SOMERSTON
ASSET MANAGEMENT

Somerston Multi Asset Fund (the Fund)

Investment Letter No.12 – March 2020

The Somerston Multi Asset Fund (US0 class) returned -14.2% in the first quarter. The MSCI World Equity Index dropped by -20.1% and a composite of UK, German and US Government bonds rose by +5.3%. During Q1, the fund had average net equity and bond allocations of 69% and 29% respectively. The fund starts Q2 with net exposures of 41% in equities, 54% in bonds and 25% 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	2.1	2.8	3.3	**18.5**
2020	-0.3	-5.9	-8.5										**-14.2**

Top Ten Equity Holdings

Name	% Fund
Johnson & Johnson	3.6%
Microsoft Corp	2.6%
Mastercard Inc - A	2.6%
Adobe Inc	2.6%
Alphabet Inc-Cl A	2.5%
Thermo Fisher Scientific Inc	2.4%
Danaher Corp	2.1%
Amazon.Com Inc	2.0%
Procter & Gamble Co	2.0%
Unilever NV	1.9%
Total for Top Ten	**24.4%**

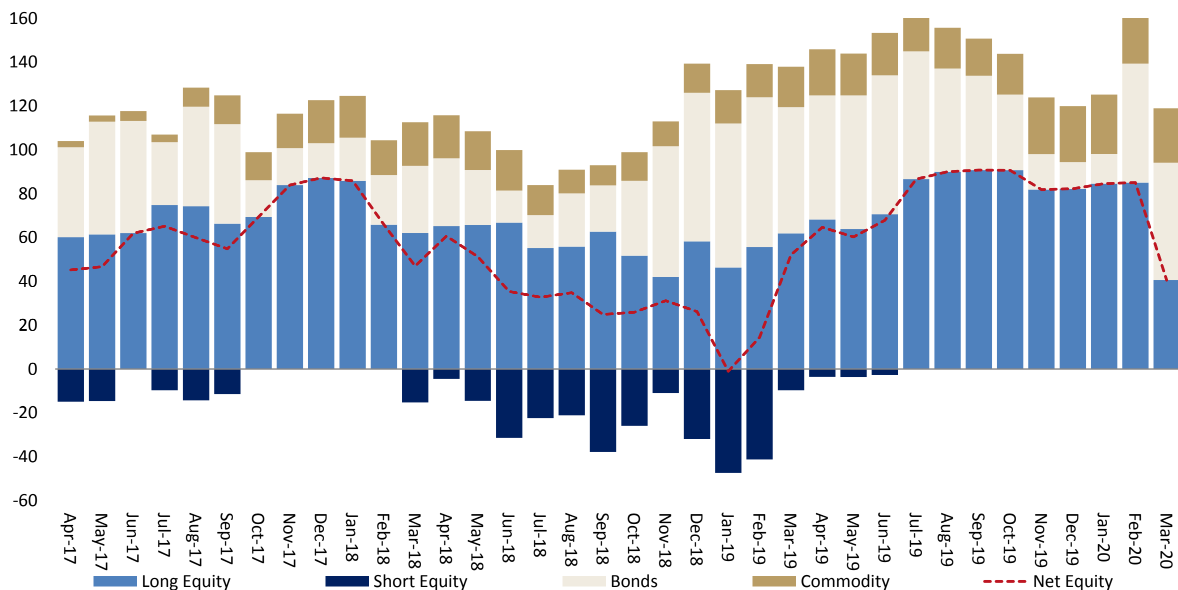
Share Classes

	ISIN	Ticker	NAV
US0	JE00BDRXFP25	SOMAUS0	102.8803
US1	JE00BDRXFQ32	SOMAUS1	100.4403
GB0	JE00BDRXFM93	SOMAGB0	97.5382
GB1	JE00BDRXFN01	SOMAGB1	95.2192
EU0	JE00BDRXFR49	SOMAEU0	94.7845
EU1	JE00BDRXFS55	SOMAEU1	92.5320

Asset Allocation

	Long	Short	Net
Core Equities	40.5%		40.5%
Equities	**40.5%**		**40.5%**
US Govt inflation linked bonds	9.3%		9.3%
US Government 10 yr. bond futures	7.9%		7.9%
US Government Ultra Long bond futs	4.9%		4.9%
UK Government 10 yr. bond futures	8.0%		8.0%
German Govt 10 yr. bond futures	13.9%		13.9%
German inflation linked bonds	9.6%		9.6%
Bonds	**53.7%**		**53.7%**
Gold Bullion ETF	11.2%		11.2%
Gold Derivatives	10.1%		10.1%
Gold Miners ETF	1.3%		1.3%
Gresham TAP Fund	2.2%		2.2%
Commodities	**24.8%**		**24.8%**
Long Vol fund	4.1%		4.1%
Total All Assets	**123.1%**		**123.1%**
Cash and Equivalents			**-23.1%**

Evolution of Asset Allocation for Somerston Multi Asset Fund



Performance

- The fund fell by -14.2% in the first quarter and its composite benchmark fell by -12.9%.
- The Fund went into the year overweight equities. This caused the fund to underperform its reference benchmark by -1.5%.
- The fund has been underweight bond duration and overweight inflation linked bonds causing a further -0.7% underperformance.
- This was partially offset from our long volatility position which added 2.1% and being long gold contributed 0.5%.
- Stock selection modestly outperformed.

Outlook & Commentary

"Everyone has the same data regarding the present and same ignorance regarding the future"
Howard Marks 2020.

We never tire of impressing the importance of acting on the weight of evidence. In normal times, such evidence generally ebbs and flows over several months generating reliable inferences into the likely range of probable outcomes for asset classes over the next 3-6 months. Every once in a while however, one piece of information dominates everything else causing outcomes to be beyond anything reasonably envisaged. The first quarter of 2020 is one such a time.

The Fund has the tools and scope to take advantage of adversity, but the weight of evidence was building more positively at the start of this year suggesting that the nascent synchronised global

recovery would accelerate; accompanied by low interest rates, low commodity costs and ample credit availability. In our view, this was likely to provide a positive surprise to financial markets and it certainly did not justify strategies that would benefit from heightened adversity.

The spread of COVD-19 together with the comprehensive measures taken to contain its spread, combined with an oil market collapse, caused the market to descend from all time highs to 'bear market' in record time and the weight of information has changed notably. On the positive side:

- The relative valuation of certain risk assets is more attractive.
- To some extent, built up market excesses and speculative activity have reduced.
- Commodities and raw materials have rarely been cheaper.
- The fiscal and monetary response has been significant.

However:

- Growth expectations have crumbled to 'depression' levels and the speed, extent and timing of recovery is highly uncertain.
- The cost and availability of capital has deteriorated for many borrowers despite Central Banks' response.
- The market is no longer 'oversold' and at unsustainably depressed levels.
- We are now in a primary bear market and surprises are often negative during such times.

Heightened volatility piques investor's interest, suggesting there maybe a potential 'opportunity' for outsized returns. However, lessons from similar episodes when volatility was excessively high throughout history are clear. Heightened volatility has provided as many outsized gains as there have been outsized losses. The chances of being right during these stress environments are virtually as good as a coin flip, and if you are wrong, you could be very wrong. While heightened volatility, oversold conditions, and other 'stressed' measures such as wide credit spreads presage the beginning of all bull markets, there have been as many bear markets under similar conditions.

Lower prices only represent an 'opportunity' if the spread between price and the net present value of long term excess cash flows widens. In other words, does intrinsic value improve? It is very notable that on almost all occasions throughout US history, despite uncertainty, the net present value of long term cash flows were hardly impacted by short term events, whether the GFC, Tech Bust, LTCM, the '87 crash etc.. In such instances, lower prices did indicate improved intrinsic value and they therefore represented a good buying opportunity for long term investors. But there have been many examples in sectors and countries outside of the US where the net present value of future cash flows fell as much, if not more than, the decline in stock prices and lower prices were not an indication of improved intrinsic value.

Presently, future cash flows for many assets seem very uncertain and a compelling case can be made for a permanently lower level. For instance, will restaurants have permanently lower throughput, will office space have permanently lower concentration of workers, will travel return to pre crisis levels? Lower levels of travel are likely to have a negative impact on associated sectors such as

luxury, cosmetics and premium spirits. At the same time, the energy industry is suffering from a demand collapse that, to some degree, may well be a permanent feature. This has ramifications across many industrial industries such as rails, valve and flow technology companies etc.

In our view, for many companies, the decline in share price, although severe, looks to be entirely reasonable, matched largely by the decline in intrinsic value, whereas, for many other companies, unaffected or potential long term beneficiaries from this crisis, and whose share prices have barely declined at all, intrinsic value looks far improved.

Long term cash flows are dramatically impacted by ‘survival’. For equity holders of entities that have high levels of debt, the inability to refinance may entirely eliminate any intrinsic value whatsoever. The longer we are in lockdown and the more protracted the return to normalcy, the more likely cash flow issues become solvency issues. Small and medium sized companies, that employ the majority of the country’s workforce, are the most susceptible to solvency issues in the coming weeks.

While we see distinct beneficiaries and some compelling opportunities, it is likely that aggregate future cash flows will be lower for several years.

It is important to acknowledge that cash flows are just half of the story in determining intrinsic worth. The appropriate discount rate to use to calculate the net worth of these cash flows is perhaps and even more important factor. Without getting into idiosyncratic detail, the risk premium afforded to a country whose government is likely to run fiscal deficits that are 20%+ of GDP, funded by the printing press of their Central Bank, must have substantially increased risk premium in our view. In other words, despite record low bond yields, valuations at a market level also compress, much as they have done for Japan.

In summary, we consider the massive increase in global unemployment to be symptomatic of significant reduction in aggregate cash flows. Some of this reduction is probably permanent. Moreover, country risk premiums have risen substantially by virtue of the incredible fiscal and monetary policies adopted. The net present value of future long term cash flows has therefore reduced and the fall in equity prices has probably not generated a significant improvement in intrinsic value in aggregate. Accordingly, on this occasion, heightened volatility may not presage a new bull market as so many are now expecting and which is now being discounted in the equity market.

Strategy

The portfolio has undergone material changes during the period. The portfolio is highly diversified in the highest quality and liquid instruments with no large allocation tilts. It is designed to do reasonably well whatever the future holds but it will not excel in any particular environment. We do not have courage, nor do we have conviction to be bolder at this time. In our bond book, we hold government bonds with a mix of inflation linked and nominal bonds. We hold 22.6% in gold and gold mining companies and we have a 4.1% position in a long volatility strategy which we will redeem in the coming weeks.

Equity Strategy:

We actively de-risked our equity book early in the quarter, neutralising our market beta and cyclicality, whilst also removing companies that have potentially more problematic debt profiles. We retain our high quality bias and now lean towards companies that are less dependent on the macro cycle and where we have a high degree of understanding of the source and reliability of future cash flows.

We balance the more defensive elements of our book (largely healthcare and consumer staples companies) with exposure to higher growth companies that we feel have the ability to outperform regardless of the outcome of covid-19 – "structural winners".

Many of the trends that were driving markets ahead of the crisis have accelerated over the last few weeks and we expect these trends to continue. Isolation, social distancing and being stuck at home have forced people to turn to online platforms. We expect e-commerce to accelerate and with it an increasing shift to mobile payments and "electronic wallets", as the trend away from cash accelerates. We expect to see an increased uptake of direct-to-consumer media platforms, which offer respite and convenient access to hours of content for those trapped at home. As a result of the crisis, more people are working from home than ever before. Companies had been slow to adopt digital infrastructure such as mobile work platforms and teleconferencing. These solutions offer work/life benefits for employees and potential long term cost savings for companies that should ensure they are adopted long after the virus recedes. As businesses demand more digital solutions, we expect cloud based infrastructure and services to grow significantly. We hold a number of high quality technology companies that are directly exposed to each of these trends, many of which have fallen 10-20% despite having the ability to grow sales and earnings in absolute terms this year.

We are increasingly excited by the valuations of a number of high quality cyclical companies that have de-rated materially and where we have great confidence in the longer term opportunity. We are being opportunistic in acquiring these positons, however for the time being we prefer to err on the side of caution and to preserve our risk capital until we have greater conviction and visibility.

Next Steps

The number of new COVID-19 cases is now falling on a daily basis and plans are being designed to remove lockdowns and return to 'normal'. The market appears to be discounting a strong economic recovery. This may be appropriate (although we doubt it), but should the market rise much further, the chance for disappointment will increase and we will reduce equities.

The weight of evidence has become resoundingly negative in our view. The fiscal and policy measures have prevented a far worse outcome than we already have; they have 'plugged a hole' and prevent depression; not even the almighty Fed can defy economic gravity.

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