SOMERSTON ASSET MANAGEMENT

# SOMERSTON CORE EQUITY FUND

## INVESTMENT LETTER AS AT 31 DECEMBER 2023

**Portfolio Objectives:** To grow capital over the medium term by investing in a concentrated portfolio of high quality companies and to outperform global equities 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 15 to 25 high quality companies. We invest in companies that demonstrate strong governance, high profitability, low capital intensity, strong economic moats, and low business risk. We invest globally, without sector/geographic restrictions.

**Performance:** The Core Equity Fund rose by +4.6% in the month and rose by +10.8% over the last three months. The reference index rose by +4.9% during the month and rose by +12.5% over the last three months.

### Performance (%)

| | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | Year |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2017** | | | | 1.2 | 5.4 | -0.2 | 0.4 | -0.1 | 1.9 | 1.8 | -1.8 | 2.1 | **10.9** |
| **2018** | 6.2 | -4.6 | -1.9 | 0.4 | 1.2 | 1.2 | 4.3 | 1.3 | 0.4 | -8.5 | 2.7 | -9.0 | **-7.2** |
| **2019** | 6.2 | 4.2 | 3.3 | 3.8 | -4.0 | 5.7 | 0.6 | 0.8 | -1.6 | 1.3 | 5.1 | 2.5 | **31.1** |
| **2020** | 0.9 | -7.3 | -14.3 | 12.5 | 5.8 | 2.6 | 4.4 | 5.5 | -3.4 | -3.8 | 9.7 | 2.9 | **13.0** |
| **2021** | -0.6 | 1.7 | 3.3 | 5.0 | 0.2 | 3.4 | 3.1 | 2.2 | -5.1 | 6.3 | -1.6 | 2.9 | **22.2** |
| **2022** | -8.3 | -4.8 | 4.4 | -9.4 | -0.2 | -8.8 | 10.4 | -4.5 | -8.6 | 6.6 | 4.7 | -4.8 | **-23.1** |
| **2023** | 2.2 | -3.8 | 5.3 | 1.8 | -1.6 | 4.7 | 3.7 | -1.1 | -5.5 | -2.8 | 8.9 | 4.6 | **17.0** |

*Total return since 2017: 67.4%*

### Geographical Allocation

| **Region** | **% Fund** |
|---|---|
| North America | 66.1% |
| Europe | 33.9% |

### Sector Allocation

| **Sector** | **% Fund** |
|---|---|
| Information Technology | 29.4% |
| Health Care | 25.4% |
| Consumer Staples | 14.6% |
| Industrials | 11.1% |
| Communication Services | 8.4% |
| Consumer Discretionary | 5.9% |
| Financials | 5.2% |

### Top Ten Holdings

| **Name** | **% Fund** |
|---|---|
| Microsoft Corp | 8.1% |
| Alphabet Inc | 8.1% |
| ASML Holding NV-NY Reg Shs | 6.8% |
| Assa Abloy AB-B | 6.7% |
| Adobe Inc | 6.6% |
| Thermo Fisher Scientific Inc | 6.5% |
| LVMH | 5.7% |
| Diageo PLC | 5.4% |
| Intuitive Surgical Inc | 5.1% |
| UnitedHealth Group Inc | 5.1% |
| **Total for Top Ten** | **64.0%** |

This factsheet shows the performance of Somerson's “Core Equity Strategy” from 31 March 2017 to 30 September 2023 then the Somerston Core Equity Fund from its launch on 02 October 2023.

## Commentary

Generative-AI was a theme that dominated markets in 2023. While this is certainly an exciting area for future growth, and a key driver of the portfolio's top performers, a consequence of the market's focus meant that many high-quality, cash generative companies were overlooked. Valuations across attractive businesses were left behind despite solid underlying execution. This trend has started to reverse to some extent with the broad market rally that began in November. However, we continue to see opportunities in 'long-term compounders' that are offering attractive valuations.

**Adobe** was the top performer in the portfolio posting a total return of 77.3% for the year. Adobe's strong performance reflected the company's early successes in integrating generative-AI tools into its product suite. Firefly, the company's generative machine learning model that enables the creation of custom images, has seen incredible levels of adoption since release. Though success in the evolving market will not be an overnight phenomenon, Adobe has a clear strategy and is well positioned to capitalise on the application of AI technology. We remain positive on the outlook for the operating performance at Adobe, however, we are growing cautious of the rich valuation following the strong run in the share price during 2023.

Like Adobe, it was **Microsoft's** position in the gen-AI market that drove the performance in 2023. The share price gained 56.8% as the company's investment in OpenAI established it as a leader in the market. Through integration of OpenAI tools across its broad product portfolio, Microsoft has been arguably the most proactive in monetising the new technology. This helped accelerate growth in the Azure business after two years of macroeconomic headwinds. Yet, even with the success seen already, gen-AI remains in the early phase of adoption, and we continue to see Microsoft as a one of the key beneficiaries of the new technology going forward.

**Apple** had a positive year, with shares gaining 52% and reaching an all-time-high in mid-December. Apple did lag the share price gains of its 'Magnificent Seven' peers in 2023, however, we note that this was following a more resilient performance the prior year. While results from the core iPhone business were weak by historic standards – with sales falling short of market estimates in several quarters – the total hardware installed base continues to increase across geographies. Importantly, this provides a growing platform for the company to generate high margin, recurring services revenue. Service growth remains impressive (+16% in Q4) as Apple has been active in rolling out new features to broaden and entrench its digital ecosystem.

It was a good year for **Alphabet** (+58.3%) as the advertising environment improved following a difficult 2022. While search advertising remains the dominant driver of free cash flow at the company, Alphabet's position in the nascent generative-AI market was an important driver of the share price performance. Despite the company initially being seen as lagging Microsoft and OpenAI, the release of the Gemini LLM clearly demonstrated its strong technological capabilities. Integration of gen-AI tools into its advertising and Cloud segments is currently modest compared to that of Microsoft but remains an exciting opportunity for future growth.

Outside of the technology sector, **Assa Abloy** was a key contributor to the portfolio's performance. After a quiet start to the year, the company's share price increased 21.9% in the final quarter, boosting the company's overall 2023 performance to 29.8%. In part, the price performance reflected a general improvement in the outlook for European Capital Goods companies, however, Assa was also a strong performer in its own right. The company published a solid quarterly update in late October, which showed healthy organic growth in a tough macroeconomic environment. Asia Pacific does remain a drag on overall growth, however, we continue to view the softness as representing cyclical end-market weakness rather than a deterioration in Assa's long-term market position. Even following the recent share price strength, we believe the valuation remains attractive given the ongoing opportunities for organic and inorganic growth at the business.

**Mettler Toledo** (-16.1%) provides precision instruments to a range of laboratories and manufacturing businesses. Suppliers to the Life Sciences industry have had a tough year as customers continue to work through the overstocking seen during the Covid period. This drag on revenue has been exacerbated by the economic malaise in China, following a weak post-Covid reopening. Despite these macroeconomic headwinds, the underlying operating performance of the company continues to show promise. Mettler holds a dominant market position in the majority of its product portfolio and showed signs of market share gains in key categories throughout the year. While headwinds could remain in the near-term the solid execution from management positions the company well to benefit from the eventual recovery in the industry.

**Thermo Fisher** (-3.6%) also experienced many of the same headwinds as Mettler Toledo. We believe the market has been too focused on the near-term weakness and is overlooking a compelling multi-year investment case.

**Estee Lauder** was the largest detractor from portfolio performance in 2023 with the stock falling 41.1%. Demand from Asia and travel retail has been a significant headwind throughout the year and the company remains in a difficult destocking cycle that has compressed group margins. This resulted in several cuts to sales and profit guidance from management, which weighed on investor sentiment. Despite these challenges the underlying portfolio of brands remains attractive and gives the company a strong position in the luxury market, which should continue to benefit from secular demand trends.

Demand for **Diageo's** (-21.8%) premium spirit business has come under pressure in recent quarters as consumers moderate spending. This is particularly the case in the important US market where inventory destocking threatens profitability. Lower input prices should provide some margin relief in 2024. We note that the valuation is far less demanding than in recent years. Therefore, given that the long-term investment proposition remains compelling, we took the weakness as an opportunity to add to our position during the year.

**Activity**:

During the year we exited Danaher. Danaher was a strong performer following the Covid pandemic but has come under pressure from many of the same headwinds as Mettler Toledo discussed above. Given the macroeconomic pressure and similar risk exposure to our holdings of Metter Toledo and Thermo Fisher, Danaher was cut from the portfolio to focus on higher conviction ideas.

**Valuation**

There is a perception that equity markets look expensive in the round. While we agree that elements of the technology space do have demanding valuations, this general perception is likely a function of the market-cap weighting within indexes. Indeed, weighting the S&P 500 on an equal basis brings the forward PE ratio down from 19.4x to 16.5x. We believe this reflects the bifurcation in stock-level valuations discussed earlier and presents opportunities for long-term stock picking. When looking at the Core Equity Fund, we continue to see attractive relative valuations in those names that did not participate in the AI-led rally but are fundamentally strong businesses. Though the portfolio does have exposure to 'AI winners', the majority of portfolio holdings are trading at, or below, their long-term averages. We are happy with the overall positioning from a valuation perspective and will continue to take advantage of what we see as unjustified valuation discounts through active management of the fund.

Nick Wakefield

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