SOMERSTON ASSET MANAGEMENT

# SOMERSTON RAINY DAY FUND

INVESTMENT LETTER No.2 AS AT 30 SEPTEMBER 2024

**Portfolio Objectives:** The fund seeks to provide readily realisable, positive returns, during most forms of financial market adversity, while maintaining good value in benign environments.

**Strategy:** We use a fundamental Multi Asset Strategy to identify attractive investment opportunities that are likely to benefit from adversity. We have a 5-year investment horizon.

**Performance:** The Somerston Rainy Day Fund (US Class) rose by +1.6% in the month and rose by +4.4% over the last three months.

**Performance (%) (US Class)**

| | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | Year |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2024** | | | | | | **-1.1** | **2.2** | **0.5** | **1.6** | | | | **3.3** |

**Allocation**

| Name | % Long | % Short | Net % |
|---|---|---|---|
| Gold Bullion | 25.0% | | 25.0% |
| Gold Royalty | 5.7% | | 5.7% |
| Gold Miners Equities | 0.8% | | 0.8% |
| Silver Bullion | 1.5% | | 1.5% |
| **Gold and Precious Metals** | 33.0% | | 33.0% |
| Equity Long Short | 14.5% | -14.5% | 0.0% |
| Volatility and CTA | 12.0% | | 12.0% |
| Inflation Linked Bonds | 16.5% | | 16.5% |
| Bitcoin | 2.4% | | 2.4% |
| Carbon | 2.2% | | 2.2% |
| Anti Beta | 2.0% | | 2.0% |
| Cash and Cash Equivalents | 32.0% | | 32.0% |
| **Total All Assets** | **114.5%** | **-14.5%** | **100.0%** |

**Top Ten Holdings**

| Name | | % Fund |
|---|---|---|
| Kilo Gold Bars (32.15 oz) | Bullion | 21.8% |
| Aspect Divers Trend-A USD | CTA | 2.6% |
| 36 South Carry Neutral | Long Volatility | 2.5% |
| Franco-Nevada Corp | Royalty | 2.2% |
| AGF US Market Neutral Anti-B | Equity Long Short | 2.0% |
| One River Dynamic Convexity | Long Volatility | 1.9% |
| Royal Gold Inc | Royalty | 1.8% |
| Wheaton Precious Metals Corp | Royalty | 1.7% |
| One River Risk Responders | Long Volatility | 1.6% |
| 36 South-Kohinoor Core FD-B | Long Volatility | 1.4% |
| **Total for Top Ten** | | **39.6%** |

## Commentary

**Somerston Rainy Day Fund – September 2024**

Central Banks around the world are celebrating a *moderation* of **year-over-year** inflation by cutting interest rates. Indeed, the US Central Bank got out the gate this month with an aggressive 0.5% rate cut, with a clear message that they remain in restrictive territory and will focus on their mandate of full employment.

While **year-over-year** inflation may be trending towards 2% in America, Chart 1 clearly shows that after four years of above trend inflation, prices remain at a significantly higher **level** than trend inflation would have dictated. Arguably inflation would need to be persistently below the 2% target, for several years, before we get back to trend. The headlines and narrative that Central Banks have 'won' their fight against inflation is shallow at best, but it serves policymakers' vested interests.

We have long considered that the only way out of the huge pile of public debt that has been accumulated in the western world is by a stealth devaluation. By allowing inflation to run above target, there is a better chance that tax receipts rise faster than would otherwise have been the case, which (all other things being equal), would allow the total nominal amount of debt to reduce relative to receipts. This is a tried and tested strategy in emerging markets; however, all other things are not equal, and western governments are accelerating their spending relative to what they receive in taxes and accordingly, debt levels are rising in both real and nominal terms.

This is a vicious cycle at the best of times but particularly when demographics turn upside down with shrinking populations. In Western Europe, the population is imminently about to peak and go in decline. An aging society expects to be looked after by the state benefit system to whom they have been paying into for their whole lives. Little do they know that these contributions have been spent and they are now reliant on the younger population to continue this Ponzi merry go round. How will the debt and these social obligations be managed with fewer and fewer workers paying taxes and social security contributions?

As I wrote last quarter, those willing to provide credit to western countries are reducing in number, and those creditors that remain, will eventually dictate their terms.

One of the ways to avoid the day of reconning is to 'keep the party going' by suppressing financial volatility and pretending 'there is nothing to see here'! Western Central Bank activities over the past few decades has been engaged in ensuring calm financial markets and to divert public attention on the state of public finances. The persistent liquidity and fiscal measures to satiate sporadic petulant financial market behaviour, has the unintended consequence of causing asset prices to rise to overvalued territory. Chart 2 shows that 90% of US equity sectors are in their highest valuation quartile historically.

Public debt levels that are growing at an incrementally faster rate, in the context of overvalued financial assets are a potent combination.

While these dynamics perhaps escape the scrutiny of many, they do not escape the scrutiny of foreign nationals. Foreign nationals in aggregate are no longer increasing their holdings of US Treasuries, instead preferring to diversify their international reserves into Gold.

While the economic cycle will ebb and flow, the foundations of western economies continue to deteriorate and go largely unnoticed.  A 'stealth' inflationary policy which allows for periods of higher inflation than targeted, will only go some way to reduce the nominal debt burden. Eventually either coupons on that debt must rise to reflect the risk and/or the currency falls to reflect the dynamic.  Under these circumstances, Gold, Silver and Bitcoin will fare well. Chart 3 clearly shows that gold has been persistently outperforming US Treasuries since the US embarked on a strategy of consistently borrowing more than they receive in tax receipts. With both Republicans and Democrats pledging further fiscal spending promises, we doubt this trend reverses for some time.

Accordingly, the portfolio has 33.0% in gold and precious metals with 16.5% invested in inflation linked bonds. We initiated a 2.5% position in Bitcoin given recent weakness. 12.0% of the portfolio is invested in strategies that benefit from a spike in Volatility and a notional of 14.5% is invested in sectors with a low equity beta and short those with a high equity beta. We retain liquidity in short, dated government securities.

**Chart 1 – The Fed's favourite inflation measure inflected higher in 2020 pushing the level of prices much higher.**

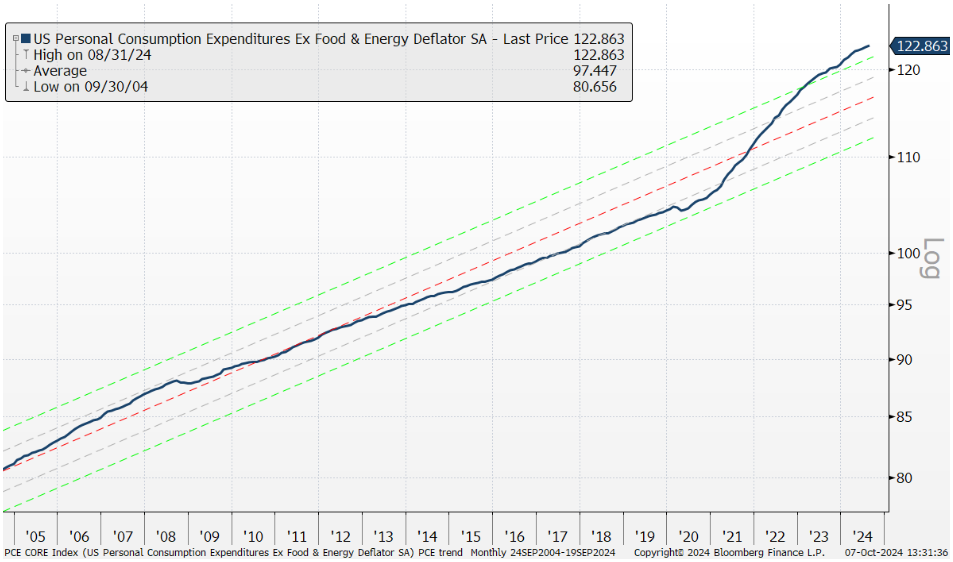



**Chart 2 - S&P versus the percentage of sectors that have valuations in their highest historical quartile.**

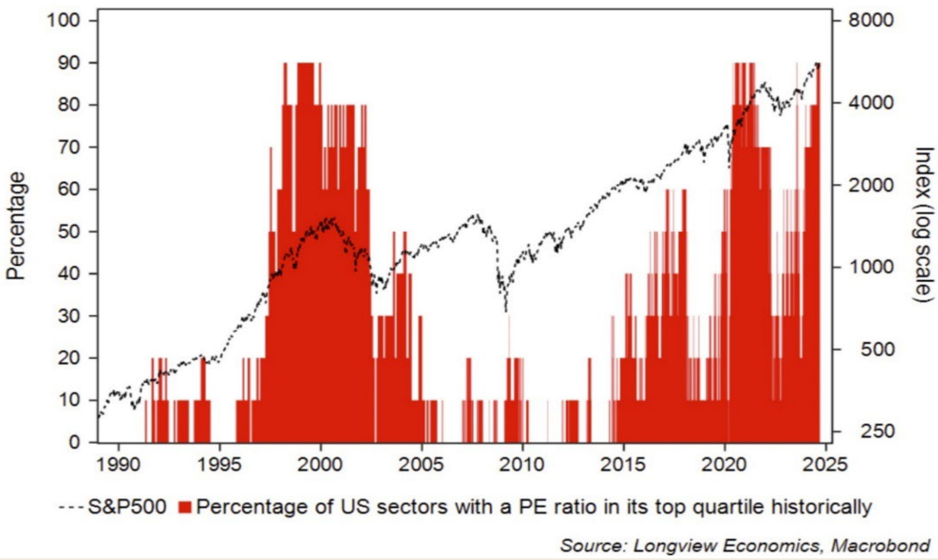
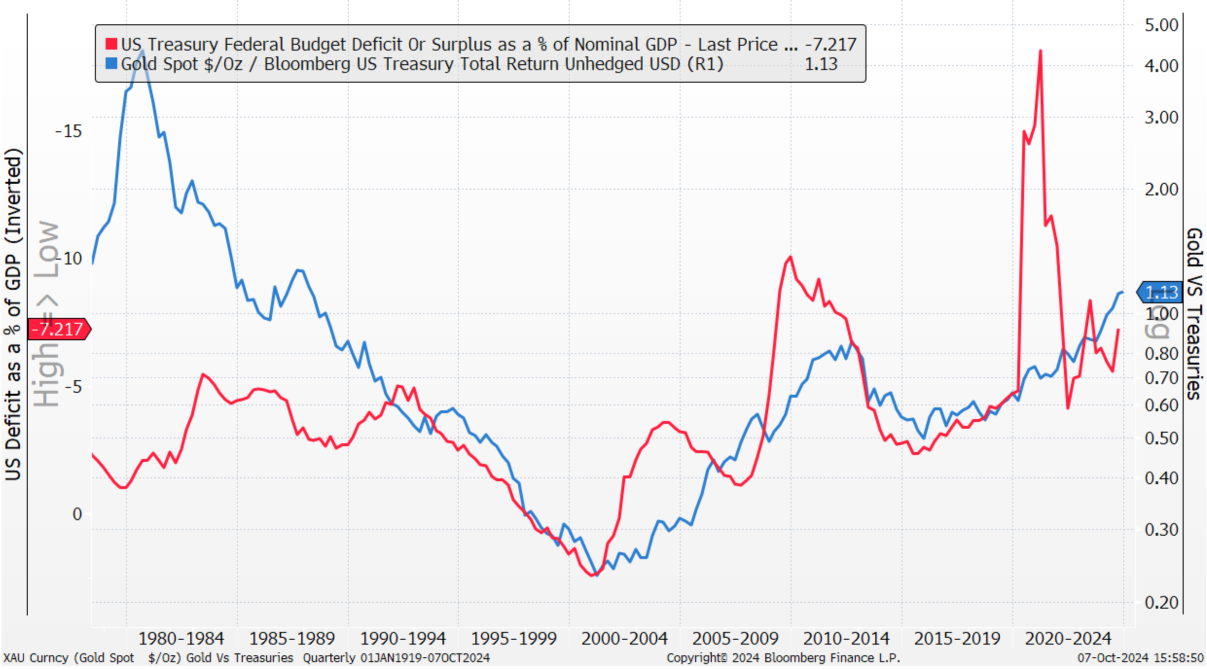


**Chart 3 – Gold has been outperforming US Treasuries (blue) since 2001 when the US Government first embarked on a strategy of spending more than they received in Tax receipts (red).**

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