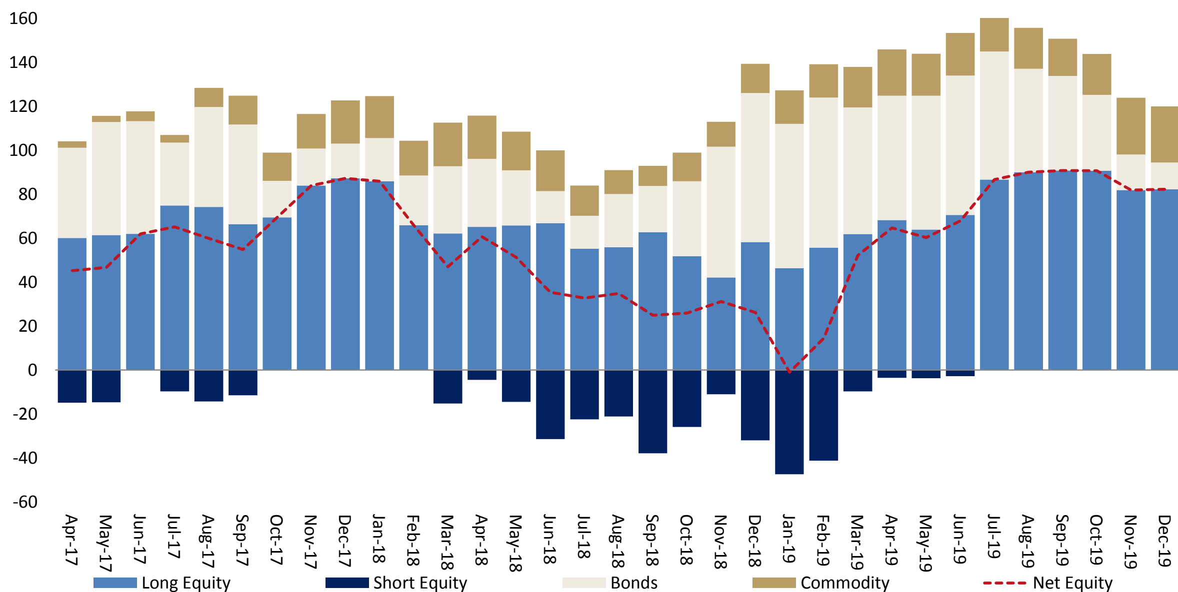
Share Classes

	ISIN	Ticker	NAV
US0	JE00BDRXFP25	SOMAUS0	119.8390
US1	JE00BDRXFQ32	SOMAUS1	117.2505
GB0	JE00BDRXFM93	SOMAGB0	114.0384
GB1	JE00BDRXFN01	SOMAGB1	111.5743
EU0	JE00BDRXFR49	SOMAEU0	110.8820
EU1	JE00BDRXFS55	SOMAEU1	108.4832

Asset Allocation

	Long	Short	Net
Core Equities	48.0%		48.0%
Equity Index futures	20.8%		20.8%
Long Small Cap Value	7.2%		7.2%
Long Large Cap Value	4.8%		4.8%
Emerging Market Equity Index futures	1.5%		1.5%
Equities	**82.3%**		**82.3%**
US Government 2 year bonds	5.8%		5.8%
US Government Long bonds		-4.4%	-4.4%
Euro Government Bonds	0.0%		0.0%
UK Govt inflation linked bonds	5.7%		5.7%
PIMCO Global Inv Grade Credit Fund	5.0%		5.0%
Bonds	**16.6%**	**-4.4%**	**12.1%**
Gold Derivatives	17.8%		17.8%
Silver Derivatives	1.9%		1.9%
Gresham TAP Fund	2.5%		2.5%
Gold Miners	1.9%		1.9%
Metals & Mining Producers ETF	1.5%		1.5%
Commodities	**25.6%**		**25.6%**
Long Vol fund	1.5%		1.5%
Total All Assets	**126.0%**	**-4.4%**	**121.5%**
Cash and Equivalents			**-21.5%**

Evolution of Asset Allocation for Somerston Multi Asset Fund



Performance

- The fund appreciated +8.4% in the fourth quarter outperforming its benchmark by +3.9%.
- The fund rose 18.5% throughout 2019.
- 2.3% of the outperformance came from stock selection and being overweight equities.
- Being underweight duration and overweight inflation linked bonds added +0.5% to outperformance.
- The precious metal book added +0.9% and other commodity exposure added +0.2%
- The long volatility position detracted 0.2%.
- Our healthcare names Fresenius SE and Johnson & Johnson were top contributors in our equity book.

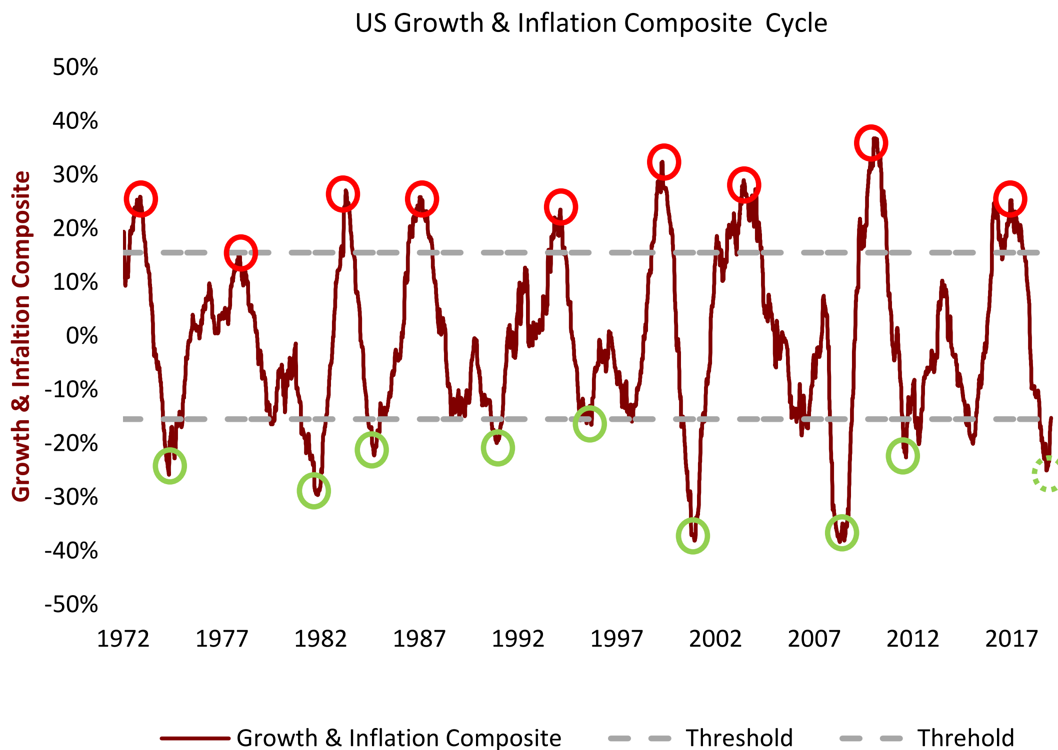
Outlook & Commentary

The cycle – “It’s [not really] different this time”.

The equity market has outperformed bonds by circa 20% in the last 12 months. The extent of outperformance is significant, and largely discounts a recovery that has yet to ‘turn up’ in economic data releases in any meaningful way. However, the economic downturn is now very mature. We consider the economic downturn ended in October and economic data is likely to become more constructive in the months ahead. During the period where economic data ‘catches up to markets’ we expect many financial markets to be broadly ‘range bound’ as investors transition their portfolios to assets and sub sectors that will benefit from the economic rebound. Assets that outperformed in the downturn are unlikely to outperform in the upturn and we have

already begun to see the transition. Our commentary this quarter examines previous cycles as we explain the rationale for our present asset allocation.

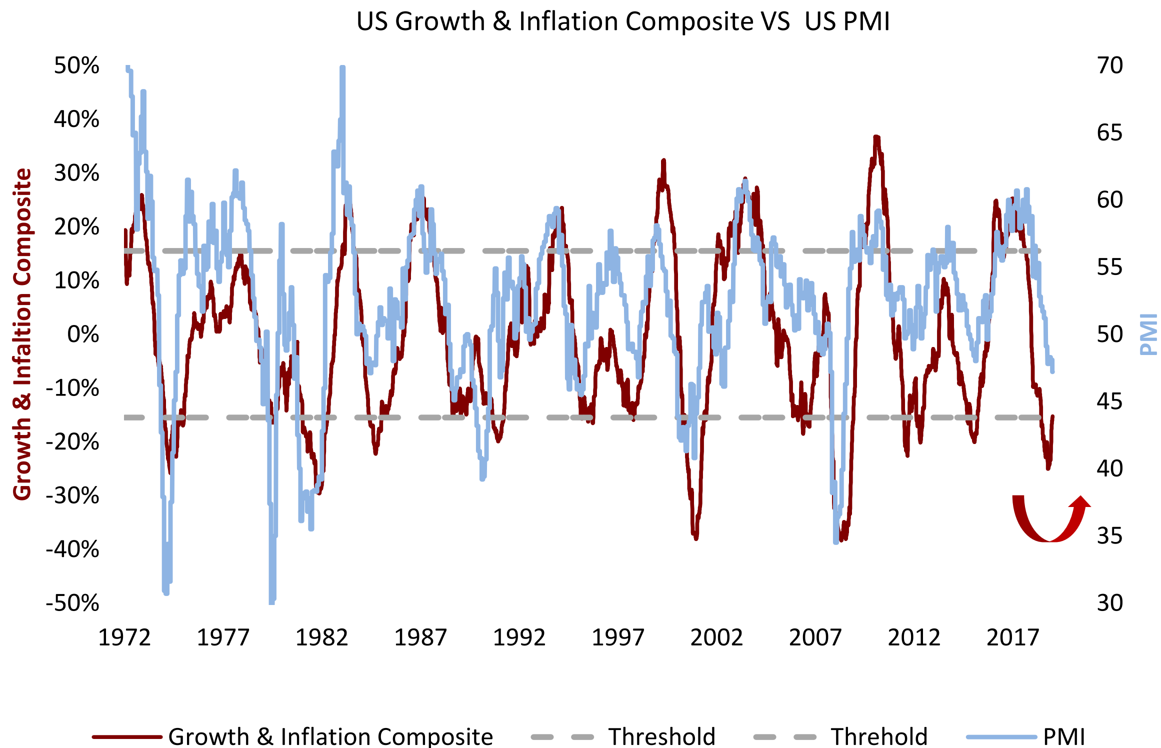
Over the last 50 years, the US has enjoyed eight economic up cycles and endured nine down cycles. The chart below is a composite of 10 inflation and 27 growth measures for the US economy which we have smoothed to illustrate these cycles. The red circles indicate the 'top' of the cycle and the green circles indicate the 'bottom 'of the cycle. The exact tops and bottoms are only known for certain after the fact. The US economy appears to have passed its worst point in October.



Our 'Growth and Inflation composite' tracks closely with the US Purchasing Managers Index, known as the US PMI, shown in the next chart. In recent weeks, commentators have been closely watching the PMI and citing its weakness as a reason for caution on financial markets. Whether the US economy slips lower still and reaches the recessionary depths of 1982, 2001 or 2008 remains to be seen, but we do not consider it consequential to asset prices in the near term. The greatest damage to financial markets occurs when the economic cycle rolls over from a top. This happened throughout 2018 and culminated in a tumultuous market in Q4 2018. In contrast, 'risk assets' have traditionally enjoyed decent market performance following the depressed cyclical readings that we saw throughout 2019. We continue to consider, that in all probability, the worst of the economic contraction is behind us and markets have rationally discounted better times ahead.

Each asset class has unique defining characteristics that cause its price to react in a predictable fashion under certain economic and market environments. For example, high quality long duration

government bonds that pay a fixed coupon do well in a deflationary economic contraction as we saw in Q4 2018. In contrast, we expect equities to do well in an expansionary, disinflationary environment such as we enjoyed from Q2 2019. Economic expansion supports sales growth and lack of inflationary pressures allows margins to expand. This combination powers earnings growth.



Active investment managers must have an approximation of where we are in the economic cycle as well as having knowledge of the types of exposures and assets that should benefit from that point in the cycle.

There is some debate that the cycle is 'dead'! Proponents of this thesis find support from some prominent macro hedge fund closures this year. The amplitude of the economic cycle has certainly compressed in the last decade with Central Banks stepping in on every occasion of weakness. But the cycle remains very much with us.

A significant justification that the cycle is alive and well is found by observing that key asset price relationships continue to behave in a predictable fashion dependent on the stage of the economic cycle.

Using our 'growth and inflation composite' model as a proxy for the economic cycle, we looked back to see how certain key asset class relationships performed in the numerous economic up and down cycles since 1970. The results are shown in the table below.

On average, up cycles last three years and down cycles last nearly two and half years. The present economic down cycle started in December 2017 and most likely ended in October.

Up Cycles (Since 1970) Average 3.0 Years	Equities vs Bonds	Cyclical vs Defensives	Copper vs Gold	Dollar	Credit Spreads	Inflation Expectations
	23.4%	27.7%	28.6%	-5.8%	-1.9%	0.6%

Down Cycles (Since 1970) Average 2.4 Years	Equities vs Bonds	Cyclical vs Defensives	Copper vs Gold	Dollar	Credit Spreads	Inflation Expectations
	-10.3%	-13.9%	-20.6%	8.3%	2.6%	-0.6%

Recent Cycle (end Oct) 1.9 Years	Equities vs Bonds	Cyclical vs Defensives	Copper vs Gold	Dollar	Credit Spreads	Inflation Expectations
	-0.7%	-4.5%	-28.4%	6.1%	0.3%	-0.4%

As shown in the tables and, consistent with economic intuition, historically:

- Equities outperform government bonds in up cycles but underperform in down cycles.
- The cyclical sectors of Industrials, Financials and Discretionary outperform defensive sectors of Utilities, Staples and Healthcare in up cycles and underperform in down cycles.
- In the commodities segment, economically sensitive commodities like copper, lumber and oil outperform precious metals such as gold in up cycles and underperform in down cycles.
- The US Dollar, being the world's reserve currency, tends to be strong in economic adversity.
- Credit spreads widen in down cycles but tighten during prosperity.
- Inflation expectations, as implied by inflation linked bonds, fall in adversity.

During the recent economic downturn, directionally, asset classes performed as we would expect. The magnitude in the underperformance of equities was not as large as historical episodes, but copper underperformed by more than the average cycle, and the US Dollar and Inflation linked bonds relative to Treasuries performed to the same degree as would be expected. The following charts illustrate some of these relationships over time with the PMI.

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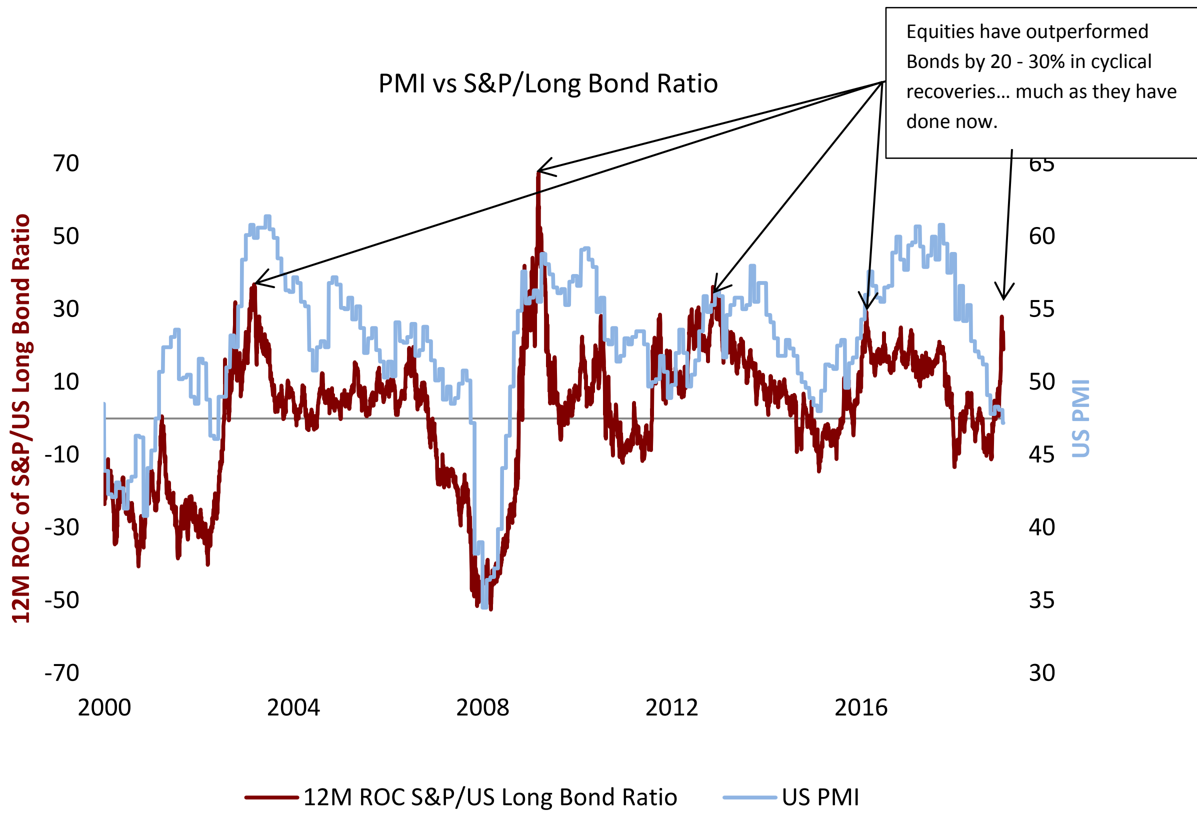
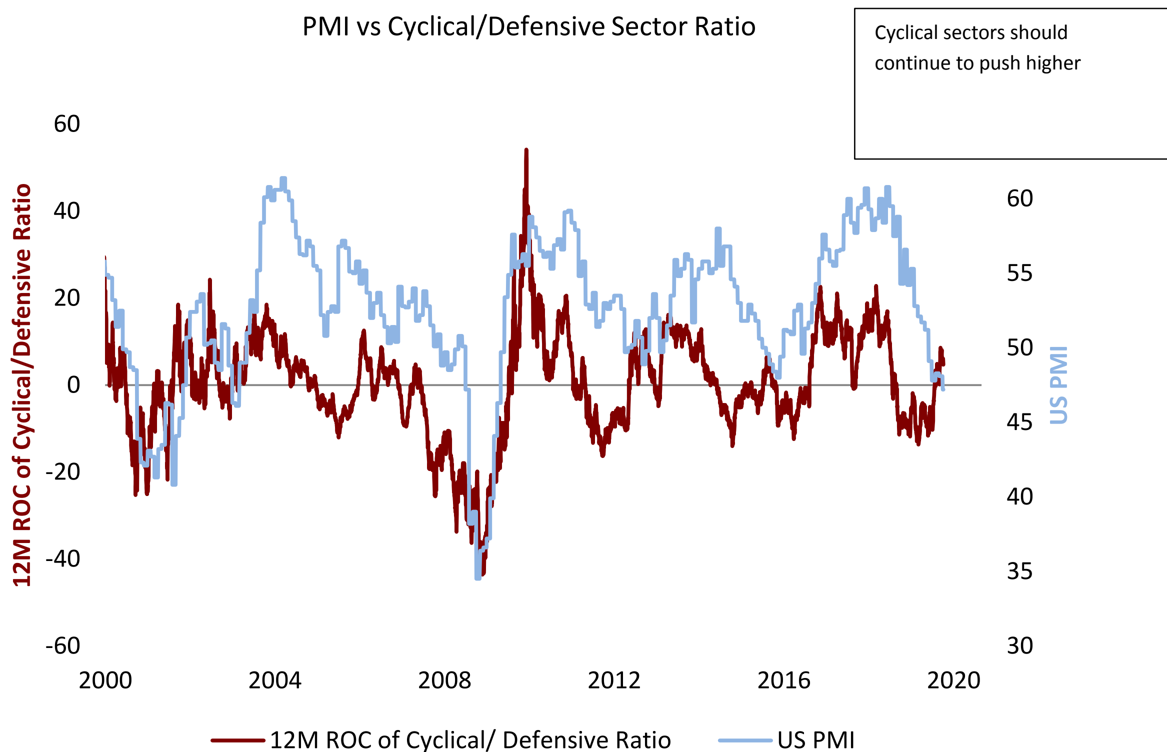
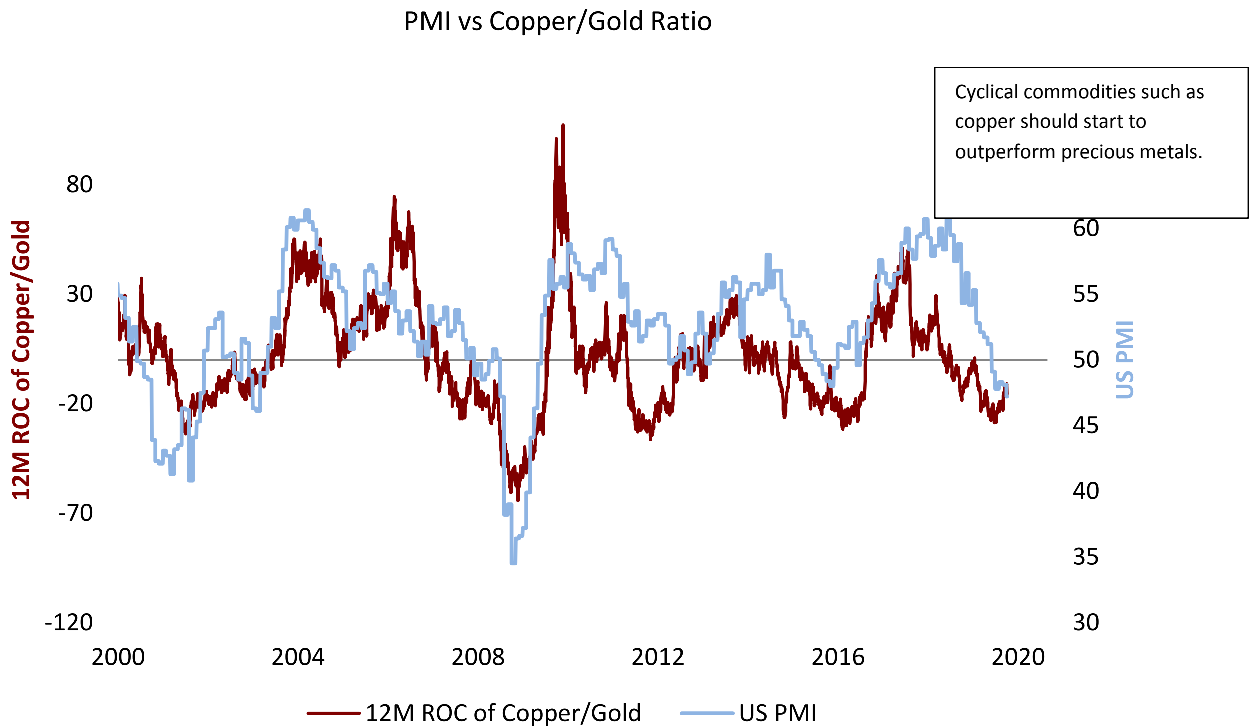




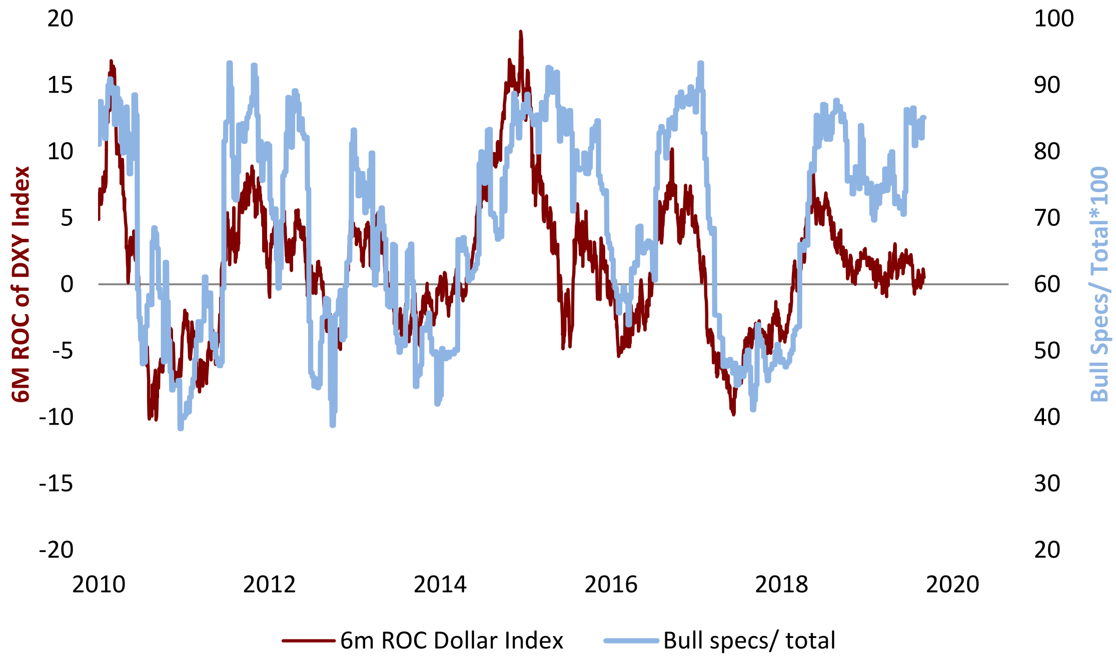


These charts illustrate the recent large decline in the PMI and that many asset classes began to discount better times ahead in the middle of last year.

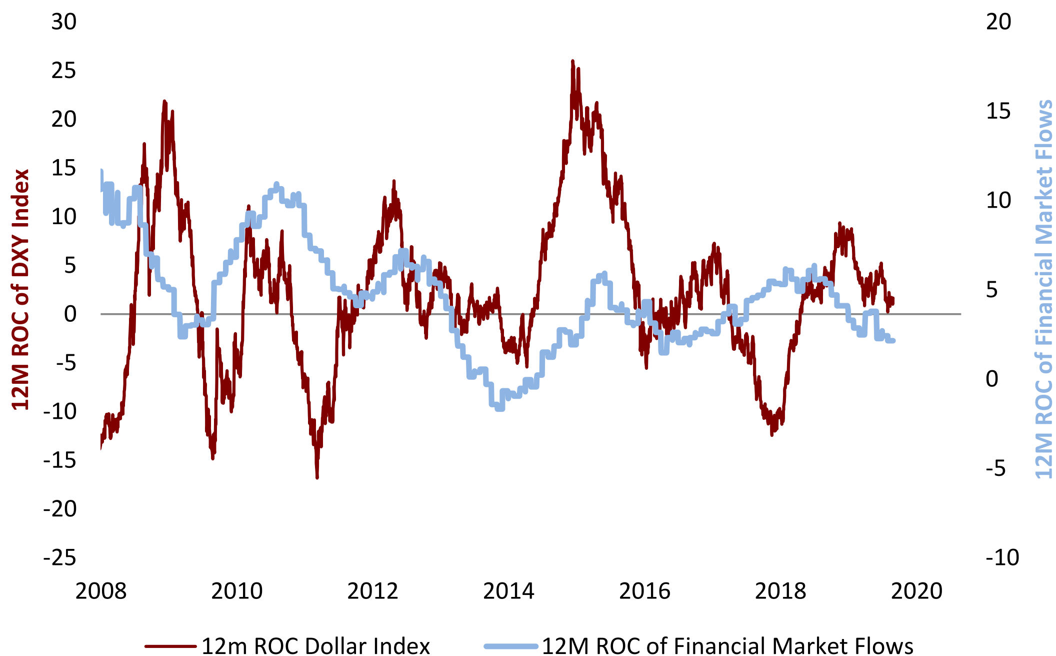
Many Investors doubt that new all-time highs in equities can be justified by present economic conditions. After all, as we see in the charts, the US PMI index continues to decline yet equities have outperformed bonds by almost 20% in the last twelve months. But reported 'growth' measures such as the PMI Index are coincident with the market cycle at best. Many other drivers of market returns such as the cost of capital, availability of credit etc. are favourable. **It is true that equities have forged well ahead of key economic data and for this reason we are selective on our equity exposure** but in contrast to the pessimists, rather than holding outright bearish view on equities, we are far more cautious of bond markets. Consequently, in our Equity book, we are overweight traditional value areas that benefit from early stages of economic recovery and rising inflation expectations and non US equities; in our bond book we are underweight duration and long inflation linked bonds and credit; and in commodities we prefer precious metals at this time.

In the recent economic downturn, the US Dollar performed exactly to the cyclical playbook as a safe haven, however, with potential economic recovery at hand, the US Dollar is now looking vulnerable. A decline in the US Dollar adds to our preference to build positions in pro cyclical assets and traditional value sectors.

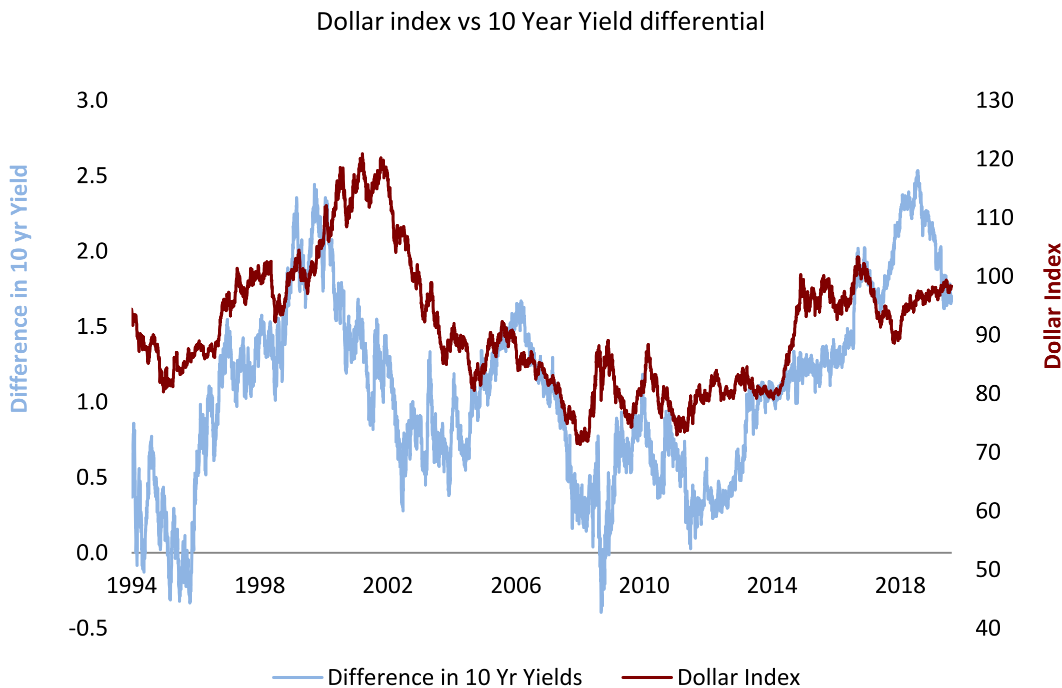
The US Dollar's strength has been persistent for several years and, unsurprisingly, derivative speculators are expecting much the same, maintaining large long positions.



Financial flows towards America are slowing which incrementally removes demand for US Dollars. This is a function of reduced global trade and fewer US Dollars in global circulation as well as large treasury issuance and poor relative valuations of US assets.

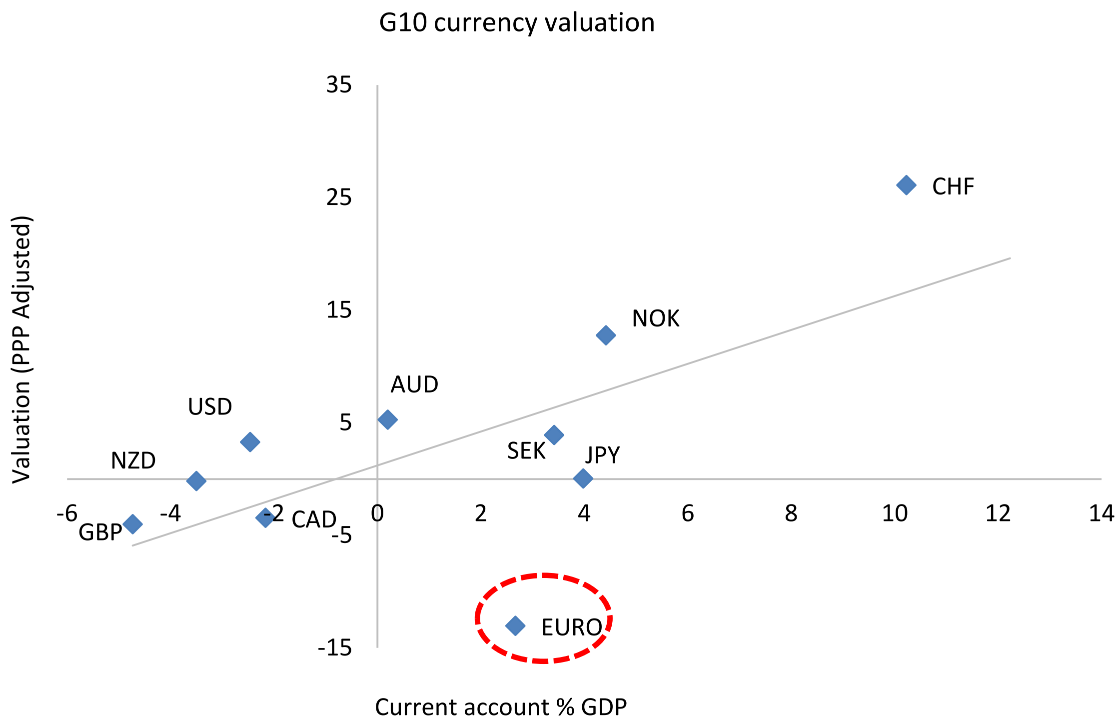


Perhaps most significantly, America has the highest interest rate environment relative to its peers. This is bow lessening and we expect that trend to continue. The chart below shows the difference in 10 year yields between the US and its three largest trading partners in blue with the US Dollar trade weighted index in red.



Finally, while currency valuation is abstract, when comparing currency valuation against the 'quality' of a country, the real stand out cheap currency is the Euro. Europe has many issues but the degree of undervaluation is more than discounting this.

Given the stage of the economic cycle, derivative positioning, reduced financial flows, likely downward US interest rate momentum and attractive valuations of the Yen and Euro in particular, we consider the US Dollar will find it hard to maintain recent levels.



In summary, we expect many of the assets that performed so well in the recent economic slump will continue to falter, and an entirely different set of opportunities will present themselves. We are building exposures to take full advantage of the forthcoming cycle.

Equity Review

- The core equity book had a solid quarter, rising 9.1% in absolute terms and outperforming global equities which rose 7.5%.
- Stock selection was the primary driver of excess returns, particularly in the Energy (Enbridge, +15.0%) and Communications sectors (Walt Disney, +11.7% and Alphabet, +9.7%).

Equity markets re-accelerated in Q4 to finish the year +27.3%. Global indices flat lined between April and September as investors digested the ebbs and flows of trade negotiations, deteriorating macroeconomic indicators and downward earnings revisions. Defensive, low volatility stocks led the market and by the end of September the safety trade had pushed the valuation gap between growth and value, defensives and cyclicals to extreme levels.

In line with our progressively optimistic macro view, we increased the cyclicality and Beta of our equity book. We added new positions in the Energy, Materials, Industrial and Technology sectors and increased our value skew, reducing highly valued positions in the consumer staples sector.

These decisions proved fruitful in Q4. Supportive central bank policy, stabilising macro data and easing trade tensions restored market confidence and the cyclical sectors led the market higher:

- High Beta stocks outperformed low beta stocks. Cyclicals outperformed defensives.
- Price momentum was the weakest factor; companies closest to their 52 week highs lagged, whilst those that had underperformed over the preceding 12 months rallied.
- Technology (+13.7%) and Healthcare (+12.8%) outperformed. Utilities (+1.0%) and Real Estate (+0.9%) lagged.

We took profits in some names that had performed well and made new investments in Intuit and Idexx Labs at the end of December.

In many ways 2019 was the reciprocal of the previous year; 2018 saw corporate earnings grow 21% fuelled by a strong global macro environment and tax reform in the US, yet equity returns were negative. In contrast, earnings growth in 2019 was flat against a backdrop of increasing macro and trade uncertainty, yet stocks appreciated a staggering +27.3% partly on the back of supportive central bank policy and anticipation of a brighter economic outlook.

Gains were broad based, but technology stocks continued to dominate the market. The sector rose a staggering 46% in 2019 eclipsing all other industries; It was the seventh consecutive year of technology outperformance.

Global Equity Sector Returns 2019

Technology	45.9%
Discretionary	25.9%
Industrials	24.3%
HealthCare	24.1%
Real Estate	23.8%
Financials	23.5%
Consumer Staples	22.6%
Communication Services	22.4%
Utilities	19.0%
Materials	18.5%
Energy	10.7%
Index Return	27.00%

World's Largest Companies

Name	% Global Equity	Return 2019
Apple	2.4%	89.0%
Microsoft	2.3%	57.6%
Amazon	1.8%	23.0%
Alphabet	1.8%	29.1%
Facebook	1.1%	56.6%
JP Morgan	0.9%	47.3%
Total	10.3%	50.4%

Whilst we are benchmark agnostic, the influence of the World's largest companies on benchmark performance (many of which are also technology stocks or proxies) is worth highlighting. The top six companies by market capitalisation constitute 10% of the global equity index and outperformed the broader index in 2019 by 23.4%! This concentration of leadership amongst the largest companies will eventually pose a risk to benchmark driven strategies.

Technology companies are benefiting from innovation and disruption. The sector has the highest expected 5 year growth rate, highest quality score, and highest ROIC, EBITDA and FCF margins of all sectors. With these characteristics it is unsurprising that technology companies continue to attract capital and outperform, especially during this period of low growth, low inflation and cyclical uncertainty. However, we see other sectors that are set to benefit from the cyclical upswing and the growth premium enjoyed by the sector may well deteriorate.

Firstly, within the technology sector, growth stocks outperformed value stocks since the beginning of 2017, but that pendulum reversed sharply in July as value technology stocks (including hardware and semiconductor companies) rallied, outpacing growth companies.

Secondly from 2013-2016, the technology sector outperformance was driven by superior earnings growth, but since 2017, relative multiple expansion became the dominant force. As the table below highlights, this trend accelerated in 2019 as the sector re-rated materially versus the broader market. Technology valuations have hit 15 year relative highs, and on a relative basis, the technology sector is now +22% more expensive compared to its three year average. We remain modestly overweight technology, but we are selective. We are wary of companies with excessively high valuations, questionable moats or excessive growth forecasts that are susceptible to disappointment.

2019 Statistics: Change in 1 year forward growth forecasts for sales and earnings over the course of the year.

	Sales Growth	Earnings Growth	Change Price	Change P/E
Global Equity Index	0.3%	-1.0%	27.3%	28.6%
Global Technology Index	-1.2%	-3.2%	45.9%	50.7%
SOMERSTON Core Equity Book	6.8%	10.6%	31.1%	18.6%

The table highlights our equity book outperformed the market by c4% in 2019 driven by superior sales and earnings growth and the portfolio was less reliant of multiple expansion to achieve this outperformance. Consequently, on a look forward basis we are not as exposed to valuation risk compared to the market.

When selecting our investments we generally favour high quality companies with low capital intensity and solid sales and earnings growth potential supported by strong economic moats and structural tailwinds. However, c. 40% of our book is now represented by 'value' companies and c. 50% of our book is now exposed to cyclical influences. In addition to our direct equity holdings, during the quarter we held a number of Value Equity Index Futures that increased our Value skew further.

Recent Changes:

- In October we sold our entire positon in **Reckitt Benckiser.** We have growing concerns over the level of investment needed to restructure the company and to drive innovation and growth, particularly as the high growth Chinese milk formula market appears to be crumbling. As a defensive exporter, Reckitts benefited from sterling weakness and the "safety trade" away from domestic exposed UK companies. In recent months these tailwinds have started to reverse, a trend that looks set to continue as the probability of a Brexit solution increases.

- **Fedex** had de-rated significantly on the back of global trade tensions creating an exciting entry point. Not long after initiating our position, management released a trading update. Disappointingly it proved structural headwinds were worse than we and the market had anticipated, overshadowing the cyclical opportunity.

- We redeployed the sale proceeds from Fedex into **Roper Technologies**, another cyclical dividend aristocrat, a high quality diversified Industrial and ostensibly, one of the best run companies in the US. Roper has a collection of high-margin asset light businesses, which generate significant defensive cash flows, whilst its industrial and energy businesses offer us upside from any cyclical upturn.

- We built a new position in **Stanley Black and Decker** the largest, fastest growing, most innovative and profitable tool company in the World. Stanley is the World leader in small battery technology, with a dominant market position in battery powered tools. Its goal is to drive the adoption of cordless power technology across industries, improving the safety and efficiency of construction and other workplaces, eliminating leads and wires and benefitting the environment. Its Industrial segment is a major beneficiary of the transition to electric vehicles but came under pressure during the cyclical downturn. This created an exciting entry point as investors are overlooking the defensive characteristics of the core business and significant long term structural opportunities and instead focusing on short term cyclical pressures which will reverse in the event of any cyclical recovery.

- In late December we added a new position in **Intuit**. Intuit develops and sells cloud based financial, accounting and tax preparation software for small businesses, accountants and individuals (best known for QuickBooks). Intuit's products save their customers money, simplify the accounting and tax process, and improve financial visibility. As a result customer retention rates are extremely high. Intuit benefits from a dominant market position in the US personal and small business tax market by providing easy to use software with AI capability. It applies machine learning algorithms to its rich data sets to continuously improve the client experience, and to expand its product offering. Cloud based delivery, and e-marketing have made it cheaper and easier for Intuit to reach customers and facilitated

cost effective geographic expansion. Intuit is highly profitable with low capital intensity, and they manage to improve margins with increased scale. Network economics are driving sustainably high earnings growth that we see continuing.

- In late December we added a new position in **Idexx Labs**. Idexx provides complete solutions to veterinary practices. It makes and sells high end diagnostic equipment which generate recurring revenues from service contracts and consumables. It also operates independent reference labs and specialised consultancy in radiology, cardiology, ultrasound etc. These businesses benefit from an increasing trend of veterinary practices outsourcing diagnostics. All Idexx's equipment is connected via a cloud platform enabling seemless integration and communication between practices and its own labs. Idexx provides a full suite of practice management and client communication software. The breadth, integration and quality of its products have led to rapid market share gains across its operations. Machine utilisation in veterinary practices is growing at a high teen CAGR and a critical shortage of vets in the US (1 vet available for every 5 job openings) is leading practices to outsource and streamline operations wherever possible.

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