SOMERSTON
ASSET MANAGEMENT

Somerston Multi Asset Fund (the Fund)

Investment Letter No.13 – June 2020

The Somerston Multi Asset Fund (US0 class) returned +11.5% in the second quarter. The MSCI World Equity Index rose by +18.5% and a composite of UK, German and US Government bonds rose by +0.8% in Q2.

During Q2, the fund had average net equity and bond allocations of 34% and 51% respectively. The fund starts Q3 with net exposures of 60% in equities, 25% in bonds and 24% 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	6.9	2.4	1.8							**-4.3**

Top Ten Equity Holdings as at 1 July 2020

Name	**% Fund**
Johnson & Johnson	2.6%
Alphabet Inc-Cl A	2.4%
Mastercard Inc - A	2.4%
Thermo Fisher Scientific Inc	2.1%
Intuit Inc	2.0%
Amazon.Com Inc	1.7%
Nextera Energy Inc	1.6%
Roche Holding Ag-Genusschein	1.6%
Adobe Inc	1.6%
Procter & Gamble Co/The	1.6%
Total for Top Ten	**19.7%**

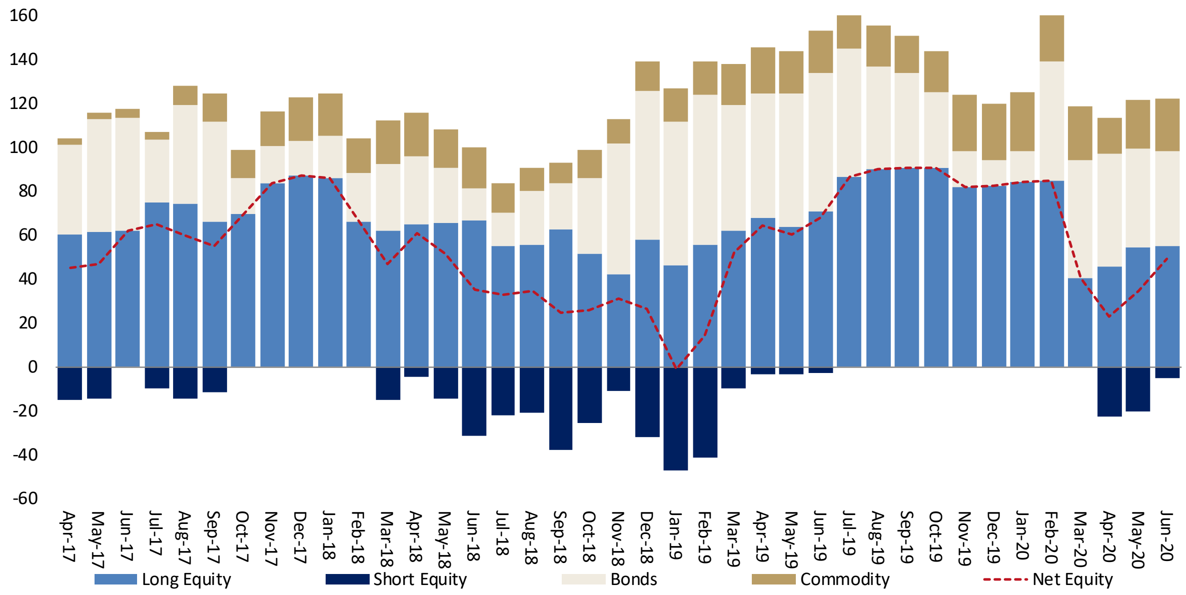
Share Classes

	ISIN	Ticker	NAV
US0	JE00BDRXFP25	SOMAUS0	114.7311
US1	JE00BDRXFQ32	SOMAUS1	111.8032
GB0	JE00BDRXFM93	SOMAGB0	108.7098
GB1	JE00BDRXFN01	SOMAGB1	105.9291
EU0	JE00BDRXFR49	SOMAEU0	105.4643
EU1	JE00BDRXFS55	SOMAEU1	102.7689

Asset Allocation as at 1 July 2020

	Long	Short	Net
Core Equities	40.3%		40.3%
Emerging Market Equity index futures	15.1%		15.1%
Long Small Cap Growth	5.0%		5.0%
Equities	**60.4%**		**60.4%**
US Govt inflation linked bonds	11.9%		11.9%
PIMCO Global Inv Grade Credit Fund	9.7%		9.7%
IShares Inv Grade Corp Bond Fund	3.0%		3.0%
US Government 10 yr. bond futures		-10.3%	-10.3%
UK Government 10 yr. bond futures	2.9%		2.9%
German Govt 10 yr. bond futures	2.8%		2.8%
German inflation linked bonds	5.2%		5.2%
Bonds	**35.4%**	**-10.3%**	**25.2%**
Gold Derivatives	13.9%		13.9%
Gold Bullion ETF	6.3%		6.3%
Gresham TAP Fund	2.1%		2.1%
Gold Miners	1.6%		1.6%
Commodities	**23.8%**		**23.8%**
Total All Assets	**119.6%**	**-10.3%**	**109.3%**
Cash and Equivalents			**-9.3%**

Evolution of Asset Allocation for Somerston Multi Asset Fund



Performance

- The fund returned +11.5% in Q2 versus its composite reference benchmark which rose by +13.0%.
- While the fund underperformed its reference benchmark by 1.5%, its risk profile was disproportionately lower.
- The fund was underweight equities during Q2 and this caused it to underperform its benchmark by -6.7% but this shortfall was significantly made up by other strategies.
- Equity selection outperformed adding +1.1% to performance.
- Bond selection outperformed adding +0.6% to performance.
- Gold added +3.8% to performance.

Outlook & Commentary

The 'reopening' from the Covid-19 shutdown is now advanced. Inevitably, new cases are emerging but crucially, (at the moment) the spread is predominantly in the 18-45 age cohort, 80% of new cases are asymptomatic and associated deaths are substantially lower. Whether this is because the elderly are strictly socially distancing, or the younger cohort do not manifest symptoms so easily, or whether the virus is mutating to a less deadly strain is uncertain. What is clear, a return to a fully-fledged lockdown appears entirely off the cards at this stage. It is socially, economically, and politically unacceptable it seems.

The recent economic collapse ushered in a global recession and induced an explosion of market volatility and a dramatic breakdown in both credit and market functioning. This would ordinarily lead to a material wave of deleveraging and compression in valuation. Not this time. On first look, debt levels have risen in aggregate and valuations remain at record highs.

The dissonance between the economy on the one hand and valuation and debt on the other, presents unusual circumstances for investors. While the extent of economic recovery is uncertain, recovery of some form is almost inevitable (it could hardly get any worse). At least in the foreseeable future therefore, economic improvement should be a tailwind for asset prices, but, at first take, high levels of debt suggest risks are high and valuations imply that a lot of the potential recovery is already discounted.

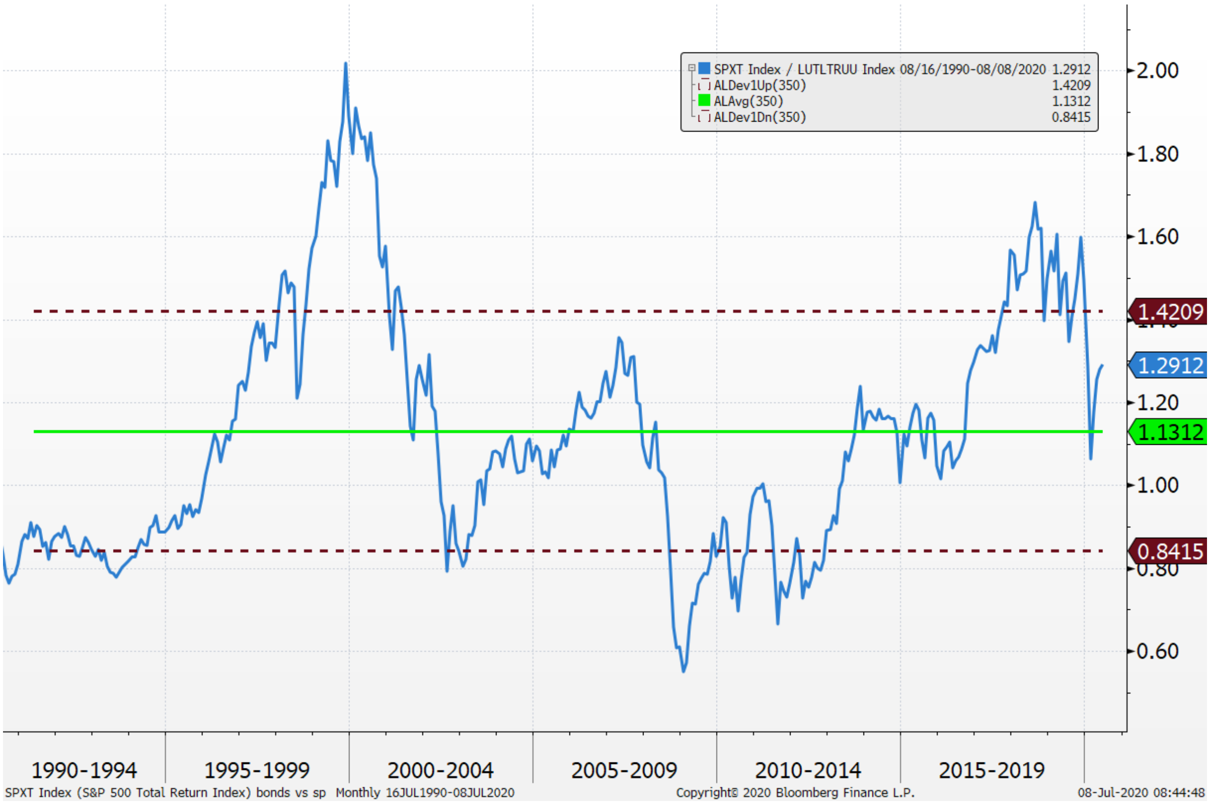
Aggregate corporate debt is at a record relative to GDP. However, the largest growth companies that dominant both our lives and financial markets, mostly have a net cash position. In fact, nearly half of the companies that comprise the technology heavy Nasdaq 100 Index have a net cash position on their balance sheets. In contrast, large outstanding debt loads are principally held by companies that have struggled to grow, where businesses have been facing secular issues and where COVID has been particularly crushing. These are 'value' companies and sectors. Not only are their debt levels near historic highs, but, unsurprisingly, their market beta is near historic highs too. 'Value' companies have never been this levered. Combining debt and cyclicality is never a good idea. It is not surprising therefore that the debt laden 'value' sector continues its 12- year underperformance.

While there certainly are high levels of corporate debt, concern surrounding levels of corporate debt would be entirely eradicated if aggregate leverage was measured by weighing that debt load by market capitalisation. The largest and most important companies in our society are boasting some of the healthiest balance sheets possible. Accordingly, while many companies will 'fold' and several companies need to restructure, we do not see high levels of corporate debt to be an insurmountable obstacle to economic recovery.

The second threat potentially undermining the upward trend in prices is the level of valuation. At first look, the absolute level of equity valuation, using a price to earnings ratio or something similar, appears exceptionally unattractive. However, the valuation for much of the equity world is more rational relative to other investment alternatives and from a 'net present value' perspective.

Chart 1, below shows the S&P total return relative to long term government bond total return over the last 30 years. The chart clearly shows US equities outperforming government bonds from the March 2009 lows. US equities started underperforming government bonds as early as August 2018 and in less than two years since then, despite the significant equity rally from the 23rd March lows of this year, US equities have underperformed government bonds by a substantial -30%. Put differently, the earnings yield on equities is almost 3% points better than the yield on long dated government bonds. Presented with the choice between equities and bonds, you would almost certainly side with equities. Fortunately, this is not our only choice!

Chart 1 – S&P total return relative to long term US Government bonds total return -S&P underperformed bonds by 30% in the last 22 months



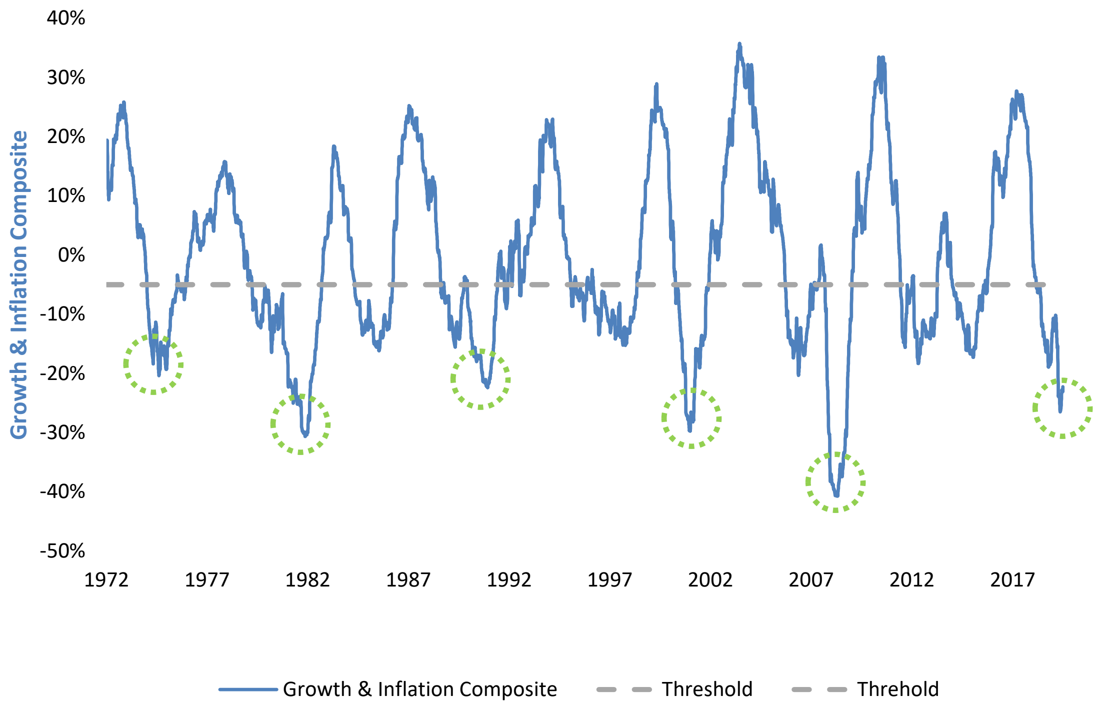
There is however a serious flaw in comparing one asset with another to determine 'value'. If you compare one expensive asset to another, there is a chance that both will fall in price! Indeed, with the US 30-year government bond yielding 1.45%, it is abundantly clear that there is no margin of safety to accommodate even a remote possibility of a rise in inflation!

The incredible policy response to the economic circumstances is unprecedented. Not just the monetary response from the Central Banks that we have now all got used to, but the fiscal response from many countries around the world. The post GFC era of austerity seems entirely abandoned and Germany, the bastion of fiscal prudence, has materially reversed course by endorsing Coronavirus Bonds and is acceding to the notion of European debt mutualisation.

US inflation is only 0.1% year over year and has averaged 1.7% in the last ten years. The combination of fiscal and monetary policy combined with 'de-globalisation' might finally generate some upward pressure on Inflation. Disrupted supply chains, reduced mobility of labour and monetary and fiscal policy that is arm in arm, is surely enough to move inflation above trend. Of all assets, bonds are most sensitive to inflationary surprises. Long dated bonds, against which many are assessing the present value of their other assets, are not priced for this. Accordingly, there is not an insignificant risk that bonds fall and the relative valuation arguments between bonds and equities would not shield investors from loss in absolute terms.

Nonetheless, with inflation still compressed and economic recovery at its early stages, the apparent conundrum for investors, of economic recovery in the context of high debt levels and excessive valuations, does not seem entirely irreconcilable. Corporate debt is concentrated amongst sectors that should (and can) be avoided and valuations relative to bonds are in fact far improved from August 2018. With our growth and inflation indicator so depressed and fiscal and monetary policy so primed, we expect continual economic recovery to be reflected in asset prices at least in the short term.

Chart 2 – US growth and Inflation composite Indicator – At levels seen only five times in the past 50 years. All signalled the start of a multiyear economic expansion.

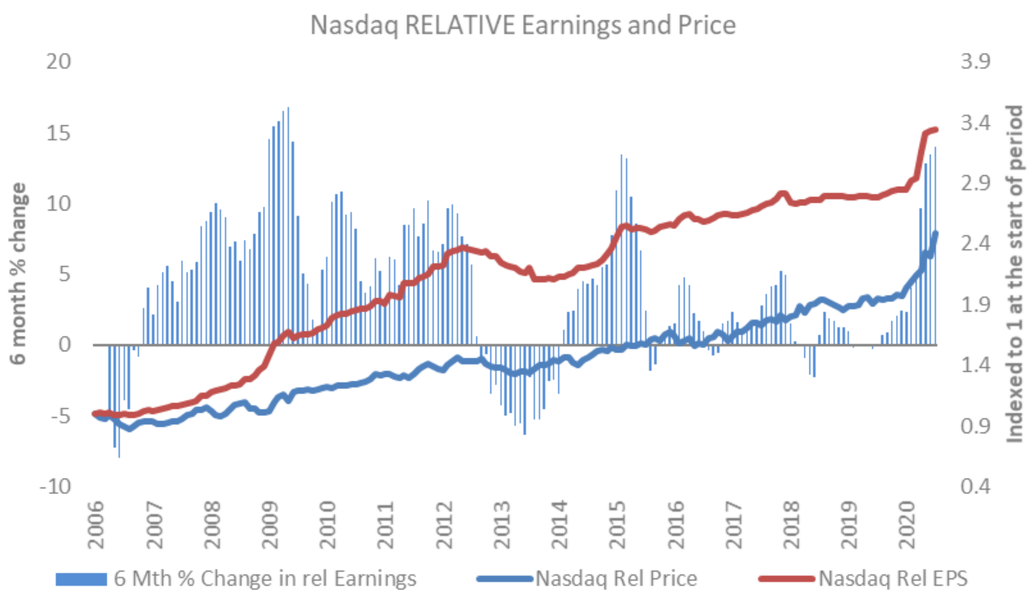


Strategy

The range of probable economic and market outcomes remains wide but perhaps not quite as large as it was before. Economic recovery is fragile, and it is in its early stages; there is a deluge of monetary and fiscal liquidity; credit conditions appear reasonable for most and there remains a healthy level of scepticism amongst investors. Accordingly, we have increased equities to a moderate allocation. More important than the absolute level of equity allocation however, is the strategy within our equity book.

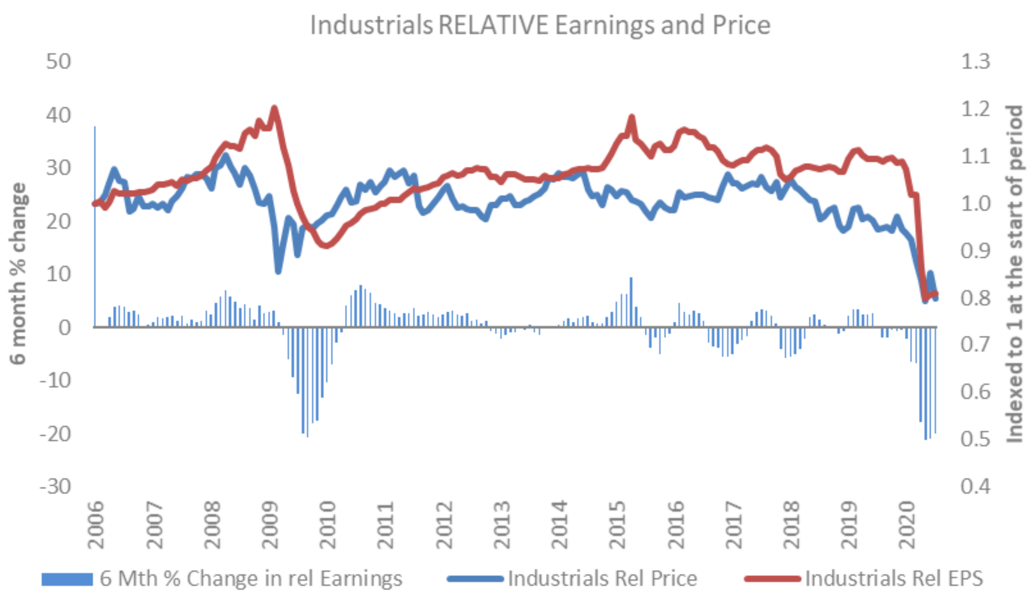
We are significantly overweight 'debt-lite' growth on the one hand and very underweight traditional cyclicals on the other. Chart 3 shows the Nasdaq 100's relative price and relative earnings (indexed to 100 in 2006). The price of technology stocks has been a steady outperformer and over the last six months, earnings have outpaced the market by 15%. Based on forward earnings estimates, much of the technology sector's outperformance has been matched by the relative resilience of the sector's fundamentals. In short we have not seen prices move dramatically ahead of the fundamentals suggesting there was a 'valuation' risk.

Chart 3 – Nasdaq 100 relative price and relative earnings – outperformance matched by earnings.



In contrast, industrials that are both cyclical and indebted, have underperformed by a similar degree to its underperformance in earnings. See Chart 4 below.

Chart 4 – The S&P industrial Sector relative price and relative earnings – underperformance matched by earnings.



If the recovery starts to take hold in a meaningful way, it will be right to shift our allocation to the more cyclical sectors but for the moment, we maintain overweight positions to Technology and defensive sectors Staples and Utilities, we are underweight cyclicals but we have introduced a meaningful weighting to emerging markets.

Emerging markets display many of the cyclical characteristics of the classic cyclical sectors, (industrial, discretionary and financial sectors), but emerging markets are perhaps one of the genuine cheap assets in financial markets. Moreover, many EM countries (notably East Asia) dealt with COVID effectively and they are six months ahead in their COVID recovery.

Within bonds, we are significantly overweight German and US inflation linked bonds, and investment grade corporate bonds, and we are very underweight government duration. As previously stated, government bonds appear to have very little cushion of safety to protect against inflation returning to trend.

We continue to hold significant allocations to gold, an asset that is likely to do well if inflation accelerates and it would be explosive if there was a widespread currency crisis.

Core Equity Strategy

Our core equity book had a very strong quarter in both absolute and relative terms, rising +22% and outperforming global equity markets by +3.6%.

Over the past two quarters, Covid-19 created great volatility and uncertainty for equity markets, with wide potential outcomes, depending on the severity of the pandemic, extent of lockdown, potential treatment, testing regimes and the impact of government intervention/stimulus. We took a barbell approach to our core equity allocation. On the one side, we built positons in high quality defensive companies and on the other we held structural growth stocks that would continue to grow well throughout the crisis and beyond. This combination worked well and we outperformed in a very strong market despite a more cautious overall allocation. We increased our core equity investments to twenty eight and the increased diversification allowed us to nimbly adjust the portfolio characteristics to suit the prevailing market conditions.

Early in the quarter we added new positions in LVMH and ASML and re-opened our holding in Stanley Black and Decker. These cyclical businesses suffered in the downturn and underperformed in the early stages of market recovery. As a result, relative valuations had fallen to attractive levels as negative, short term factors weighed disproportionately on share prices whilst strong long term fundamentals were overlooked.

We added a new position in Visa. Visa and MasterCard operate a very powerful duopoly of payment networks and benefit from the exponential trend away from cash and towards card and digital transactions. The share price of both companies declined c.30% on covid concerns which does not tally with their solid long term fundamentals or the potential tailwind they should receive from the acceleration of e-commerce and the shift towards contactless and digital payments during lockdown. We continue to prefer MasterCard, which we held for some time but, the valuation gap between the two companies had reached extreme levels and as MasterCard was already a good size holding we opted to increase our payments exposure by adding a smaller second unit in Visa. Our decision to increase beta and cyclicality supported performance as the market rallied.

As we move forward, the winners and losers of the post covid world are becoming clearer, and investors will begin to focus more on long term fundamentals and relative value. At quarter end we started to consolidate our portfolio, reducing the number of holdings. We took profits in a number of tech holdings which had outperformed strongly and re-rated ahead of fundamentals – Amazon, Adobe, Okta, and Microsoft.

We sold our entire position in Disney which performed well during the market rally. Disney’s earnings profile for the next two years is increasingly volatile and uncertain, which may weigh on long term growth. The theme park business needs high capacity utilisation to thrive, the parks are re-opening but for how long and to what capacity? ESPN remains plagued by irregularity of sports programming and advertising budget cutbacks. But our biggest concern is the film business; super profitable and the main driver of excess growth and returns for the last 5 years (before the Disney+ euphoria). This year’s slate of new releases has been pushed back indefinitely, with uncertainty about cinemas re-opening, and the business will continue to suffer in 2021 and beyond as new filming has stopped entirely. Disney needs cash from these businesses to fund its high cost Disney+ rollout which is at a critical stage of growth in a highly competitive industry.

We sold our holdings in Nestle and Unilever entirely. Both companies are defensive consumer staples businesses with relatively little exposure to product categories most at risk from the covid-19 disruption. They provided shelter during the crisis. However, we are concerned that pre-covid sales growth was anaemic for both companies (Unilever in particular) and structural trends are not favourable. We added a new positon in Walmart. Walmart has quality defensive properties but it is also a direct beneficiary of Covid-19 through its ecommerce and home delivery businesses. Walmart lagged whilst digital native ecommerce businesses like Amazon soared. We believe Walmart's opportunity to dominate the digital food delivery channel has accelerated as a result of Covid-19.

As a result of portfolio changes, the core equity book starts the new quarter with a fairly neutral allocation; a beta slightly below one, an overweight allocation to technology, growth, healthcare and defensives, and an underweight allocation to cyclical value. Our core equity book is likely to underperform in the event of a strong cyclical/value rally, but likely to outperform if conditions deteriorate and the market sells off again or if growth remains scarce and the market continues to recover steadily.

Summary

In summary, our allocation is presently highly differentiated. We consider there are some compelling opportunities on offer within the equity complex and we maintain a 'barbell' approach, overweight growth on the one hand and emerging markets on the other with very little in between.

In our bond book with have very little traditional duration and instead have allocated to assets that would fare much better should inflationary pressures begin to rise from their very low levels.

We consider Gold to continue to have significant merit in the context of the entire portfolio.

We have positioned the portfolio to fare reasonably if the economy continues to slowly recover. If recovery starts to accelerate, our significant under-weight to cyclicals would cause underperformance. If we get another bout of deflationary pressures, we expect gold to do well together with growth equities but being underweight duration would likely cause underperformance.

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