SOMERSTON ASSET MANAGEMENT

SOMERSTON MULTI ASSET FUND

INVESTMENT LETTER No.29 AS AT 30 JUNE 2024

Portfolio Objectives: To maximise risk adjusted returns through a diversified portfolio across global equities, bonds, commodities and alternative strategies.

Strategy: We adjust asset class exposure tactically and strategically to align with market cycles.

Performance: The Somerston Multi Asset Fund (USO class) rose by +0.5% in the month and rose by +2.2% over the last three months. Our composite reference index rose by +2.0% in the month and rose by +2.0% over the last three months.

Performance (%) USO 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**
2024	0.0	1.2	3.2	-1.9	3.7	0.5							**6.7**

Total return since inception 58.4%

Top Ten Equity Holdings

Name	**% Fund**
LVMH	4.0%
Mastercard Inc	3.1%
Alphabet Inc	2.9%
Assa Abloy AB-B	2.5%
Meta Platforms Inc	2.2%
Microsoft Corp	2.0%
Reckitt Benckiser Group PLC	1.8%
Diageo PLC	1.8%
Intuit Inc	1.6%
Nvidia Corp	1.6%
Total for Top Ten	**23.5%**

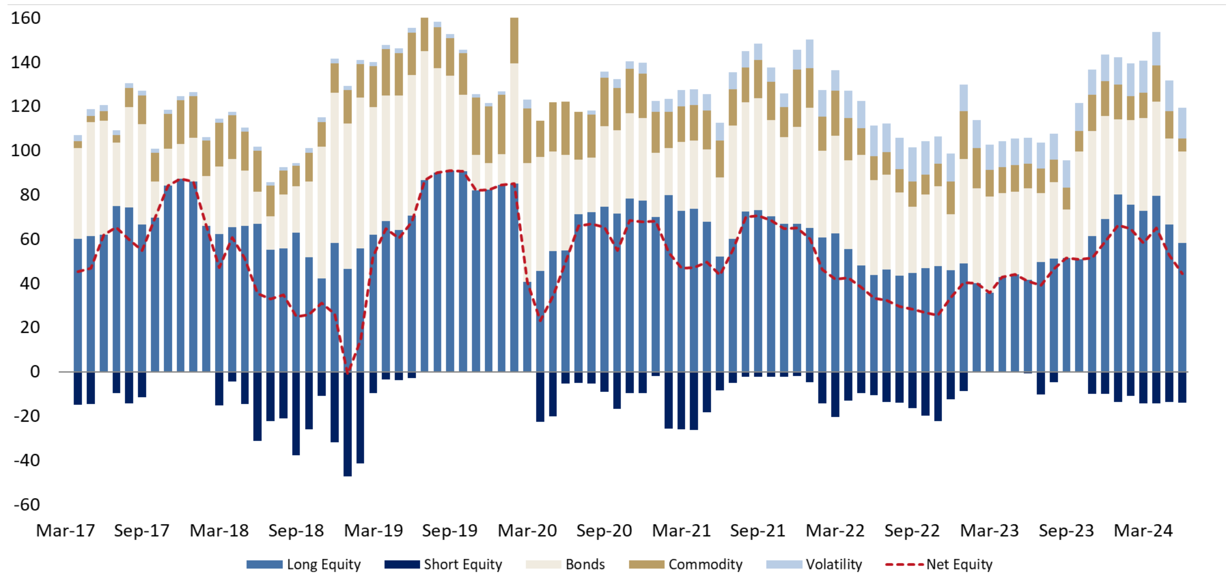
Currency Allocation

USD	88.5%
GBP	5.9%
SEK	2.5%
EUR	1.6%
CHF	1.6%
Total	**100.0%**

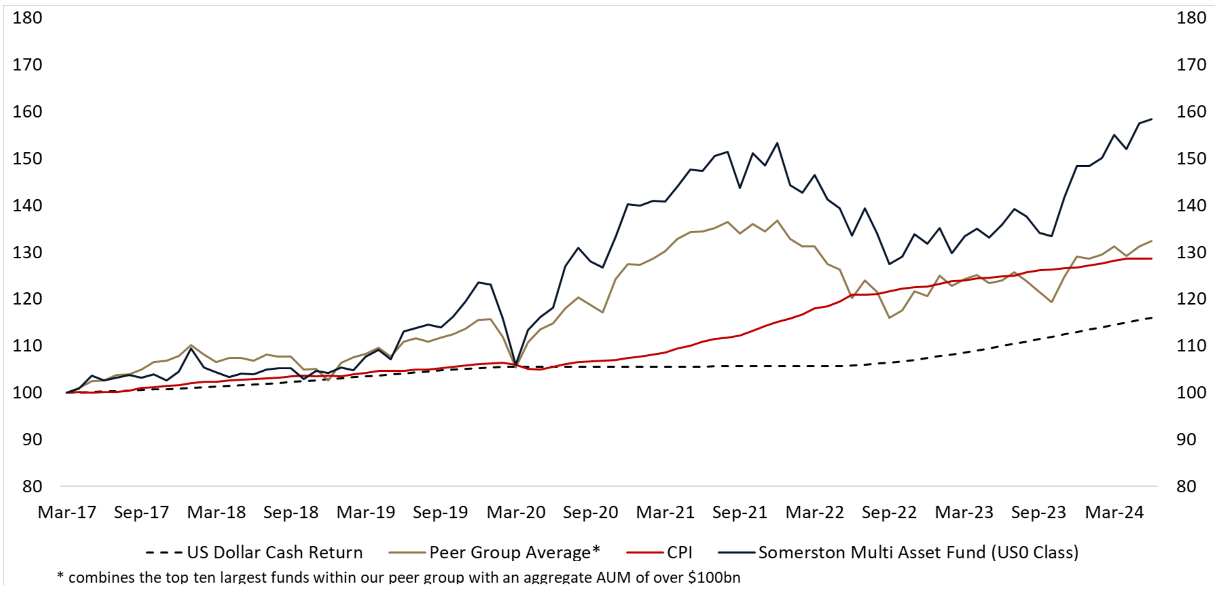
Asset Allocation

	Long	Short	Net	
Core Equity	40.6%		40.6%	↑
Defensive Equities	3.4%		3.4%	↑
Equity Long Short	14.0%	-13.9%	0.1%	↓
Equities	**58.1%**	**-13.9%**	**44.2%**	↓
Corporate Bonds	4.6%		4.6%	↑
US Govt Ultra Long Bond		-3.0%	-3.0%	↓
US Govt 2 yr. Bond	23.7%		23.7%	↔
US Govt TIPS	16.2%		16.2%	↔
Bonds	**44.5%**	**-3.0%**	**41.5%**	↑
Gold Bullion Derivatives	5.7%		5.7%	↔
Commodities	**5.7%**		**5.7%**	↓
Volatility and CTA	13.9%		13.9%	↓
Total All Assets	**122.2%**	**-16.9%**	**105.3%**	↓

Evolution of Asset Allocation for Somerston Multi Asset Fund



Performance of USO Class since inception



Performance

- The Fund appreciated +2.2% over Q2.
- Core Equites contributed +0.8% however our underweight equity allocation detracted from relative performance.
- Macro Equity positions added +0.5%.
- Commodities and precious metals added +1.2% to performance.
- The bond strategy added +0.2% to performance and volatility detracted -0.3%.

Commentary

Strategy has turned decisively cautious in recent weeks. A trinity of metrics has now aligned, namely: 1) high valuations; 2) deteriorating economic data releases and 3) complacent market conditions.

High Valuations

We do not subscribe to the "US is expensive UK is cheap" narrative. Each company needs to be valued based on its own merits. Highly profitable companies with decent long-term growth potential should have high price to earnings multiples. Companies which can barely turn a profit and have few growth opportunities will have low price to earnings multiples. Unfortunately, many of the UK and European public companies are home to the latter type of company and the US is home to more of the former. It is nonsensical to look at price earnings multiples of technology companies and compare with banks and say one is more expensive than the other based on a PE of 30 vs 10. Valuing the free cash flow over time and ascribing a discount for the uncertainty is what investors need to do. The flip side of this is to work out what level of growth and profitability is 'baked into' prices today. For Nvidia for instance, in our estimation, Nvidia would need to grow at an annualised rate of 20% with only marginal erosion in its profit margins for at least 20 years to justify its price today. This is not impossible, but it is a high bar with very little room for disappointment.

Chart 1 below shows various metrics of the US technology sector over the last 20 years. The top clip shows that prices are 37.5% above its long-term price trend; the second clip shows the multiple of price to forward earnings estimate for the next 12 months is 28.5 times; and the bottom clip shows analysts expect 14% sales growth from the sector in the next 12 months. Said differently, 1) analysts are optimistic about revenue growth and 2) investors are optimistic that analysts' optimism will be exceeded. This is not impossible, but should analysts be wrong, investors have no margin of safety.

Chart 2 below compares Equities with Government bonds. The blue line is a valuation proxy for the relative value for bonds over equities by comparing bond yields with dividend yields. While there are valid criticisms of this approach based on companies' general preference for buying back their own stock versus paying a dividend, the indicator has a very good track record.

Finally, **Chart 3** is taken from Professor Shiller's website, author of the book, Irrational Exuberance, written in 1999. Using a formulaic approach, Shiller extrapolates the excess return from equities versus bonds over the next ten years.

Whichever way you cut it; equities look richly valued. They can get more richly valued in the short term, but prospective returns look unappealing.

Stocks will not enter a bear market based solely on their valuation. Macroeconomic and market deterioration needs to accompany high valuations for a bear market to get going. It is the latter dynamics that have concerned us in recent weeks.

Chart 1 – The S&P Technology Sector is 37.5% above trend; causing the forward 12-month Price to earnings ratio to rise to 28.5x; and this is based on analysts' expectation of 14% sales growth.

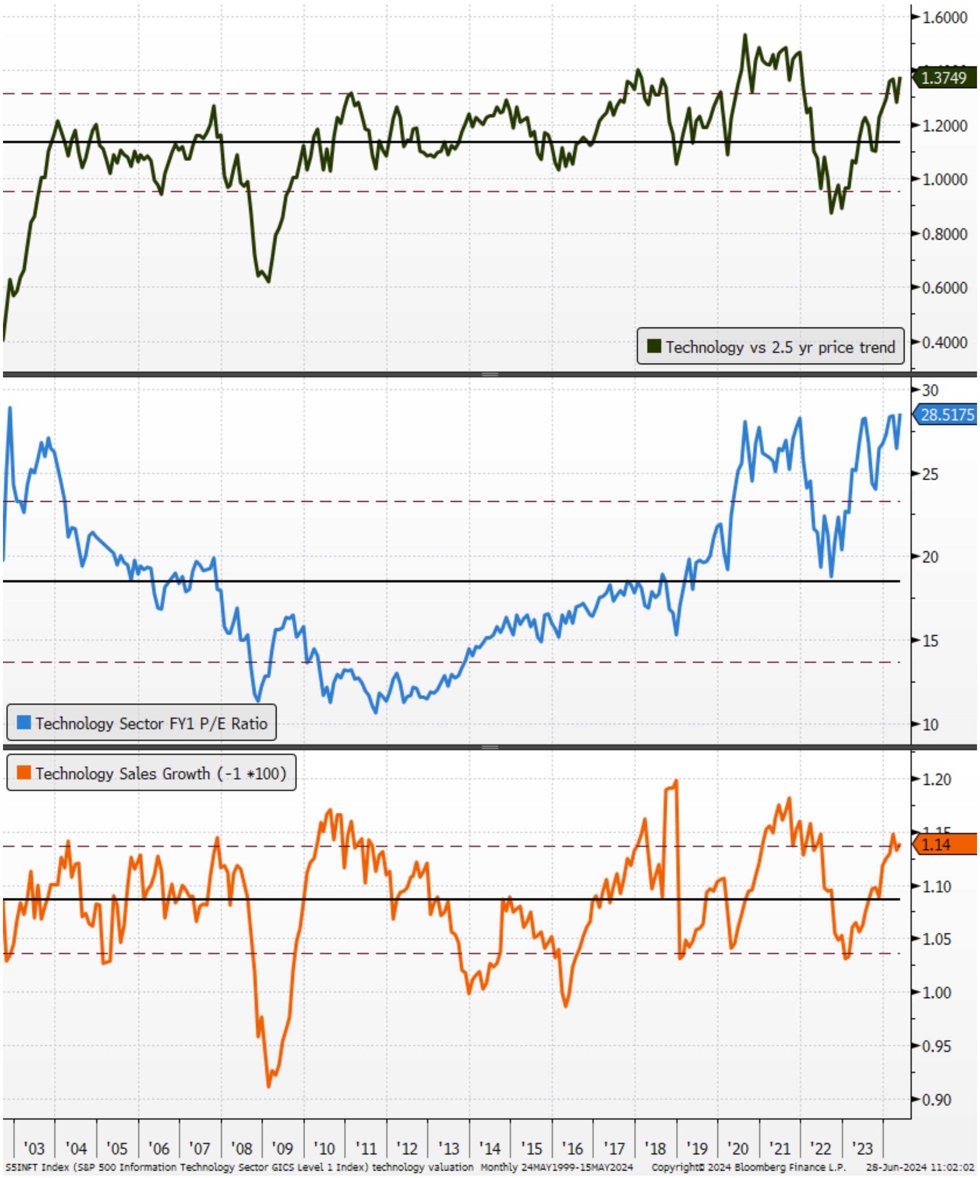


Chart 2 – the blue line shows the relative valuation advantages of Government bonds over equities. The red line is the relative performance of stocks versus bonds.

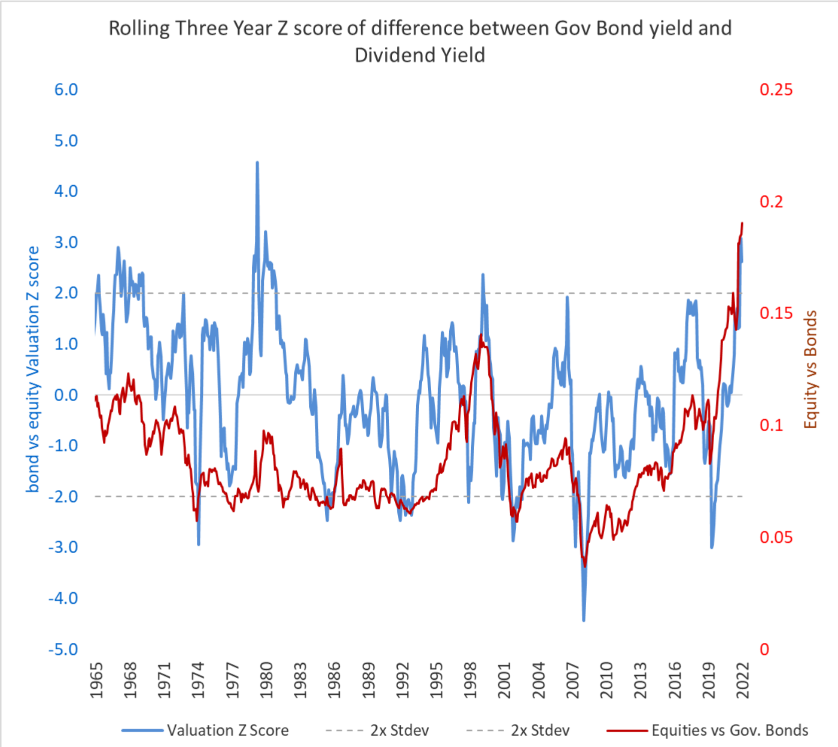
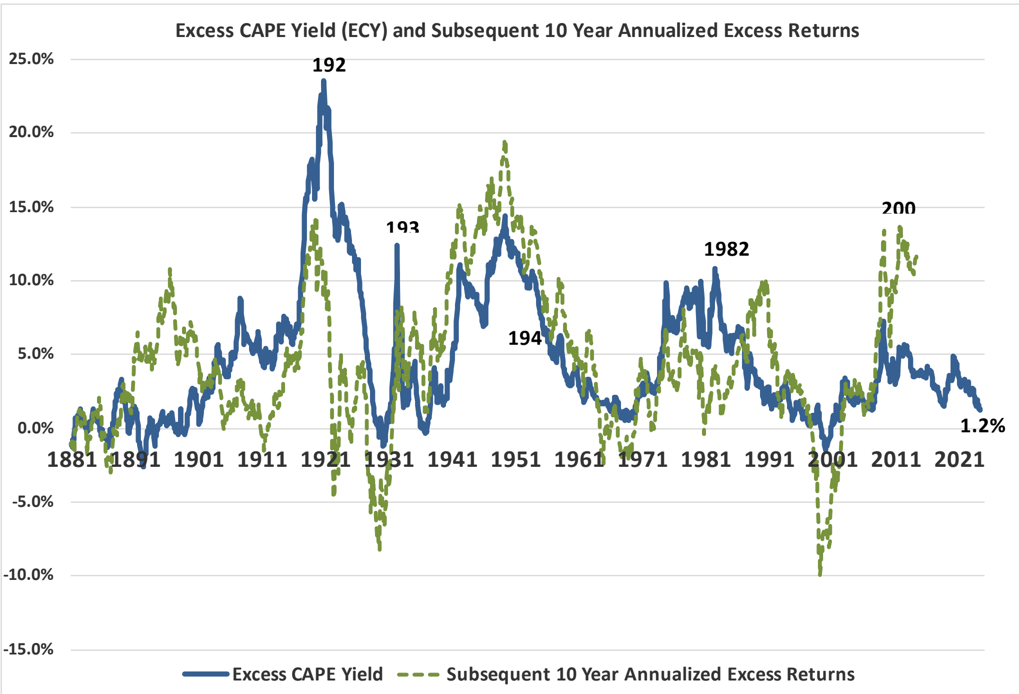


Chart 3 – Professor Shiller's extrapolation for the relative performance of government bonds vs equities over the next 10 years.



The Macro

Citigroup publish a very useful data series which simply calculates the number of economic data releases that beat estimates when released, less those that are falling below estimates. Presently, in almost all regions, economic data releases are not positively surprising.

Chart 4 -Bloomberg Economic Surprise index (blue) vs S&P forward P/E (white).

The most crucial of all data releases is the level of employment. Since the COVID lockdowns, there has seemingly been a significant shortage of labor and therefore, the unemployment rate has been low. We have been pointing at the early telltale signs that this trend was mature. The number of temporary jobs continues to fall as are overtime hours. More recently, US unemployment rate has risen from secular low of 3.4% in 2021 to 4.1%. At what point this becomes troublesome and draws the attention of investors and policy makers is unclear. Yet, the recent surveys of purchasing managers indicate that new order flow, for both the service economy and manufacturing, is not as good as last year and typically, companies will adjust employment levels according to the pipeline of new business.

This employment 'softness' is permeating retail sales. If we adjust retail sales growth for inflation (thereby measuring volumes rather than prices), retail sales have been contracting in recent months.

Yet residential construction employment, which is so often the 'canary' of the economy, remains respectable.

At best, we would describe the US economy as moderating.

Below is a snippet of an email we received about China from Goldman Sachs today:

- While we have known for some time now that the consumption backdrop in China is weak, recent data points suggest this is getting worse and that this will be a source of downgrades in Q2.
- **On the micro side, three MNCs have lowered outlooks this week, citing China as a driver**: 1) L'Oreal lowered its 2025 global beauty market growth forecast (from 5% to 4.5-5%) due to China; 2) Nike cut FY25 guidance last night citing a subdued macro outlook especially in China (along with the product

transition); 3) General Mills missed on fiscal Q4 saying that in China they saw "a real souring and downturn in consumer sentiment". **Meanwhile, local companies at this week's store tour have talked to sequential softness QTD**, baiju companies have been scrambling to stabilise prices and Topsports missed.

- This comes alongside all the **high frequency data that we track for China which is deteriorating**: 1) restaurant SSS have slowed, 2) air fares and hotel RevPar are now in decline YoY, 3) Hainan DFS sales are getting worse with May -38% YoY (and airports at our recent China conference said they expect this to continue). As a reminder, Louise's macro tracker shows a meaningful deterioration in China lead indicators e.g. handbag & jewellery imports (-20-30% vs -9% in Q1) which follows many Luxury companies (including the typically more defensive brands) talking people down on China.

Activity is clearly moderating/slowing in the two largest economies of the world.

Market Structure

We monitor all aspects of the markets to watch for inconsistencies and opportunities. We find that option markets, credit, Emerging fx, commodity markets etc can hold distinct clues for the major developed markets we spend our time investing in.

These 'other markets' are in chorus and their message is getting harder to ignore. This work suggests we are creeping into a riskier environment. Meanwhile many developed market equity markets are close to all-time highs.

We developed the chart below to illustrate the point. The blue line shows how divergent the US equity market index (S&P 500) is from these other markets. While volatile, when the blue line is as depressed as it presently is, the S&P has ordinarily pulled back.

Presently, we have this signal in the context of markets that are overvalued and an economy that moderating (at best).

The portfolio

We have reduced equities to 44% but crucially much of the portfolio is invested in 'defensive' equities. These are equities that are relatively less sensitive to economic gyrations, and/or they have a record of paying growing dividend streams and/or they have minimal volatility compared to their peers. Not only do these companies have a history of outperforming in equity bear markets, but they are also presently far more attractively valued and are generally under owned by investors.

Chart 5 – The divergent indicator (blue) measures the difference between the equity market and similar 'risk on' markets. It is very divergent!

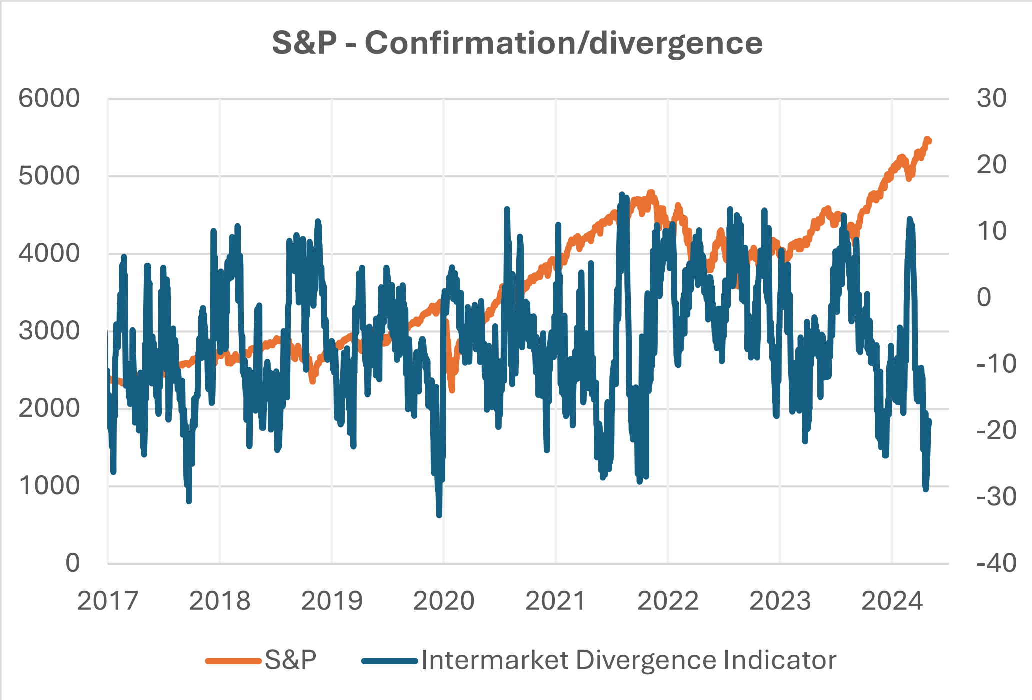
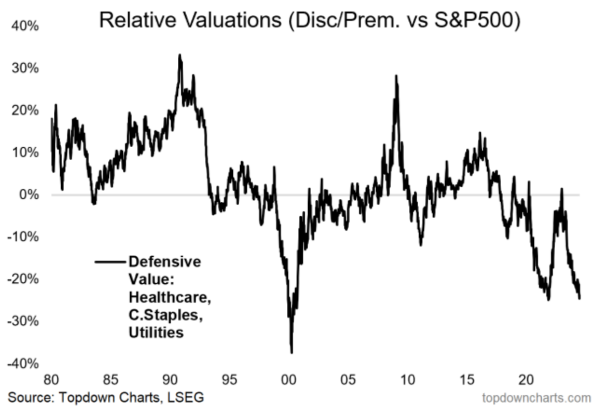
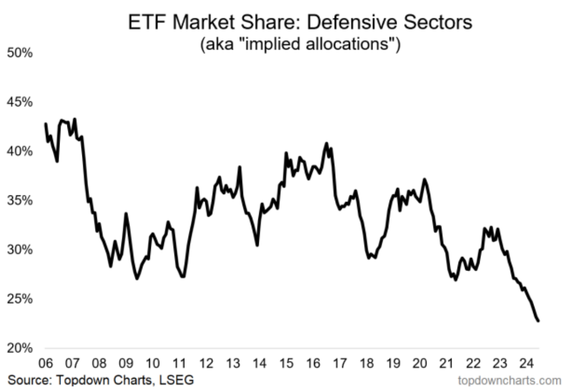


Chart 6 – Defensive equities are both cheap and are under owned.

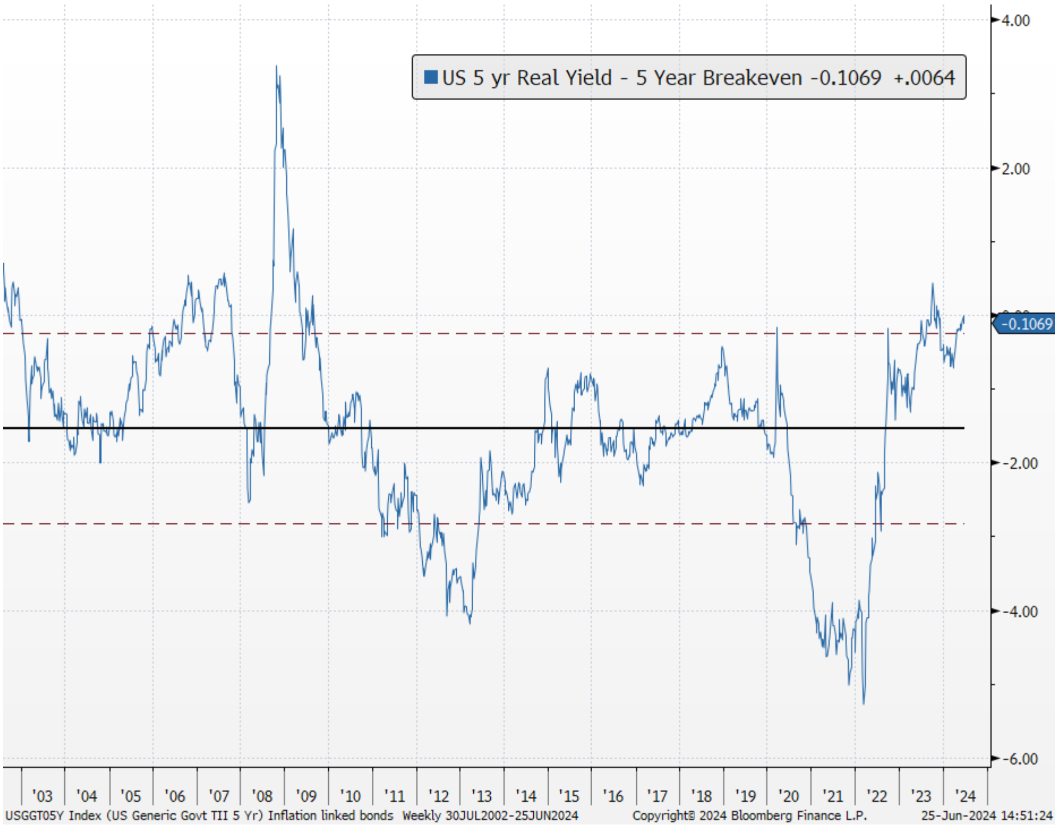




Within bonds, you will notice that we have increased our allocation to two-year government bonds. There is little exposure to corporate credit. The US two-year bond yields 4.7% and the 30-year yields 4.4%. Lower yields on longer duration fixed income assets is a nonsense that will either be resolved by two-year yields moving lower and/or 30-year yields moving higher. Either way, if the equity markets move lower, rate cuts will again become topical and two- year bonds will offer an attractive if unspectacular total return.

We are also invested in 5-year US Inflation protected bonds. These offer some of the best prospective returns in the past 20 years and if there is an oil spike caused by further middle east conflict, the inflation component of these bonds will be extremely valuable.

Chart 7 – US 5 year inflation linked bond valuation indicator. Buy above upper threshold.



5.7% of the portfolio is exposed to Gold. Over the last 25 years, (since Gordon Brown sold the UK's gold pile at an average price of $275/oz), gold has delivered a total annualised return of 9.0%, outperforming even the best performing regional equity market, with the S&P returning an annualised 7.7% and government bonds that have delivered a 3.4% rate of return. Yet, despite this stellar performance, gold's rate of return has largely only matched the rise in Global Money Supply (measured as M2 in USD in Europe, China, USA, Japan, South Korea, Canada, Taiwan, Brazil, Switzerland, Australia, Mexico, and UK). As Government debts rise, and public debt issuance swells, it is unsurprising to us, that international reserve managers are once again increasing gold bullion in preference to government debt **(Chart 8).**

Global debt, excluding contingent liabilities like pensions and future healthcare costs, amounts to approximately $300 trillion. In contrast, global public equity is valued at about $100 trillion, whereas gold's market cap is around $16 trillion, or one-twentieth of the global debt value.

In recent years gold has been performing significantly better than the total return from government debt. This trend is closely linked to worsening government fiscal budgets. The dotted line in **Chart 9** is the relative performance of Gold versus 20 + year US government debt. The blue line is the US fiscal deficit as a percentage of nominal GDP. However the political land settles at the end of the year, neither party of the US Government has any plans to address the fiscal deficit and consequently, we expect gold's outperformance of US government debt to be underpinned.

Chart 8 -Gold is once again regaining its share of Global International Reserves

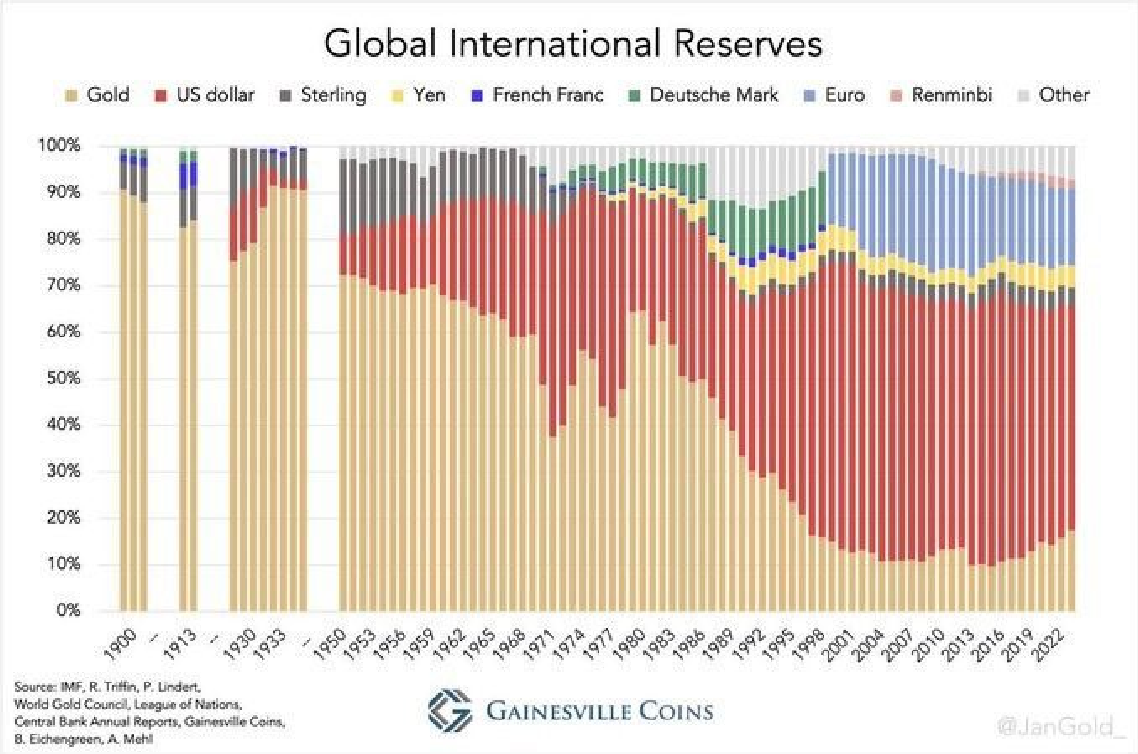
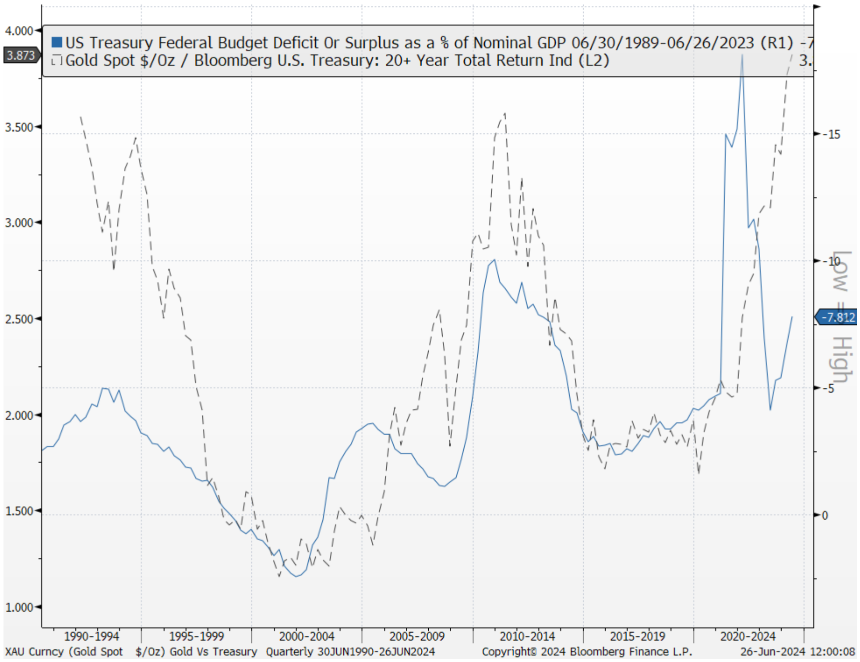
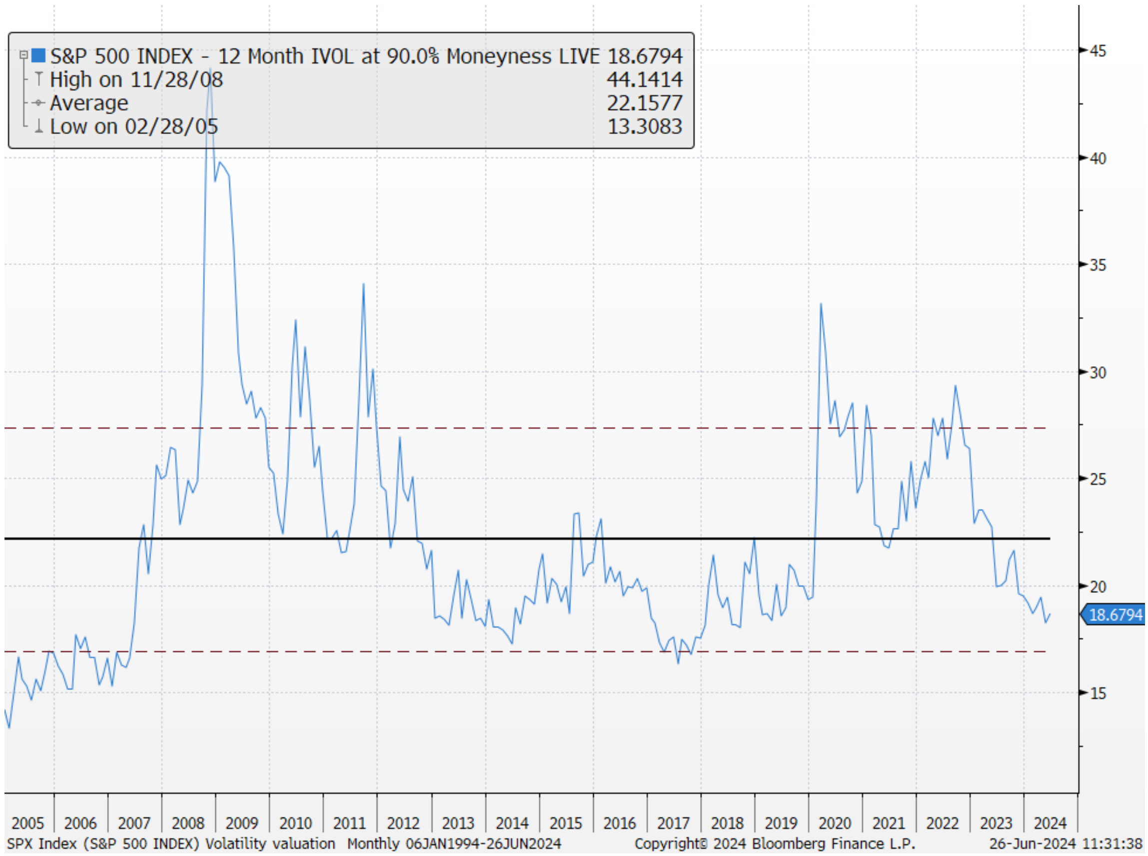


Chart 9 – Gold performance relative to long dated US governement treasuries is influenced by the extent of the fiscal deficit



We maintain our exposure to strategies that are directly linked to an increase in volatility. The fund allocates to large, experienced managers with a long track record in this area. The Fund will not always have such a large allocation to this sleeve of the strategy, but presently, as **chart 10** illustrates, volatility for many financial assets is towards their lower bound for the past 20 years. Moreover, volatility is generally a product of market illiquidity and there are several measures which show liquidity is nowhere near as plentiful as it once was. It is also worth noting, that the launch of Zero days to expiration options ('0TE') has led to a massive increase in speculation in option markets. This has caused certain distortions which the managers are taking advantage of. Participants in this new product are generally sellers, causing a general cheapening in option prices across the spectrum.

Chart 9 – A representation of equity volatility. The implied volatility of the 10% out of the money 12 month put on the S&P 500 Index.



This is the fund is most defensive position since 2018. Like then, our best endeavours to preserve capital may be undone by Central Bank Liquidity injections which sent markets higher in 2019. But the credibility of these institutions is increasingly in focus. The market's reaction to the most recent political movements in Europe is telling. Bond and Currency traders will not tolerate proliferation and radical policies that cannot be paid for.

Arguably, China is doing the right thing by letting bankruptcies occur thereby causing a repricing of the excesses that built up. They are not throwing money at every problem to paper over the cracks. They are taking some hard medicine and allowing a structural change of their economy.

Let's see.

We invite you to read our latest Core Equity Letter and Technology Letter.

Kindest regards,

Nick

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