SOMERSTON
ASSET MANAGEMENT

Somerston Multi Asset Fund (the Fund)

Investment Letter No.18 – September 2021

The Somerston Multi Asset Fund (US0 class) returned -2.5% in the third quarter. The MSCI World Equity Index rose by +0.6% and a composite of UK, German and US Government bonds fell by -0.5% in Q3.

During Q3, the fund had average net equity and bond allocations of 56% and 45% respectively. The fund starts Q4 2021 with net exposures of 63.1% in equities, 45.2% in bonds and 15.3% 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	7.4	3.1	-2.2	-1.0	5.2	5.2	**13.6**
2021	-0.3	0.8	-0.1	2.3	2.5	-0.2	2.2	0.5	-5.1				**2.4**

Top Ten Equity Holdings

Name	% Fund
Nextera Energy Inc	2.6%
Adobe Inc	2.2%
Booking Holdings Inc	2.3%
Alphabet Inc-Cl A	2.0%
Walmart Inc	1.9%
Amazon.Com Inc	1.8%
Mastercard Inc - A	2.0%
Roper Technologies Inc	1.7%
Digital Realty Trust Inc	1.6%
Anglo American Plc	1.4%
Total for Top Ten	**19.5%**

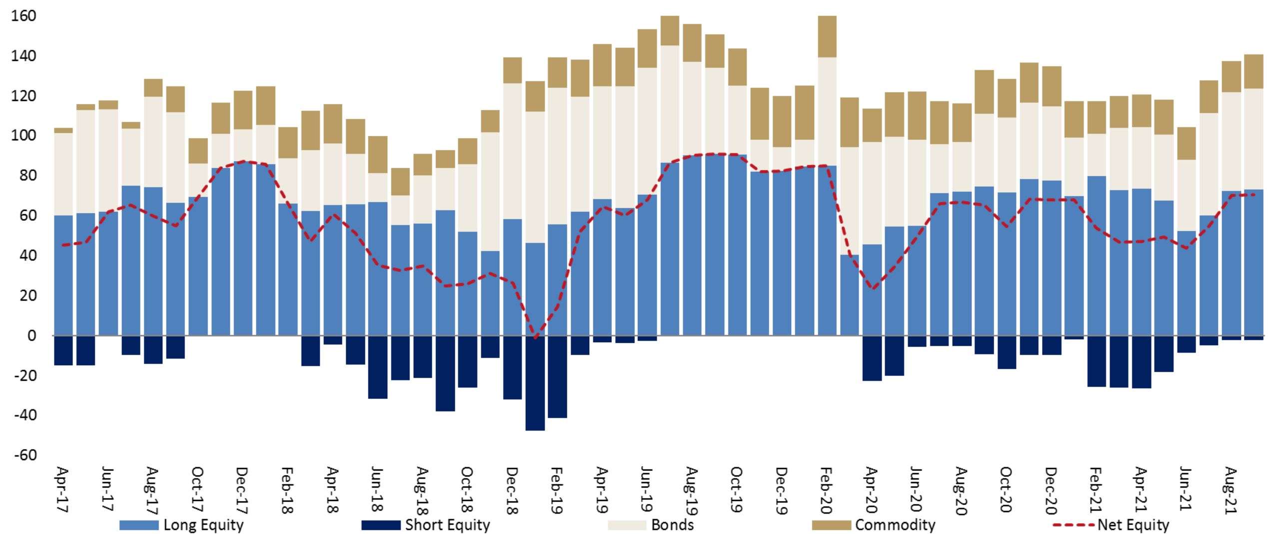
Share Classes

	ISIN	Ticker	NAV
US0	JE00BDRXFP25	SOMAUS0	139.3971
US1	JE00BDRXFQ32	SOMAUS1	134.1154
GB0	JE00BDRXFM93	SOMAGB0	130.9941
GB1	JE00BDRXFN01	SOMAGB1	126.0296
EU0	JE00BDRXFR49	SOMAEU0	125.9616
EU1	JE00BDRXFS55	SOMAEU1	121.1842

Asset Allocation

	Long	Short	Net
Core Equities	35.7%		35.7%
Emerging Market Equities	0.3%	-2.2%	-1.9%
Small Cap Equities	1.9%		1.9%
Real Estate Equities	4.2%		4.2%
Dev Market Equities	13.8%		13.8%
Small Cap Growth Equities	3.0%		3.0%
Defensive Equities	6.3%		6.3%
Equities	**65.3%**	**-2.2%**	**63.1%**
US Govt Inflation Linked Bond	21.5%		21.5%
US Government 10 yr. Bond	9.9%		9.9%
UK Government 10 yr. Bond	13.7%		13.7%
Bonds	**45.2%**		**45.2%**
Gold and Gold Miners	8.1%		8.1%
Silver and Platinum	5.0%		5.0%
Gresham TAP Fund	2.2%		2.2%
Commodities	**15.3%**		**15.3%**
Volatility	6.7%		6.7%
Total All Assets	**132.4%**	**-2.2%**	**130.2%**
Cash and Equivalents			**-30.2%**

Evolution of Asset Allocation for Somerston Multi Asset Fund



Comment

Strategy has been cautious so far this year and exposures to assets we would expect to do well in adversity have been a drag on performance. Our outlook remains cautious at this time. We maintain high levels of diversity and, within our equity book, we have a focus on quality and defensive attributes.

Outlook

Evidence continues to build that both growth and inflation will moderate in the next 6-18 months. This moderation will cause leadership to change, with greater overall volatility and rotation. However, the probability of recession in the next 6 months is presently low and crucially, the proverbial canary in the market's coalmine, in the form of credit markets, show few strains whatsoever. Time will tell whether credit markets are overly complacent, though we doubt it, what is for sure, if the overall equity market is to correct, credit markets are likely to deteriorate before, or at the very least contemporaneously.

Chart 1 – Investment grade credit spreads.

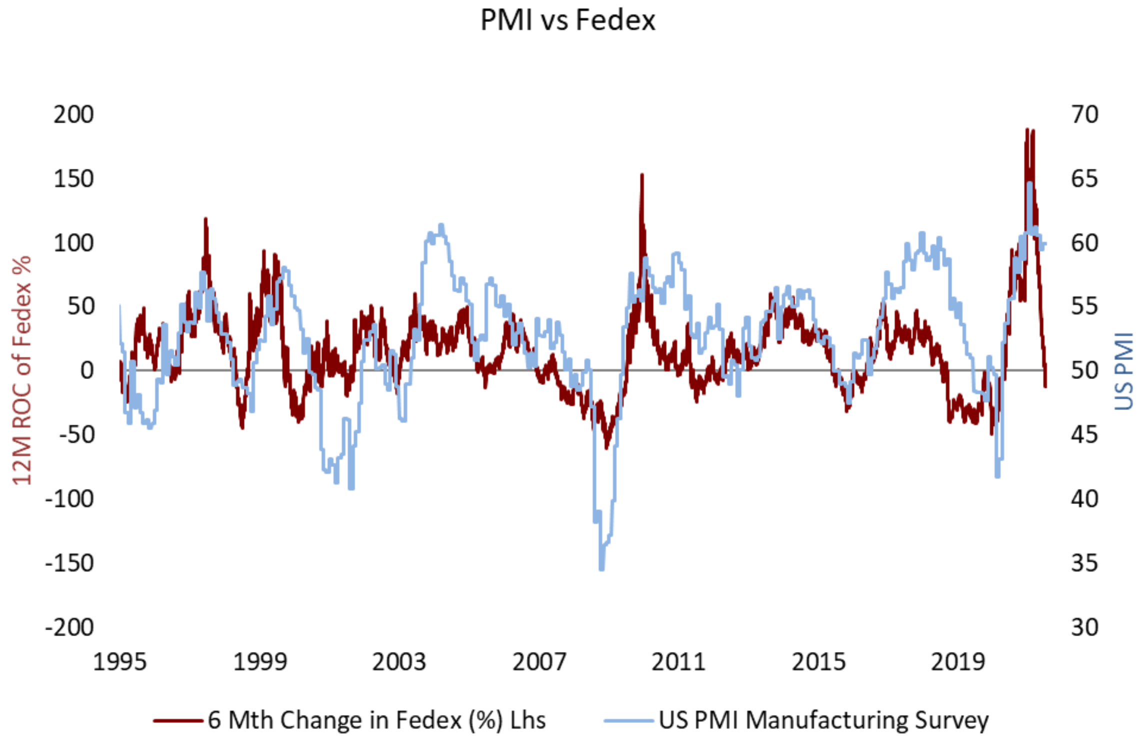
We are not entirely carefree about the risks, particularly in the context of 'Growth & Inflation moderation'. These environments are often accompanied by jubilant investors who, having extrapolated recent high growth trends well into the future, suddenly realise valuations are too high.

Specifically, we consider the moderation of economic growth will primarily be caused by:

1. Events in Chinese real estate markets and the policy of 'Social Prosperity'
2. Monetary 'Tapering' and reduced fiscal support
3. Rising interest rates, energy prices, and logistics costs serving as a growth tax.
4. High 'base effects'.

The US listed, global logistics company FedEx is a barometer of global activity. Its recent earnings report was dismal on many fronts, causing its share price to fall. The chart below shows the rolling 12-month percentage change in FedEx share price (red) overlaid with US Manufacturing PMI survey (blue). While not perfect, the historic relationship between FedEx share price and the path for US manufacturing is clear.

Chart 2 – FedEx Share price (12-month rate of change) (Red) vs US Manufacturing survey (Blue)



FedEx woes are not idiosyncratic but representative. The moderation in economic growth is manifesting in several other areas. While equity market indices continue to be near their highs, the average stock in the US is not faring so well with only 52% of the Russell 3000 above their 200-day moving average (chart 3). Dwindling stock participation is usually an early indicator of both market and economic deterioration.

Meanwhile bond yields around the world continue to edge higher. Chart 4 shows the 2-year change in 'G4' 10-year yields in blue and the MSCI World Equity index in red. A 50-bps increase in 10 year yields over two years, has historically caused equity markets to struggle. In all likelihood, if yields continue at these levels, yields will have risen by 75 bps to 100 bps over a two-year period by February 2022 (see circle on Chart 4). Such high levels have historically marked significant headwinds for equity markets and the increased level of outstanding debt only makes the interest rate burden more acute.

Chart 3 – The average stock is much weaker than the reported market Indices.

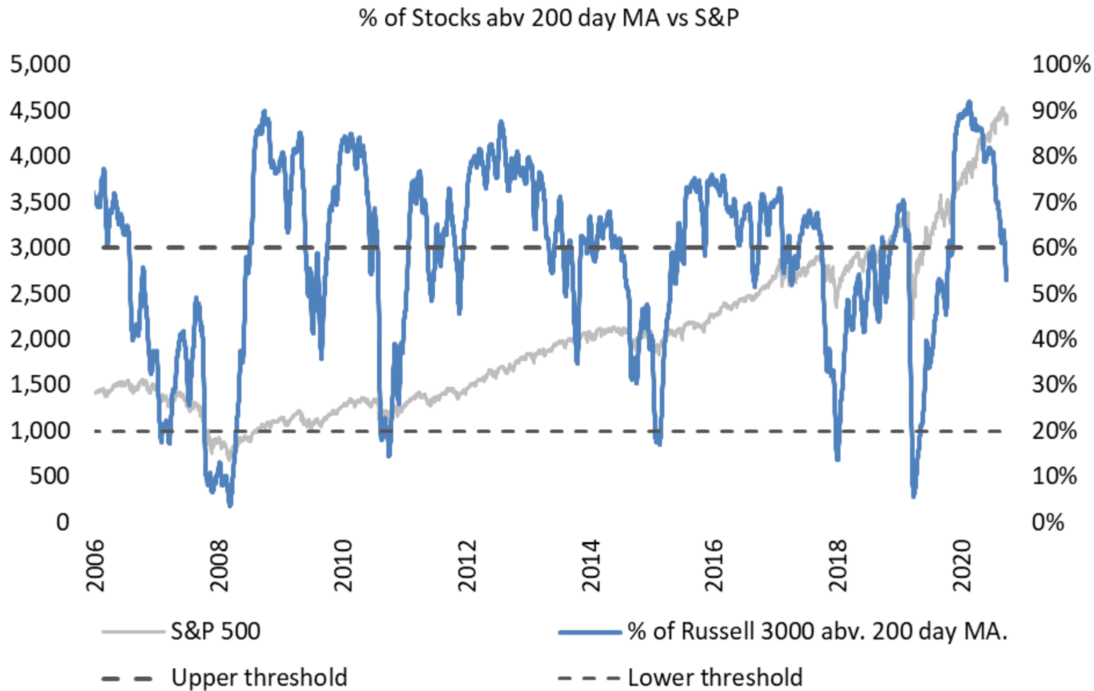
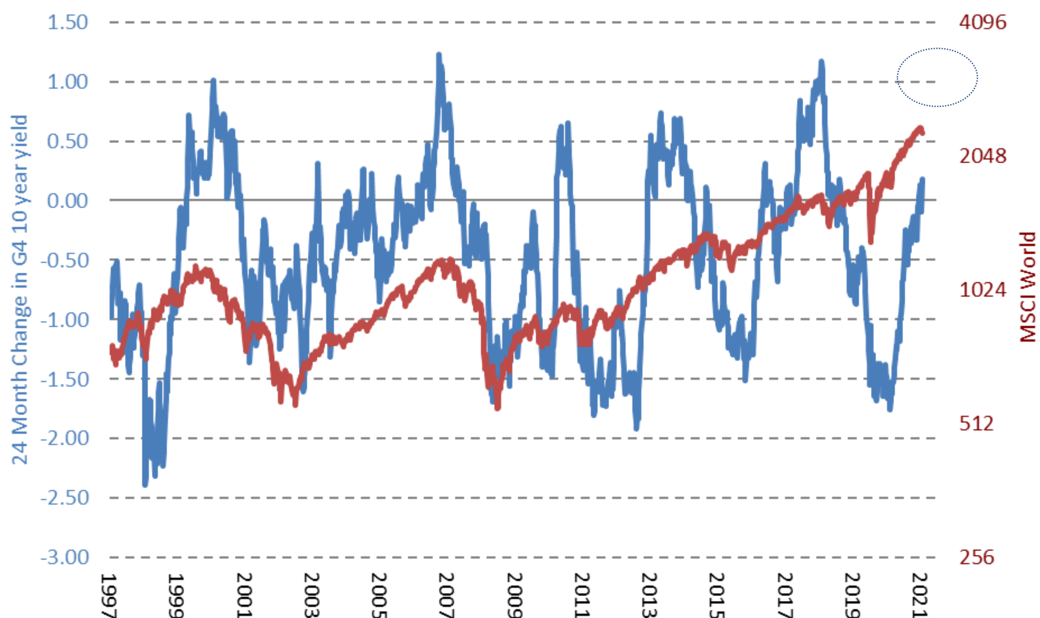


Chart 4 – Rate of Change of 'G4' 10-year bond yields over the last 2 years (Blue) vs World Equity Markets (Red). At 50 bps increase over two-years, World Equity markets have often struggled.



The Chinese Evergrande situation appears contained in China, but the size of the problem is much larger than is immediately apparent. We don't have perfect information, but Evergrande's $300 billion debt pile appears to be just the tip of the iceberg. Obligations in the forms of guarantees to purchasers' mortgages and underwriting of collateralized loan notes not to mention the pocketing of down payments make up the sordid tale. Any belief that this is a company specific problem is naive in our view and we would expect other companies in the real estate sector to unravel in the weeks and months ahead. We expect the Chinese Government to manage these exposures over the course of time, with losses accruing in an orderly fashion, but the impact this has on the Chinese consumer who has driven their lifestyle on increasing leverage and property gains cannot be understated. Even if the Chinese authorities manage the problem as we expect, growth is likely to fall sharply.

Though distinct, the Chinese clamp down on capitalism in the name of 'Social Prosperity' is having a profound impact on many sectors from education to technology. This 'interference' is causing international investors to think twice, and it is materially changing the fundamentals of some of the most successful Chinese companies.

Inflation

Inflation has featured prominently in the headlines in recent months.

The bout of inflation in certain sectors has two predominant reasons. Firstly, the huge fiscal and monetary stimulus caused a onetime step up in demand, and because of the lockdown, consumption channelled towards goods – online consumption, housing, autos and vocational goods- rather than services - holidays, travel, hotels, restaurants and other services. This caused a demand shock for goods that the supply side was just not prepared for. The result is higher house prices, higher logistic costs and higher consumer goods. The second reason underpinning the inflation story is the break in labor mobility causing geographical labor pressures in certain industries.

Neither of these forces are likely to be long lasting. The pandemic did not destroy manufacturing capacity and while the pandemic had a cost to life, there remain enough workers in the world. In fact, the responses to the inflationary pressures, has led to increased investment in automation and long-lasting productivity strategies that will eventually feed through. Perversely, their impact will probably be felt just as demand abates. In contrast to the elevated reported inflation numbers, we are seeing now, this is likely to cause a disinflationary surprise in 2022.

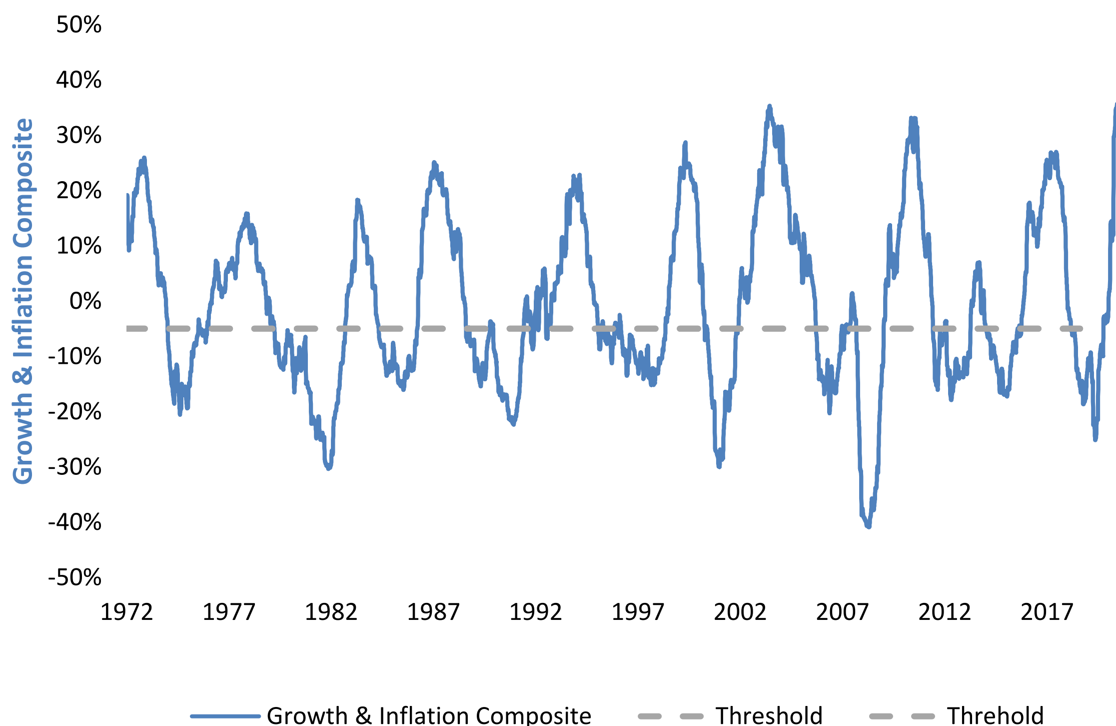
Moreover, the productivity gains we have seen elsewhere in the economy are astounding. Working from home, step change to cloud usage, VC meetings, home entertainment are just some of the enormous disinflationary movements.

The consumption demand for goods is undeniably causing pockets of material inflation but inflation expectations remain very anchored. Market based expectation of US 5-year inflation in five years' time is just 2.2%.

Tolerance to 'high costs' is not without limit either. For instance, there is some evidence building projects are being deferred with building permits slowing and new orders as a percentage of inventory is just starting to normalize from very high levels.

Finally, we cannot ignore that the long-term deflationary forces of debt and demographics have only got worse. An addition $1 dollar of debt is having an increasingly muted impact on growth causing the velocity of money to dwindle.

Chart 5 – 50 years of growth and inflation cycles. Now peaking.



Strategy

In our view, we are now past the maximum economic expansion and inflation phase and a period of moderation is ahead. As Chart 5 shows, there have been nine comparable peaks in growth and inflation in the past 50 years. In these periods, the appropriate strategy was to be balanced overall but within equities, overweight quality and stability and underweight cyclicality; in bonds stay away from credit and prefer precious metals to other commodities. Our models support this stance and within equities, dividend and high quality balance sheets appear far more reasonably valued than other areas of the market. With bond yields and cash returns so low, it is difficult to ignore the relative proposition these investments offer. We continue to hold precious metals and Long Volatility funds to protect from 'unknown unknowns'. These have been a drag on performance all year. Should something happen, we will be thankful we held them.

Core Equity

- The core equity book finished the quarter flat, modestly underperforming the MSCI World equity index (+ 0.6%) but outperforming our quality peer group (-0.8%).
- Growth and defensive equities performed strongly through July and August, global equities rose +4.4% as inflation expectations eased.
- The market tone shifted dramatically in September. A more hawkish central bank tilt pushed government bond yields higher whilst soaring energy prices (European gas +160% over the quarter) drove a 9.6% rally in energy companies. In contrast, all other sectors declined. Quality stocks underperformed as the market fell -3.7%.
- Our careful exposure to cyclical value stocks, primarily in the energy and travel industries supported performance during the quarter. Energy prices have now hit unsustainable levels and there is growing evidence that growth and inflation will moderate over the next 6-18 months.
- We took profits in our cyclicals and increased our skew to growth and quality early in October.

Notable Performers:

Thermofisher (+13.3%) was our top holding. Thermo played a critical role in the global covid response generating an additional $6.7bn in revenue over the last year from covid related operations (c.20% of prior sales). Thermo is involved in everything from the supply of PPE to the development and production of covid tests, vaccines and therapies. Covid revenues are declining but have proven more resilient than expectations on protracted demand for testing and booster vaccinations. Record covid cash flows empowered management to embark on an aggressive capital deployment strategy bolstering R&D and investing heavily into high growth markets like biopharma. Thermo's cyclical end markets also look increasingly healthy as the global economy recovers. As a result, organic revenue is forecast to grow 8% next year despite covid related sales falling c. 85%! At the September analyst day management significantly increased their long term guidance to 8-9% organic revenue growth and 14-15% eps CAGR, well ahead of investor expectations and historic trends (c.5% revenue growth). They also announced an aggressive buyback program.

Booking holdings, our third largest position, rose 8.5% following an impressive Q2 earnings release. Higher vaccination rates and easing travel restrictions drove a surge in domestic European travel and to a lesser degree international travel. Q3 trends for both room nights and bookings also came in well ahead of expectations. Booking is gaining market share in the US (a key growth market), gaining market share in the alternative accommodation segment and continues to grow its payment platform and ancillary services. Whilst we are increasingly cautious on cyclical businesses Booking

remains the gold standard of travel companies and travel remains depressed. Hotel bookings are still 26% below 2019 levels offering plenty of cyclical upside. Before the pandemic Booking was growing earnings per share at a consistent 20% CAGR and it exits the pandemic with a more dominant market position.

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