SOMERSTON ASSET MANAGEMENT

Somerston Multi Asset Fund (the Fund)

Investment Letter No.21 – June 2022

The Somerston Multi Asset Fund (US0 class) returned -8.7% in the second quarter. The MSCI World Equity Index fell by -14.3% and a composite of UK, German and US Government bonds fell by -4.6% in Q2.

During Q2, the fund had average net equity and bond allocations of 38% and 44% respectively. The fund starts Q3 2022 with net exposures of 33% in equities, 43% in bonds and 11% 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	5.2	-1.7	3.2	**9.3**
2022	-5.9	-1.1	2.6	-3.5	-1.4	-4.1							**-12.8**

Top Ten Equity Holdings

Name	**% Fund**
Pepsico Inc	3.2%
Nextera Energy Inc	2.9%
Walmart Inc	2.7%
Alphabet Inc-Cl A	2.5%
Adobe Inc	2.4%
Thermo Fisher Scientific Inc	2.3%
Intuit Inc	2.0%
Amazon.Com Inc	1.9%
Microsoft Corp	1.7%
Danaher Corp	1.6%
Total for Top Ten	**23.4%**

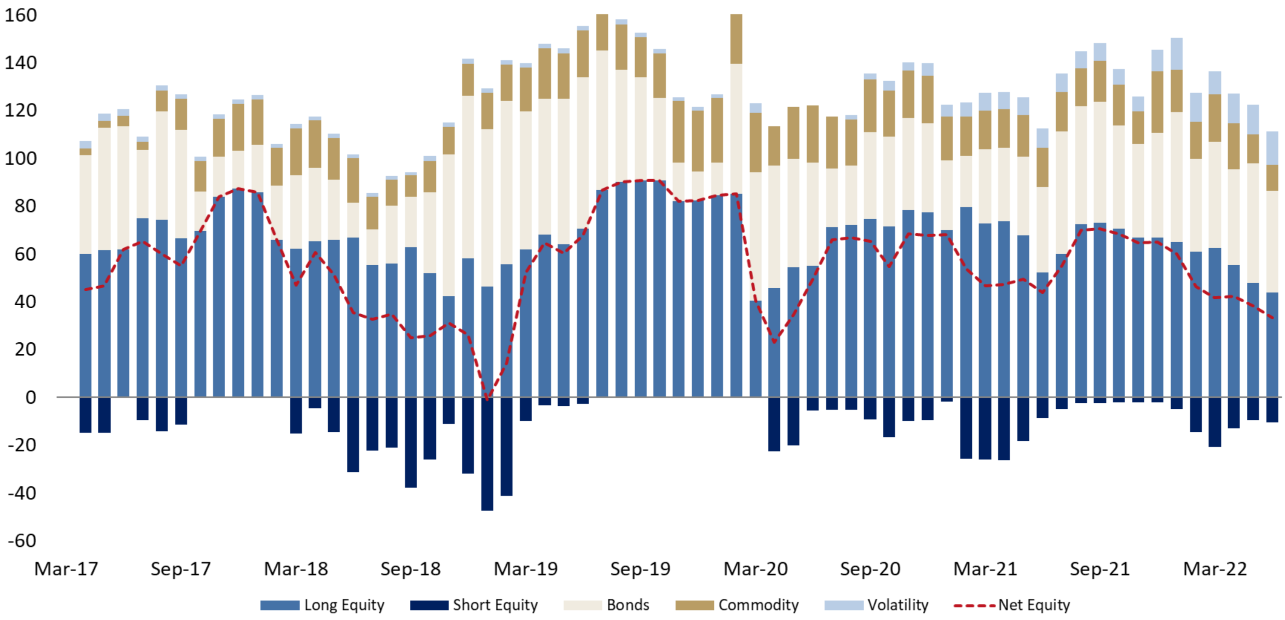
Share Classes

	ISIN	Ticker	NAV
US0	JE00BDRXFP25	SOMAUS0	129.6565
US1	JE00BDRXFQ32	SOMAUS1	123.6708
GB0	JE00BDRXFM93	SOMAGB0	121.2107
GB1	JE00BDRXFN01	SOMAGB1	115.6028
EU0	JE00BDRXFR49	SOMAEU0	115.7011
EU1	JE00BDRXFS55	SOMAEU1	110.3437

Asset Allocation

	Long	Short	Net
Core Equities	33.6%		33.6%
Developed Market Equities (US)		-5.0%	-5.0%
Emerging Market Equities		-2.5%	-2.5%
Real Estate Equities	3.7%		3.7%
Small Cap Equities		-3.0%	-3.0%
Defensive Equities	6.5%		6.5%
Equities	**43.8%**	**-10.5%**	**33.3%**
US Govt Inflation Linked Bonds	16.7%		16.7%
US Govt (+15yrs) Inflation Linked Bonds	6.0%		6.0%
US Government Ultra Long bond futs	9.4%		9.4%
US Government 10 yr. Bond	10.6%		10.6%
Bonds	**42.7%**		**42.7%**
Gold Derivatives	7.2%		7.2%
Gold Miners	3.7%		3.7%
Commodities	**10.9%**		**10.9%**
Volatility and CTA	13.9%		13.9%
Total All Assets	**111.3%**	**-10.5%**	**100.8%**
Cash and Equivalents			**-0.8%**

Evolution of Asset Allocation for Somerston Multi Asset Fund



Notable Performance Drivers

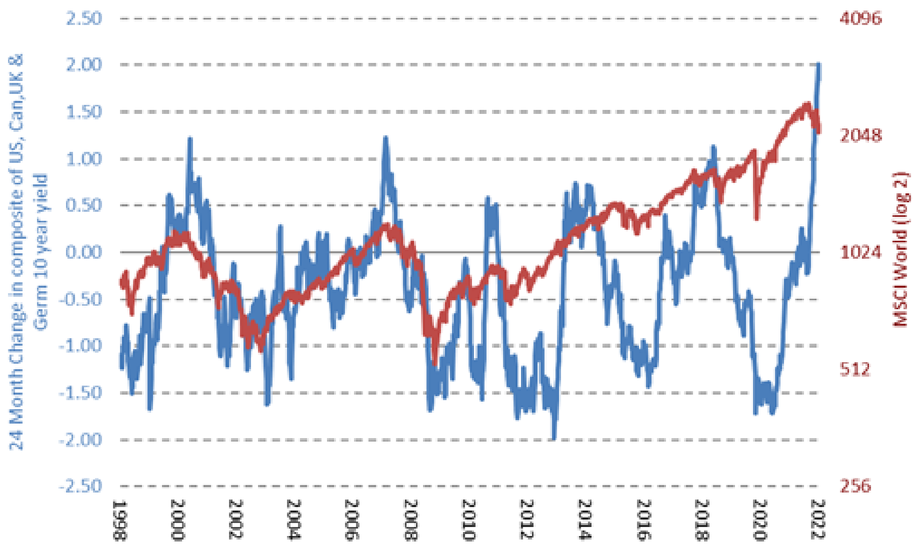
- During Q2 we were underweight equities which added 4% relative to the benchmark.
- Equity selection was also additive by 0.5%. Our macro positions added 0.9% while stock selection detracted 0.4%.
- However, bonds continued their bear trends and our overweight position in long duration assets detracted 1.2%.
- Gold was similarly disappointing and detracted 1.4%.
- Our long Volatility positions added 1.4%

Commentary

The present financial conditions are really quite poor and unfortunately, it is difficult to see how they improve anytime soon.

Despite ultra-low interest rates in the past decade, Central Banks were unable to generate consumer price inflation. Rather their policy, which was employed to address the rolling crises since 1998, caused asset inflation, driving all asset valuations to record highs on many measures. The pandemic induced a different type of stimulus. Fiscal stimulus - direct payments to individuals has caused consumer demand to rise at the same time supply chains are clogged up and global tensions are causing the cosy international partnerships, a movement termed 'globalisation', to pause. Increased demand for goods and services together with shortage of supply has caused consumer price inflation to increase markedly. This is an interesting quandary. Higher consumer inflation appears to be a function of fiscal stimulus and supply chains; years of low interest rates did not make any difference. Yet now, Central Banks are trying to bring consumer inflation under control using tools that proved so deficient in generating consumer inflation in the first place. Fiscal stimulus has already dried up and supply chains are slowly improving. This will go a long way to resolving today's inflation problems. However, if Central Banks keep on their present path, we suspect they will contribute to tackling inflation by inducing asset price declines and a reversal in the 'wealth effect' that has been so powerful in the last decade.

Chart 1 – Bond yields have risen over 2% in the last two years.



Nonetheless, bond yields have anticipated Central Bank Policy by moving substantially higher, increasing the cost of capital. Higher cost of capital together with higher raw material prices and freight costs are beginning to throttle consumption, they are constraining company's revenue growth, and tightening corporate profit margins. Chart 1 shows 10-year bond yields are 2% higher than 24 months ago and we compare this series with the MSCI World Equity Market (red). A change of this magnitude has seldom been recorded and certainly not in the past 25 years. It takes time for increased costs to bite, consumption habits evolve slowly, and companies are slow to start making redundancies – but in the most recent earnings season, many companies gave guidance that they either had enough staff (Amazon and Walmart) or, in the case of high growth companies (Snowflake), they were slowing hiring.

It seems highly likely that inflation will also slow in the near term BUT we are concerned of an increasing probability that inflation may have a 'new normal' at higher levels than we have been used to.

a. A pause in globalisation and underinvestment in secure supply chains, will force new investment and might push costs of production higher.
b. As aging populations withdraw from the pool of workers, Labour appears scarce, and wages are rising.
c. Companies appear to be undergoing a change in philosophy from efficiency to resiliency, causing higher levels of inventory.

When inflation is low and tame, much as it has been in the last 30 years, a few things happen:

1. In the absence of a currency problem or asset price bubble, when inflation is low, Central Banks have the freedom to lower interest rates and 'bail out' financial markets.
2. In low and tame inflation environment investors attach a low risk premium on risk assets and valuations rise.

When inflation is high and unpredictable, as it appears today, the opposite is true. Central Banks have no freedom to assist financial markets and the risk premium of risk assets continues to climb forcing valuations down.

The critical question is whether this **is the start of a regime change**. In other words, are we in for years, possibly decades, of higher inflation? A 20% drawdown in equity prices indicates investors in aggregate believe inflation is a cyclical problem and not structural. If we are in a new regime of higher and more unpredictable inflation, asset prices will probably fall much further, Central Banks with a mandate to maintain price stability (even if they do not have the tools to achieve such) will have no option but to keep increasing rates and bonds and equities are likely to fall together. However, the cyclical vs structural debate is a concern for later in the year in my view. Inflation will fall in the coming months.

Inflation linked bond investors are presently very clearly in the ‘transient inflation’ camp and do not believe this is a regime change. US Government inflation linked bonds are pricing inflation to average 2.2% over 30 years and 2.3% over 10 years.

In the longer term, the only way governments can reduce their indebtedness is for interest they pay on their debt to be lower than inflation. In financial parlance, indebted entities require negative real yields – a situation where interest rates are lower than inflation. This was the situation in the 1940 and 1950’s’s allowing governments to recover from war expenditure. Using inflation levels implied by 30 year inflation linked bonds, nominal government bonds have a real yield of 0.8%. This is not ideal for governments to inflate away their debt levels. In short, if inflation linked bonds are correct, bonds have the capacity to rally significantly, if they are wrong, Inflation linked bonds are too cheap. You can see from our asset allocation tables we have a foot in both camps. We have some nominal bonds that would benefit from slowing growth and inflation over the next few quarters and we have some inflation linked bonds that would benefit if inflation expectations suddenly rose to discount a regime change.

There is another risk that I need to share which supports owning high quality government bonds and having low equity positions. Over the past few months, The US Federal Reserve Chairman, Jerome Powell, has likened himself to Paul Volker who is credited as defeating inflation of the 1970’s by relentlessly increasing interest rates. However, in an interview with Paul Volker a few years ago, he said the levels of debt in the present economy would have prevented him from pursuing the same strategy. As it stands, if Chairman Powell continues with his tightening strategy, he may cause another financial accident. Indeed, the strength in the US Dollar and falling prices across all asset classes depicts very tight liquidity conditions or, in other words, too few dollars in circulation. Furthermore, commercial banks are risk averse, evidence of poor liquidity conditions, choosing to hold 3-month T-bills rather than earn an additional 0.5% lending to other banks. Additionally, I note Italian Government bonds are yielding 2.1% more than German Bunds, a level we have only seen in 2018 and the European debt crises. I could go on citing deterioration in credit conditions, and yet, starting on 1st June, the US Central Bank began its quantitative tightening - instead of buying assets in the open market to maintain the level of its balance sheet, the Central Bank will allow up to $95 billion to mature – essentially withdrawing $95 billion a month from financial markets. We are already seeing stresses even before quantitative tightening.

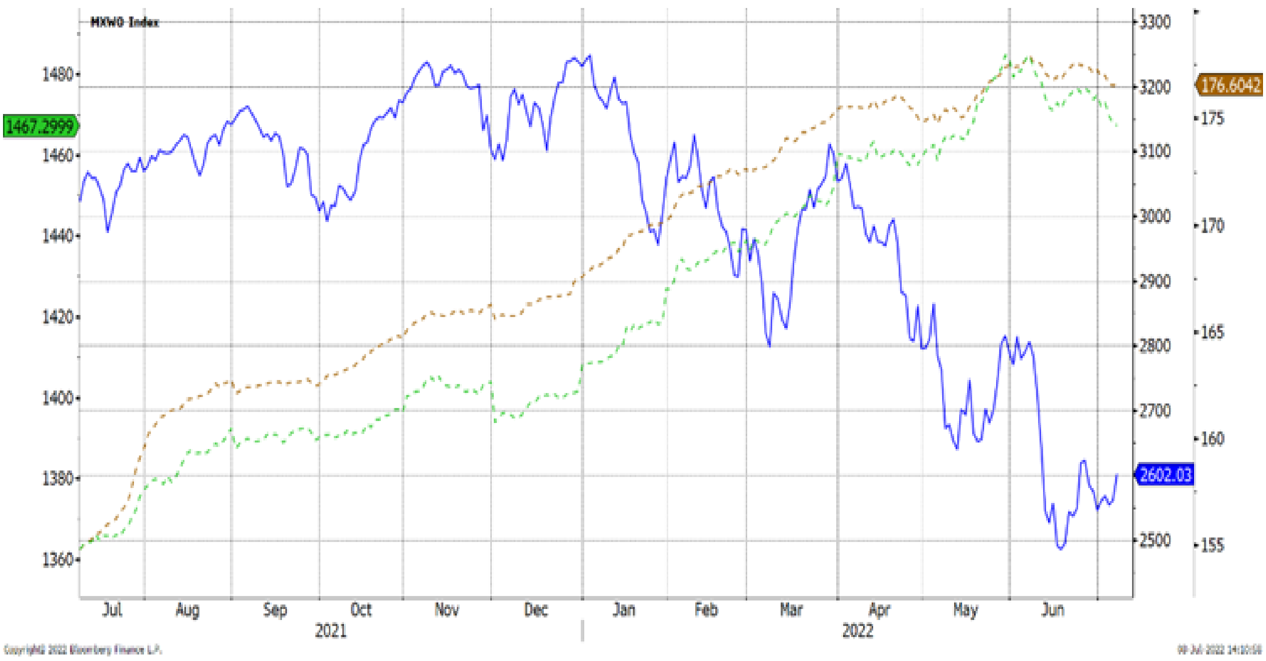
It is true that bonds don't like inflation however high-quality government bonds love credit deterioration. When credit risks rise faster than Inflation, high quality government bonds are the asset to own. We think we are very close and maintain above benchmark allocation to long duration US government bonds.

In summary, financial markets and vulnerable. The Fund has low equity weightings, and moderate holdings in safety assets: government bond holdings, gold and long volatility funds.

Core Equity

Global equity markets continued to fall, finishing the quarter -14.3%. This has been the worst first half of the year for developed market equities in over 50 years.

The major contributor to equity market performance YTD has been a significant de-rating in valuations on the back of rising interest rates. The global equity index has fallen -18.3% since the start of the year (blue line). In contrast, analyst forecasts for sales (green) and earnings (brown) continued to rise, with the first downgrades only emerging last month.



As a result, equity market valuations are now well below their 10-year average in every major region.

Equity Index Valuations

	P/E		
	CURRENT	AVG	
MSCI WORLD	15.2	17.1	-11%
S&P 500	17	18.2	-7%
DOW JONES	16.5	16.9	-2%
NASDAQ	24.3	24.2	0%
NIKKEI	14.8	17.8	-17%
FTSE 100	9.6	14.3	-33%
DAX	10.6	13.7	-23%
CAC	10.3	15.2	-32%
HANG SENG	11.1	11.5	-3%

As valuations have now normalised in most regions, a key risk for equity markets going forwards is whether earnings can live up to expectations. We think this will be a challenge, and the earnings downgrade cycle is likely to be a major driver of equity market performance over the next few months. Persistently high energy costs, rising capital costs and deteriorating economic conditions are a major hurdle for most companies. The first casualties have already fallen with Target and Walmart slashing their financial guidance in June.

We maintained an overweight allocation to defensive companies during the quarter which aided performance. 48% of our core equity holdings are in the Utilities, Healthcare, Consumer Staples and Real Estate sectors vs 28% of the Global Equity benchmark. Towards quarter end we took some profits in **Pepsi** and **Nextera Energy** which had become very large holdings, but we otherwise maintain a defensive tilt considering our macro view.

Early in the quarter we added a new position in US oil refiner **Valero**. Valero benefits from the ongoing disruption in international energy markets and more generally from a global shortage in refining capacity. 5-10% of global refining capacity is believed to have been shut down permanently by the pandemic. China has implemented export caps on its refined products to try to cover local demand. Russia, (previously the second largest exporter of refined products in the World) has cut production by over 30% as most countries are now prevented from buying its products due to international sanctions. In contrast, global distillate demand is rising as the global economy emerges from the pandemic. Valero benefits from cheap US oil inputs and high international prices for its products and it was our top performer during the quarter.

At quarter end we added to some of our structural growth holdings: **Intuit, Intuitive Surgical, Google** and **Adobe**. Given all the challenges facing the global economy we believe it is unlikely that the current rate of growth enjoyed by cyclical and value companies can be maintained. In contrast, these businesses delivered steady growth throughout the pandemic which we expect to continue in the months ahead. These businesses have de-rated significantly over the past 6 months and their sales and earnings forecasts are arguably less optimistic and more resilient than the market.

	Change Since January	
	Share Price	**Sales**
Intuit	-40%	20%
Intuitive Surgical	-43%	6%
Adobe	-42%	7%
Google	-20%	13%
Average	-36%	12%

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