SOMERSTON ASSET MANAGEMENT

SOMERSTON MULTI ASSET FUND

INVESTMENT LETTER No.26 AS AT 29 SEPTEMBER 2023

The Somerston Multi Asset Fund (USO class) fell by -2.5% in the month and fell by -1.2% over the last three months.

The MSCI World Equity Index fell by -3.7% during the month and a composite of UK, German and US Government bonds fell by -1.8% in the month. Our composite reference index fell by -3.1% in the month and fell by -2.3% over the last three months.

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	4.3	-3.8	-4.9	1.3	3.7	-1.5	**-14.0**
2023	2.5	-4.0	2.9	1.1	-1.3	2.0	2.5	-1.2	-2.5				**1.8**

Total return since inception 34.2%

Top Ten Equity Holdings

Name	% Fund
Alphabet Inc	3.6%
Microsoft Corp	3.3%
Thermo Fisher Scientific Inc	2.9%
Adobe Inc	2.7%
LVMH	2.5%
Assa Abloy AB-B	2.4%
UnitedHealth Group Inc	2.3%
Danaher Corp	2.3%
Estee Lauder Companies-Cl A	2.3%
Mastercard Inc	2.2%
Total for Top Ten	**26.6%**

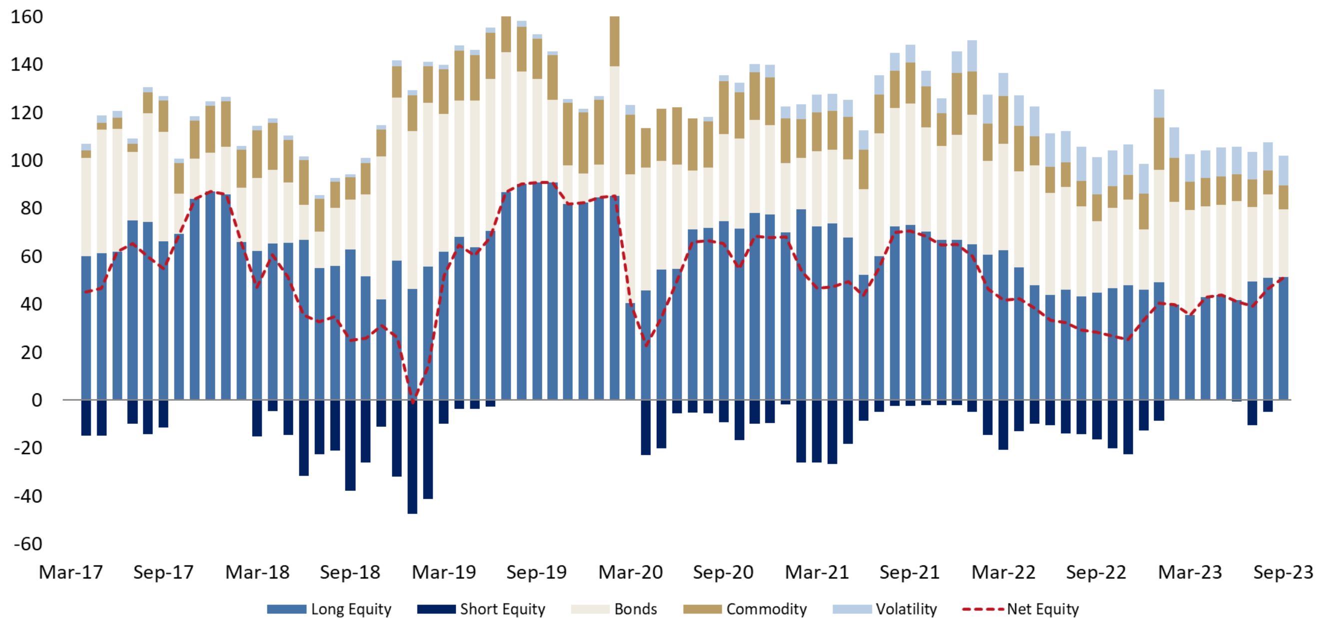
Asset Allocation

	Long	Short	Net	
Core Equity	43.1%		43.1%	↑
US Equities	8.2%		8.2%	↑
Equities	**51.3%**		**51.3%**	↑
Nowegian Govt Bond	2.6%		2.6%	↑
Corporate Bonds	7.5%		7.5%	↓
Interest Rate Hedge		-2.0%	-2.0%	↓
US Govt Ultra Long Bond		-4.7%	-4.7%	↑
US Govt TIPS	18.5%		18.5%	↑
Bonds	**28.6%**	**-6.7%**	**21.9%**	↓
Gold Bullion Derivatives	9.9%		9.9%	↓
Commodities	**9.9%**		**9.9%**	↓
Volatility and CTA	12.5%		12.5%	↑
Total All Assets	**102.3%**	**-6.7%**	**95.6%**	↑
Cash Equivalents		-1.4%	-1.4%	

Currency Allocation

USD	80.9%
NOK	2.7%
SEK	2.4%
EUR	4.5%
GBP	7.6%
CHF	1.9%
Total	**100.0%**

Evolution of Asset Allocation for Somerston Multi Asset Fund

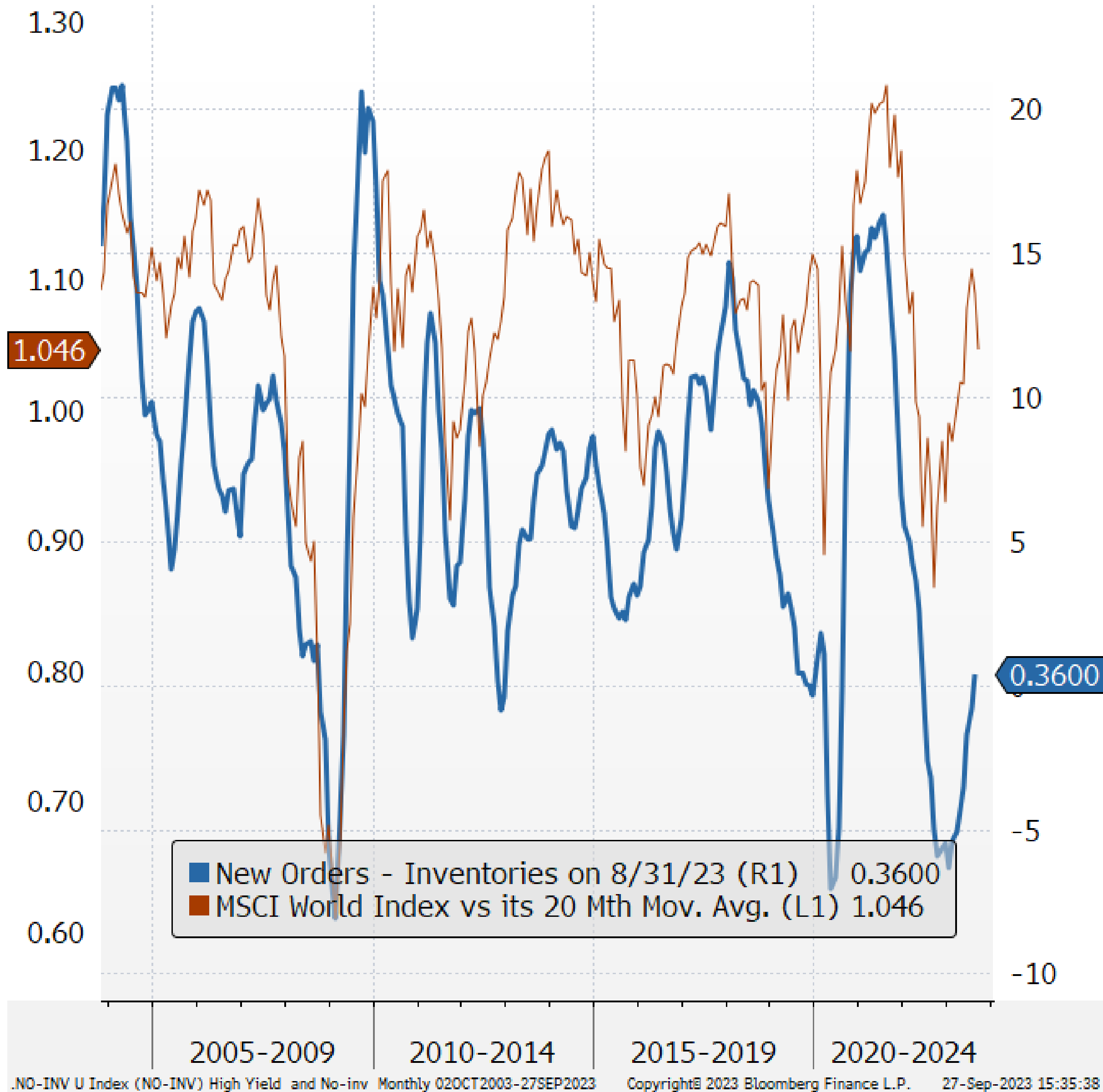


Performance

- The Fund slightly increased equity allocation throughout the quarter to 51.3%.
- Core Equity detracted -1.1% in the quarter. Adobe, Alphabet and Intuit were the major contributors, while Estee Lauder, Mettler Toledo and LVMH were the major detractors.
- Macro equity strategy added +0.4% during the quarter. Mainly driven by exposure to growth factors and energy.
- Bonds contributed +0.3%, the Fund has had a long exposure to inflation linked bonds while being short long duration, this strategy has been beneficial this quarter.
- Precious metals detracted -0.4%.
- Long volatility added +0.2%

Commentary

The most recent post pandemic market cycle has been unique – disjointed and unsynchronised. But then again, the pandemic and ensuing lock downs was anything but usual. Big industry was the first to restart from lock downs, the constrained supply chains started to ease, inventories refilled and eventually became bloated. Ordinarily, we would expect a significant growth slowdown at that point, but as the broad release from lockdown became widespread, personal consumption significantly rebounded, and this more than made up for the headwinds of normalising inventory levels. Recent data releases suggest inventories have now largely normalised, and new orders are outpacing inventories (chart - blue). Indeed, we also see supporting nascent evidence that the worst is possibly behind us for the manufacturing sector from the Japanese Machine Tool Orders and South Korean Exports. As the chart below shows, normalising inventories and resurgence of new orders, ordinarily coincides with better equity market performance.



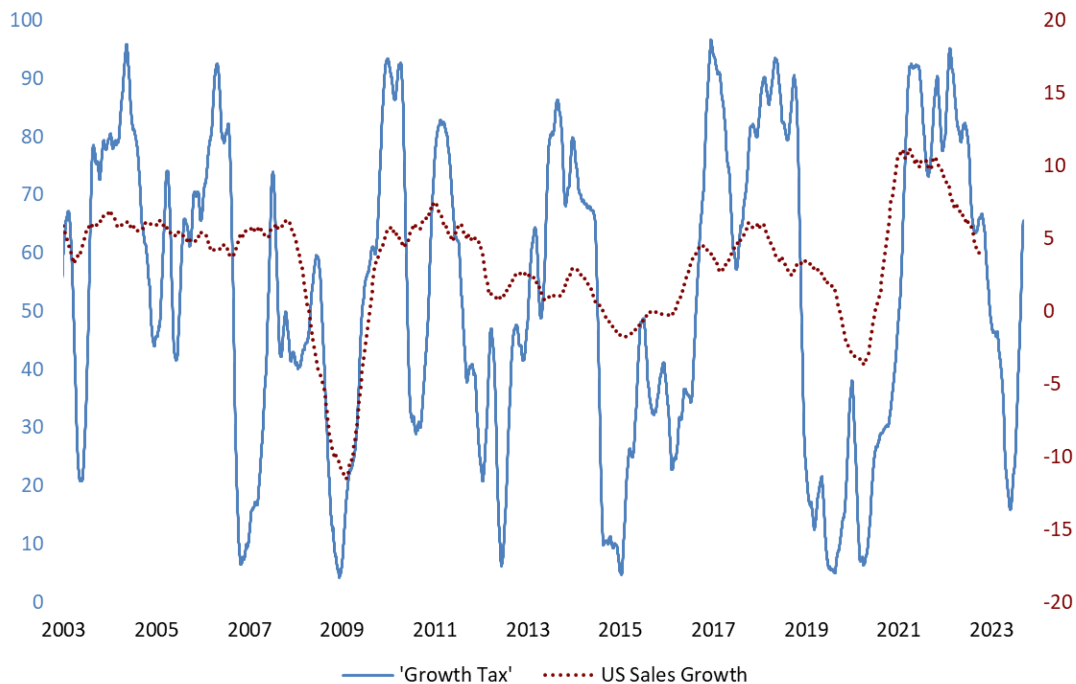
On the whole, financial markets are corroborating this positive outlook. Cyclical stocks have been outperforming, Credit spreads have been tight and implied volatility has been calm. Conversely, government bond markets suggest that a recession is all but guaranteed. In the US, 30-year bonds yields are 0.86% below six-month money. This level of 'inversion' is highly unusual and has preceded recessions in all instances. Furthermore, the curve is beginning to 'un-invert' by 30-year yields rising – again unusual. However, the bond and equity markets may not necessarily be at odds, it might just be a question of timing.

We recently suggested that US initial unemployment claims data was probably, the most important determinate for financial markets. The Federal Reserve (and all other Central Banks) are unlikely to reverse their tightening bias while inflation is above their target rates, and the employment market is buoyant. Inflation has come down but remains above target levels and in recent weeks, unemployment claims have fallen, all but eliminating the possibility of near-term rate cuts.

Moreover, as we have previously considered, the energy markets, which remain the main driver of inflation expectations, are precariously positioned. OPEC has once again asserted their dominance in energy markets. Effectively, they are making it impossible for the US to refill their Strategic Petroleum Reserves. Whether because of geology, or ESG concerns, or substantially increase capital cost, rig activity in the US Permian Basin is surprisingly lacklustre. Whereas the US were the swing Energy producer in world markets in the past ten years, they are seemingly unable to vary their output to maintain price stability in the same way, much to Saudi Arabia's benefit.

Last year, Europe had a surprisingly mild winter, and the full effects of the Russian energy embargo were not felt. With the state of the War in Ukraine as it is presently, combined with OPEC's renewed hold on energy markets, we work that energy prices maybe on a bumpy assent higher.

Financial conditions are only partly driven by Central Bank actions. The most critical contributory aspects are energy markets and bond yields. We have previously described the market as a self-correcting mechanism, meaning that high demand for energy (relative to supply) and borrowing eventually force prices to such levels that serve as a 'growth tax'. The chart below illustrates this concept. Our 'Growth Tax' indicator normalises energy prices and borrowing costs over a three-year period. When high, it eventually causes US sales growth to moderate.



Rapidly rising bond yields and Oil prices will do as much (if not more) than rate rises alone. When they 'bite', we suspect the global economic cycle will again become synchronised, causing a recession and vilify the bond markets.

There is however, a far bigger concern we are monitoring closely. The rate hiking cycle is impotent if government's higher spending and large deficits offsets monetary policy. If higher interest rates mean greater and greater deficits through (amongst other things) interest costs on ever increasing government debt, then the US government has a genuine and urgent problem. Perversely, the deficit is presently compounded by lower tax receipts as interest rate sensitive industries (like US Energy) cannot afford to invest and grow precisely because the cost of capital is too high. In our view, it is particularly noteworthy that Gold is performing much better as a 'risk off' asset, than long term treasuries. In our view, financial markets are beginning to signal genuine concern of US fiscal control.

Strategy

In the absence of genuine high conviction for the near-term macro-outlook, and with risks elevated, we remain balanced, focussing on quality and valuations while maintaining long volatility strategies.

In this regard, we consider there is substantial value in the following areas:

1. **Core Equity -** Valuations are reasonable if not outright cheap (see Below).
2. **US Inflation linked bonds** – Implied inflation over the next 10 years is just 2.35% and the real yield is 2.15%. This instrument guarantees a real rate of return, and should inflation prove higher than 2.35% on average for the next ten years, we will have the opportunity to profit from a re pricing of these bonds.
3. **Short duration hedged with long duration** – 6-month cash rates are 5.52% - and 30-year bonds yield 4.67%. We expect the 30-year yield to rise.

Activity During the Quarter

1. **Core equity:** We sold Amazon and Total Energies; we reduced Intuit and Adobe; we initiated new positions in LVMH, ASML and Apple; we increased Estee Lauder, Mastercard, Intuitive Surgical, Thermo Fisher, Microsoft and Assa Abloy.
2. **Bonds –** We added 4-year Inflation linked bonds and Shorted 30-year bonds. Our duration is very low.
3. **Commodities** – We have not been active.

Core Equity

We are pleased to announce the launch of Somerston Core Equity Fund ("SCEF"). This strategy has been employed for over 10 years, and while the launch always takes longer than anyone expects, we do feel the timing is good.

While the aggregate market can be described as expensive, we are finding many of our 'core equity' candidates' valuations to be fair, if not outright cheap. The table below shows our top ten holdings together with their valuation rank compared to the last ten years.

	Name	Valuation
1	ALPHABET INC-CL A	31%
2	MICROSOFT CORP	75%
3	THERMO FISHER SCIENTIFIC INC	54%
4	ADOBE INC	57%
5	LVMH MOET HENNESSY LOUIS VUI	39%
6	ASSA ABLOY AB-B	1%
7	UNITEDHEALTH GROUP INC	75%
8	ESTEE LAUDER COMPANIES-CL A	44%
9	MASTERCARD INC - A	55%
10	DIAGEO PLC	8%

Only Microsoft and UnitedHealth Group are towards the top end of their 10-year range (and for good reasons), with companies such as Assa Abloy and Diageo appearing very cheap.

Assa Abloy is the global leader in access solutions. Its valuation has compressed because of concern that softening real estate markets will negatively impact the company. Yet in the most recent quarter the company announced 3% organic revenue growth and 6% acquired revenue leading to an 18% earnings per share growth at constant currency. Assa is at the leading edge of a changing technological landscape, digitalising entrance systems, allowing for efficiencies, control and monitoring. This theme has a long runway and Assa is augmenting its leadership by rolling up a highly fragmented industry. Clearly a recession will negatively impact Assa in the short term, but on most measures, Assa Abloy's valuations are already discounting a more challenging marketplace.

While different, the story around Diageo is somewhat like Assa Abloy. Recent reports from the drinks industry show a meaningful slowdown, particularly private consumption. Indications are that inventory levels became bloated, and depletion is now well underway causing a cyclical slowdown. There is also debate whether new CEO Debra Crew, can replicate her recently deceased predecessor, Sir Ivan Menezes', who grew the companies' market share in the growing US Spirits market while divesting low margin business of wines and beer. Diageo's ambition is to lift its beverage alcohol market share to 6% by 2030 from 4.7%. Over the medium term, Debra has the balance sheet strength and cash flow at her disposal, to make the required investments to fulfil this ambition.

We see similar situations with LVMH and Estee lauder which we have been accumulating into recent weakness. There are cyclical headwinds for both companies, but valuations are already reflecting that.

The Core Equity strategy aims to invest in fairly valued companies that have leading positions in growing markets; that are able to use internally generated cash for astute investment while maintaining high returns without reliance on financial leverage.

Over the last several years, we have seen all sorts of economic and market conditions. Yet, viewed through a long-term lens, core equity candidates, while not immune to these macroeconomic gyrations, take these events in their stride.

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