SOMERSTON ASSET MANAGEMENT

SOMERSTON MULTI ASSET FUND

INVESTMENT LETTER No.27 AS AT 31 DECEMBER 2023

The Somerston Multi Asset Fund (US0 class) rose by +4.7% in the month and rose by +10.6% over the last three months.

The MSCI World Equity Index rose by +4.2% during the month and a composite of UK, German and US Government bonds rose by +4.3% in the month. Our composite reference index rose by +4.2% in the month and rose by +9.1% 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	-0.6	6.3	4.7	**12.6**

Top Ten Equity Holdings

Name	**% Fund**
Microsoft Corp	3.5%
Alphabet Inc	3.5%
ASML Holding NV-NY Reg Shs	2.9%
Assa Abloy AB-B	2.9%
Adobe Inc	2.8%
Thermo Fisher Scientific Inc	2.8%
LVMH	2.5%
Diageo PLC	2.3%
Intuitive Surgical Inc	2.2%
UnitedHealth Group Inc	2.2%
Total for Top Ten	**27.6%**

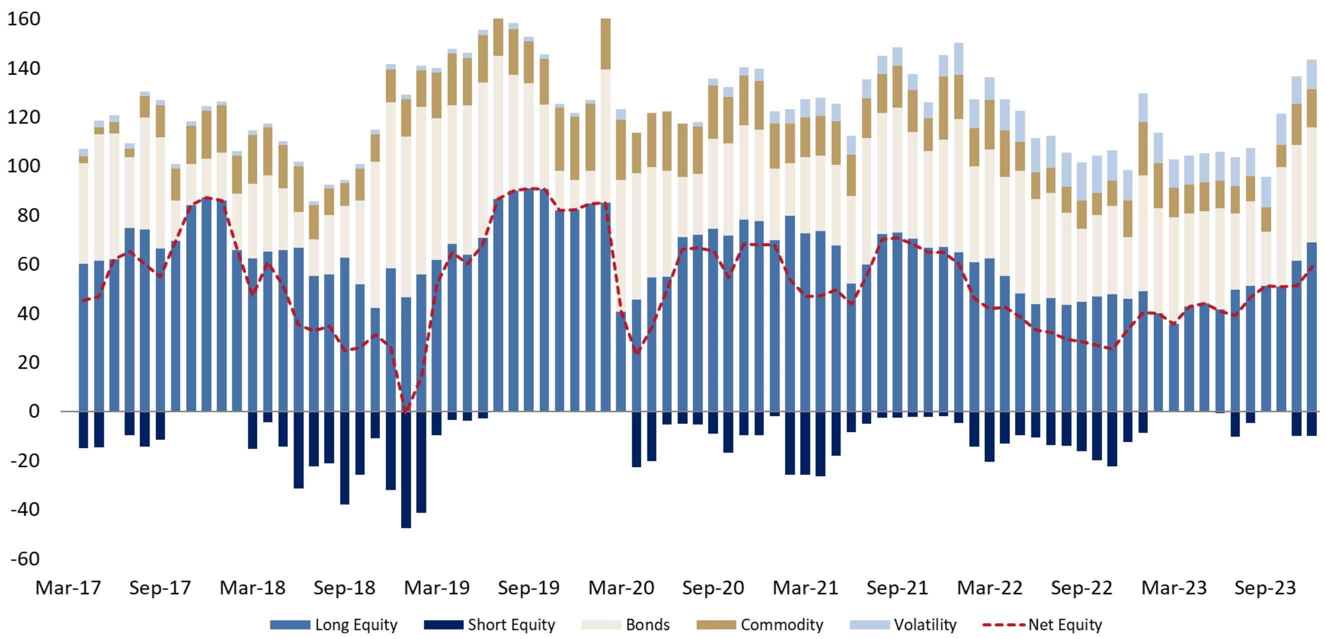
Currency Allocation

USD	91.9%
SEK	2.9%
NOK	2.6%
CHF	1.7%
GBP	0.8%
EUR	0.1%
Total	**100.0%**

Asset Allocation

	Long	Short	Net	
Core Equity	43.1%		43.1%	↓
Small Cap Equities	5.3%		5.3%	↑
DM Equities Ex US	10.1%		10.1%	↓
Emerging Market Equities	5.0%		5.0%	↑
Anti-Beta Stock	2.2%		2.2%	↑
US Equities	3.3%	-10.0%	-6.8%	↑
Equities	**68.9%**	**-10.0%**	**58.8%**	↑
Nowegian Govt Bond	2.6%		2.6%	↑
Corporate Bonds	7.3%		7.3%	↓
Long Gilt	10.1%		10.1%	↑
US Govt 10 yr. Bond	9.4%		9.4%	↓
US Govt TIPS	17.4%		17.4%	↓
Bonds	**46.8%**		**46.8%**	↓
Copper Derivatives	2.3%		2.3%	↓
Brent Derivatives	2.3%		2.3%	↓
Gold Miners Equities	2.9%		2.9%	↓
Gold Bullion Derivatives	8.2%		8.2%	↓
Commodities	**15.7%**		**15.7%**	↑
Volatility and CTA	12.1%		12.1%	↑
Total All Assets	**143.5%**	**-10.0%**	**133.5%**	↑

Evolution of Asset Allocation for Somerston Multi Asset Fund



Performance

- The Fund enjoyed a strong Q4, appreciating 10.6% and bringing the year to date to 12.6%.
- Our equity book performed satisfactorily in the quarter. Core equity contributed 4.0% to performance but this was a slight underperformance.
- Our Macro equity book outperformed due to its holdings in small caps and Technology.
- Our bond booked performed particularly well during the quarter, contributing 3.5%. We started the quarter underweight duration and gradually, increased duration through exposure at the front end.
- The Commodity book contributed 0.9% and FX added 1%.
- Volatility collapsed through the period and our long volatility positions detracted 0.6%.

Commentary

Macro

In 2023 dwindling inflation and reasonable growth provided the foundations for good returns. Furthermore, expectations are for these conditions to persist.

However, as we have experienced so often during this cycle, with the very unusual set of events that led up to this recovery, there are compelling arguments on both sides.

a. US data such as the ISM Manufacturing Survey, the Empire State Manufacturing Survey and the National Association of Home Builders are moving lower.

b. While remarkably resilient, the US labour markets are not quite as robust as they were. Temporary staff numbers have past their peak, overtime hours are near record lows, and inflation adjusted wages have fallen -2%. It feels like there is a reluctance for firms to make outright staff cuts, and maybe, in an era of structural labour shortage, companies will do everything they can to avoid layoffs. Yet lower real wages, less overtime and less part time work suggest firms are being as prudent with their wage bills as they can.

c. While not well broadcast, commercial property, (particularly offices), are facing significant valuation compression. The 'mark downs' in this sector have not been booked.

d. There is a high level of complacency in certain asset prices.

e. Geopolitical risk continues to build.

Liquidity

Interest rates rose substantially from the 2021 lows, and Central Bank's balance sheets have indeed been shrinking. This infers substantial monetary tightening. Yet there are some unique offsets to these traditional tightening measures.

a. During the pandemic, many corporates and households chose to fix their borrowing for as long as they could get away with. In the absence of a need to refinance, higher rates are not yet biting as we would expect.

b. During the pandemic, the Federal Reserve set up a 'Reverse Repo' facility allowing commercial banks to 'park' excess cash with the Fed and mitigate specific bank risk. At the start of this year $2.7 trillion sat in this facility. Effectively, money in the Reverse Repo is money taken out of the system. The US Treasury, (who of course, are distinct from the Central Bank) have uncharacteristically, funded themselves predominantly through the issue of T bills rather than Bonds. Issuing government T bills at attractive rates, has induced money to leave the Reverse Repo facility and buy bills. Bills can then be used as collateral in the banking system, which has a 'multiplier effect'. The reverse repo facility now stands at $1.15 trillion. In other words, despite the headlines leading us to believe that rising rates and diminishing Central bank assets are tightening financial conditions, $1.55 trillion has been injected into the financial system through the draining of the Reverse repo facility and that money has a significant multiplier effect.

c. Heating Oil, Natural Gas and Gasoline have fallen significantly, and that energy saving is yet another form of 'easing'.

Despite higher interest rates and shrinking Central Bank balance sheets; lower energy costs, the absence of a material refinancing wave, and the huge depletion in the reverse repo facility has in fact caused financial conditions to ease. Moreover, with inflation down significantly, some emerging market Central Banks are now in an outright easing mode. This moderation of financial conditions together with moderating inflation explains much of the recent asset price appreciation, and it appears set to continue in the near future.

Outlook

We continue with the same message we have given for most of 2023. In our view, there is little room for strong opinions in the context of the environment we find ourselves. We therefore stay very balanced across asset classes and invest largely on valuation grounds.

Despite the macro being unclear, there are compelling valuations for investments in both 'Risk on' and 'Risk off' strategies which makes portfolio construction a lot easier than it has been in recent years.

1. Despite the strong performance in December, the valuation of smaller companies remains below average levels, which relative to the market, is particularly attractive.

2. In aggregate, our core equity holdings are below their average valuation range over the past ten years whereas the market as a whole is close to its 80th Percentile.

3. Short dated, US Inflation linked bonds are offering some of the best terms for a decade.

4. Similarly, Healthcare, Utilities and Staples (The defensives) have severely underperformed, Industrials, Discretionary and Financials (The cyclicals) in the past year and the valuation difference between these groups is very attractive.

5. Volatility has fallen enormously and being long volatility is not anywhere near as costly as it was a few years ago.

6. Gold is arguably a little expensive versus other commodities such as Oil, Copper and Silver and you will see we have diversified our commodities accordingly.

7. Resource companies are also offering attractive entry points.

In summary, despite a macro environment that remains 'cloudy', we can see decent opportunities in a range of asset classes.

Activity During the Quarter

1. **Core equity:** There were no new investments during the period. We exited our position in Danaher. The rationale is discussed below.

2. **Macro Equity:** We have gone long Europe & Asia and short US, we went long Emerging Markets, Small Caps and Resources and initiated positions to be long Defensive sectors and short Cyclical sectors. All these positions have been initiated on valuation grounds.

3. **Bonds:** We have been a little surprised at the parallel move in the yield curve and remain focussed at the shorter end of the curve where we believe there is much better value.

4. **Commodities:** We have been reducing Gold bullion in favour of Copper, Oil, Silver and mining stocks.

5. **Volatility:** With volatility near low levels we have modestly added to long volatility strategies.

Core Equity

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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