SOMERSTON ASSET MANAGEMENT

SOMERSTON TECHNOLOGY FUND

INVESTMENT LETTER No.11 AS AT 29 SEPTEMBER 2023

Portfolio Objectives: To grow capital over the medium term by investing in a concentrated portfolio of high growth companies and to outperform our reference index over the economic cycle.

Strategy: We use a fundamental bottom-up approach to identify attractive investment opportunities. We have a 5 year investment horizon. We focus our investments in 30-40 high growth companies.

Performance: The Somerston Technology Fund (USO Class) fell by -3.5% in the third quarter of 2023. Our reference index fell by -2.0%.

Performance (%) (USO Class)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2017	6.1	3.9	4.2	4.5	7.7	-1.5	5.8	3.2	-0.1	8.5	3.8	-0.8	**55.1**
2018	12.3	-1.4	-4.1	1.0	8.0	-0.1	0.0	8.9	-1.8	-12.3	1.3	-7.5	**1.7**
2019	12.0	2.9	5.6	6.3	-8.0	8.2	4.1	-3.8	-1.8	3.1	6.1	3.8	**43.6**
2020	6.2	-3.8	-6.6	18.2	9.6	10.0	9.1	8.5	-6.2	-0.7	9.6	5.5	**73.4**
2021	-0.2	1.6	-6.5	8.8	-3.6	11.6	1.0	5.7	-7.9	6.2	-1.5	-5.0	**8.5**
2022	-13.8	-5.5	2.2	-20.2	-6.1	-11.2	13.8	-6.9	-13.0	2.1	4.9	-10.0	**-50.8**
2023	16.7	0.3	11.9	-1.1	13.2	4.6	6.5	-3.3	-6.3				**48.0**

Total return since 2017: 100.1%

Sector Allocation

Sector	**% Strategy**
Information Technology	62.5%
Consumer Discretionary	17.8%
Communication Services	15.1%
Industrials	2.9%
Financials	1.7%

Top Ten Holdings

Name	**% Fund**
Apple Inc	9.8%
Microsoft Corp	9.5%
Alphabet Inc	9.5%
Nvidia Corp	8.8%
Amazon.com Inc	7.1%
MercadoLibre Inc	6.2%
Meta Platforms Inc	4.5%
ASML Holding NV-NY Reg Shs	3.8%
Advanced Micro Devices	3.8%
Adobe Inc	3.8%
Total for Top Ten	**66.8%**

Geographical Allocation

Region	**% Strategy**
North America	88.7%
South America	5.9%
Europe	5.4%

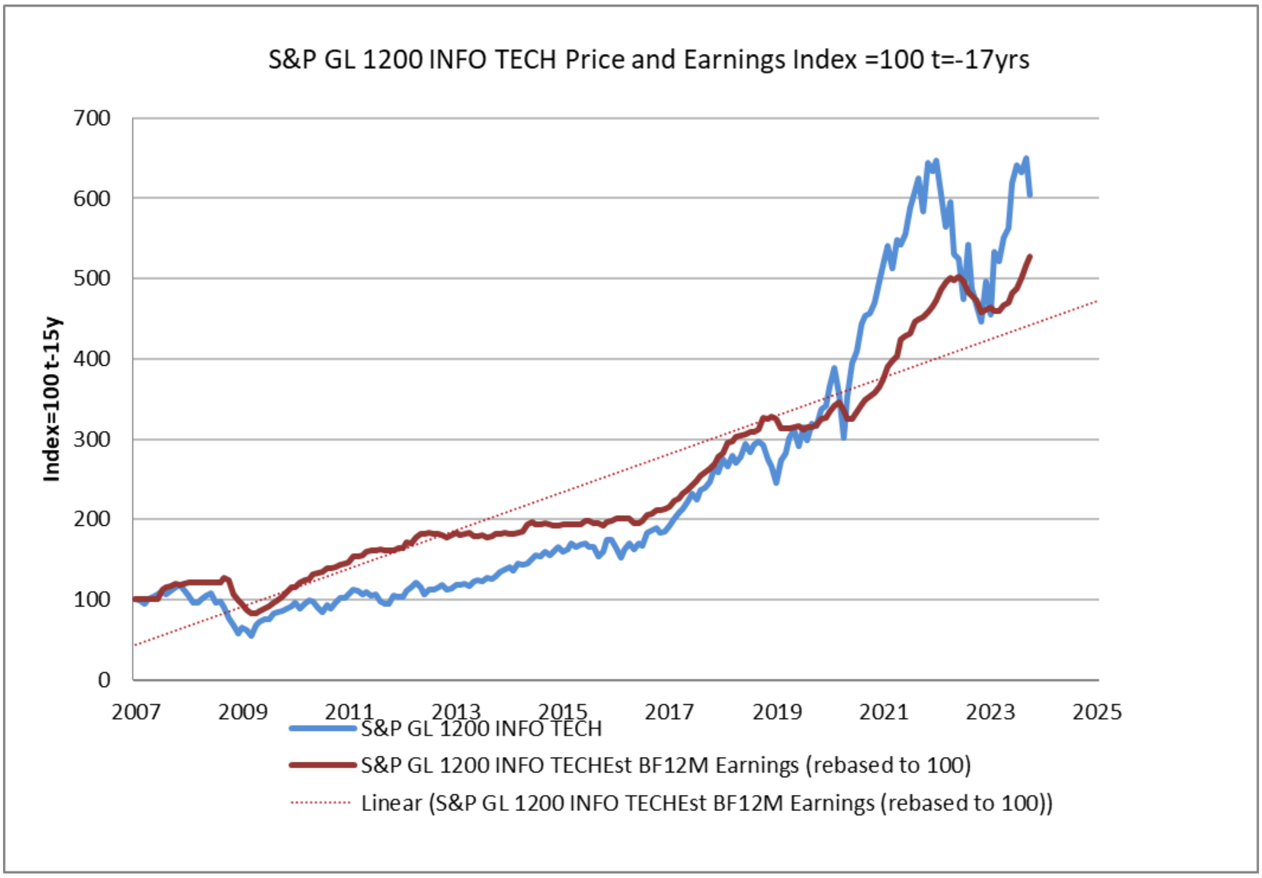
This factsheet shows the performance of Somerson's "Technology Equity Strategy" from 31 December 2014 to 30 November 2020 then the Somerston Technology Fund from its launch on 01 December 2020.

Commentary

Unlike the start of the year, the technology sector has become more richly valued. We started the year with P/E's for the Technology sector around 17x and they are now 20x. Much of this valuation expansion is a result of investors 'AI fever' and an expectation of strong earnings growth. Risks have risen and we are therefore highly focussed on valuations and quality.

The chart below shows earnings for the technology sector in red and prices in blue. We can clearly see that prices have discounted a significant rise in earnings and more time is required for earnings to 'catch up'.

Chart 1 - Price and Earnings of the Global Technology Sector – indexed to 100 in 2007.



Stocks

Nvidia (mkt Cap $1.2 trillion)

Q2 earnings were quite spectacular. Primarily, the guide for Q3 implies annual datacentre growth of 226%, an acceleration from the 171% year-over-year reported in Q1. Channel checks published by The Financial Times and The Information, plus China were pointing toward analysts/sources expecting between $30B to $40B in datacentre revenue growth. Nvidia is going to now easily clear the $40B number.

The fund has been trimming Nvidia to keep it below the 15% threshold and more recently, in September we felt valuations had become excessive in the short term. We estimate that the market price is discounting long term growth in excess of 25% CAGR. This is not impossible, but it is a high bar.

Apple (Mkt Cap $2.9 trillion)

Apple reported revenue for the third quarter that met the average analyst estimate. Revenue of $81.80 billion for the quarter, was -1.4% y/y. While flat revenue is unexciting, the installed base of Active Devices sets All-Time Record at over two Billion. To that installed base Apple has been successfully upselling services: "We are happy to report that we had an all-time revenue record in Services during the June quarter, driven by over 1 billion paid subscriptions…." said Tim Cook, Apple's CEO. Crucially, services have very high margin, and on our calculations, Services now represent a little over 40% of operating earnings for the company.

Apple trades close to its all-time high with a valuation of 20x EV/Ebitda, However, annuity like services will be valued much higher than hardware sales. Accordingly, we consider it is fair to lower the discount rate and the long-term implied growth rate is 8%, which we consider is fair.

Microsoft (mkt Cap $2.4 trillion)

Microsoft reported revenue for the fourth quarter that beat the average analyst estimate. While overall results in the period ended June 30 topped analysts' projections, Azure revenue growth slipped to 27%, excluding currency impacts, from 31% in the previous quarter. The world's largest software maker projected that Azure gains would slow further in the current quarter and said it would boost spending to expand data centres for new cloud services — while expecting only a gradual increase in AI revenue. However, Alphabets offering also grew 27% y/y from a much lower base and AWS growth was just 16%.

We do think MSFT is moderately expensive, but much depends on the trajectory of its AI offering which is highly uncertain. We estimate that the stock is pricing long term growth of 10%.

Alphabet (mkt Cap $1.7 trillion)

The Google parent reported second-quarter results that beat expectations growing revenue Ex TAC by 8% Year-over- year.

Google's flagship search business has weathered an advertising slowdown that affected social media companies, such as Meta Platforms Inc. and Snap Inc., more severely in recent quarters. The company's search product also continues to dominate despite new competitive threats from Microsoft Corp. and OpenAI, which have joined up to provide an alternative called ChatGPT that answers users' questions with conversational responses powered by generative AI. Google's chatbot, Bard, isn't yet as widely used.

We note Google's cloud offering had the fastest growth vs Amazon Web Services and Azure and it is now at breakeven.

Alphabet appears valued to discount 8% long term growth rates. Alphabet looks fairly valued.

Amazon (Mkt Cap 1.4 trillion)

"It was another strong quarter of progress for Amazon," said Andy Jassy, Amazon CEO. "We continued lowering our cost to serve in our fulfilment network, while also providing Prime customers with the fastest delivery speeds we've ever recorded. Our AWS growth stabilized as customers started shifting from cost optimization to new workload deployment, and AWS has continued to add to its meaningful leadership position in the cloud with a slew of generative AI releases that make it much easier and more cost-effective for companies to train and run models (Trainium and Inferentia chips), customize Large Language Models to build generative AI applications and agents (Bedrock), and write code much more efficiently with CodeWhisperer. We're also continuing to see strong demand for our advertising services as the team keeps innovating for brands, including the ramp up for Thursday Night Football with the ability for advertisers to tailor their spots by audience and create interactive experiences for consumers. We remain excited about what lies ahead for customers and the company."

This is an exciting announcement, but we have some concerns. Amazon's 12% Y/y AWS growth is the slowest amongst its peers. It seems that both Alphabet and Azure are taking market share. This needs to be monitored closely.

The valuation seems reasonable with EV/ EBITDA at 13.6 vs 27.5 in 2020. However, even with advertising, retail barely marks a profit. $2.2 bln op profit on $110 bln revenue. AWS makes $5.4 bln on $22 bln of revenue. How long does Amazon need to 'land grab' in retail before it turns a profit?

Amazon's situation is in stark contrast to its Emerging Market peer Mecardo Libre.

Mercardo Libre (Mkt Cap $71.8 billion)

MercadoLibre continues to gain market share, especially in Brazil and Mexico, and still deliver consistent margin expansion. Below we list some of its accomplishments in the Second Quarter.

SECOND QUARTER RESULTS

- EPS $5.22 vs. $2.43 y/y, estimate $4.31 (Bloomberg Consensus)
- Gross merchandise volume $10.51 billion, +23% y/y, estimate $9.95 billion
- Net revenue $3.42 billion, +31% y/y, estimate $3.3 billion
    - Brazil Net revenues $1.78 billion, +23% y/y, estimate $1.6 billion
    - Argentina Net revenues $771 million, +30% y/y, estimate $740.6 million
    - Mexico Net Revenues $703 million, +64% y/y, estimate $649 million
    - Other Countries Net revenues $161 million, +30% y/y, estimate $148.5 million
- Unique active users 109.0 million, +30% y/y
- Payment volume $42.06 billion, +39% y/y, estimate $40.13 billion
- Payment transactions 2.13 billion, +69% y/y, estimate 1.96 billion

ASML (Mkt Cap $248 billion)

ASML reported a second quarter FY23 net sales growth of 27% year-on-year to €6.90 billion ($7.52 billion) above the consensus of $7.51 billion. The gross margin increased by 220 bps Y/Y to 51.3%.
"Due to strong DUV revenue and despite the increased uncertainties, ASML expects strong growth for 2023 with a net sales increase towards 30% and a slight improvement in gross margin, relative to 2022," said ASML CEO Peter Wennink.
ASML are in a unique situation with a monopoly on much of the equipment that is required to make very high-end chips and provide the equipment necessary to fuel the AI wave. Yet, the stock is priced reasonably.

Summary

As you can see, we are more focussed on the large cap stocks now. We are excited about innovation in the Artificial intelligence space but, insights are building gradually.

Activity

During the quarter we entirely sold out of Twilio, Sea and Magnite. Ostensibly, all three companies had the ingredients to flourish but all three seem to have management teams that have made missteps, and their credibility has diminished.

We added to Mercado Libre, Paycom, Salesforce and Adyen on improved valuation grounds. We introduce a small position into Bill.com that is growing rapidly and working with SMB's for invoicing and payment services.

Kind Regards,

Nick Wakefield

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