SOMERSTON
ASSET MANAGEMENT

SOMERSTON MULTI ASSET FUND

INVESTMENT LETTER No.31 AS AT 31 DECEMBER 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 (US class) fell by -2.3% in the month and fell by -5.0% over the last three months. Our composite reference index fell by -1.9% in the month and rose by +0.5% over the last three months.

Performance (%) US 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	3.6	0.4	0.8	2.0	1.3	-3.7	0.9	-2.3	**5.4**

Total return since inception 56.5%

Top Ten Equity Holdings

Name	% Fund
Alphabet Inc	3.5%
Meta Platforms Inc	3.0%
Mastercard Inc	2.9%
Synopsys Inc	2.4%
Microsoft Corp	2.4%
Visa	2.3%
LVMH	2.3%
Amazon.com Inc	1.7%
Intuit Inc	1.7%
ASML Holding NV-NY Reg Shs	1.7%
Total for Top Ten	**23.9%**

Currency Allocation

USD	98.0%
SEK	5.6%
NOK	4.8%
AUD	4.6%
GBP	-3.3%
EUR	-9.7%
Total	**100.0%**

Asset Allocation

	Long	Short	Net	
Core Equity	40.9%		40.9%	↑
US Equities	2.2%		2.2%	↓
Defensive Equities	7.9%		7.9%	↓
European Equities	2.4%		2.4%	↔
Equity Long Short	2.0%	-2.0%	0.0%	↔
Equities	**55.4%**	**-2.0%**	**53.3%**	↑
High Yield Corp Bond		-2.5%	-2.5%	↔
Inflation Linked Bonds	20.0%		20.0%	↑
Bonds	**20.0%**	**-2.5%**	**17.5%**	↑
Gold Bullion Derivatives	4.2%		4.2%	↓
Copper Derivatives	1.9%		1.9%	↔
Silver Derivatives	1.3%		1.3%	↔
Gold Royalty	4.2%		4.2%	↑
WTI Derivatives	1.1%		1.1%	↑
EU Carbon Emissions	2.0%		2.0%	↑
Commodities	**14.7%**		**14.7%**	↑
Volatility and CTA	16.6%		16.6%	↑
Total All Assets	**106.7%**	**-4.5%**	**102.2%**	↑

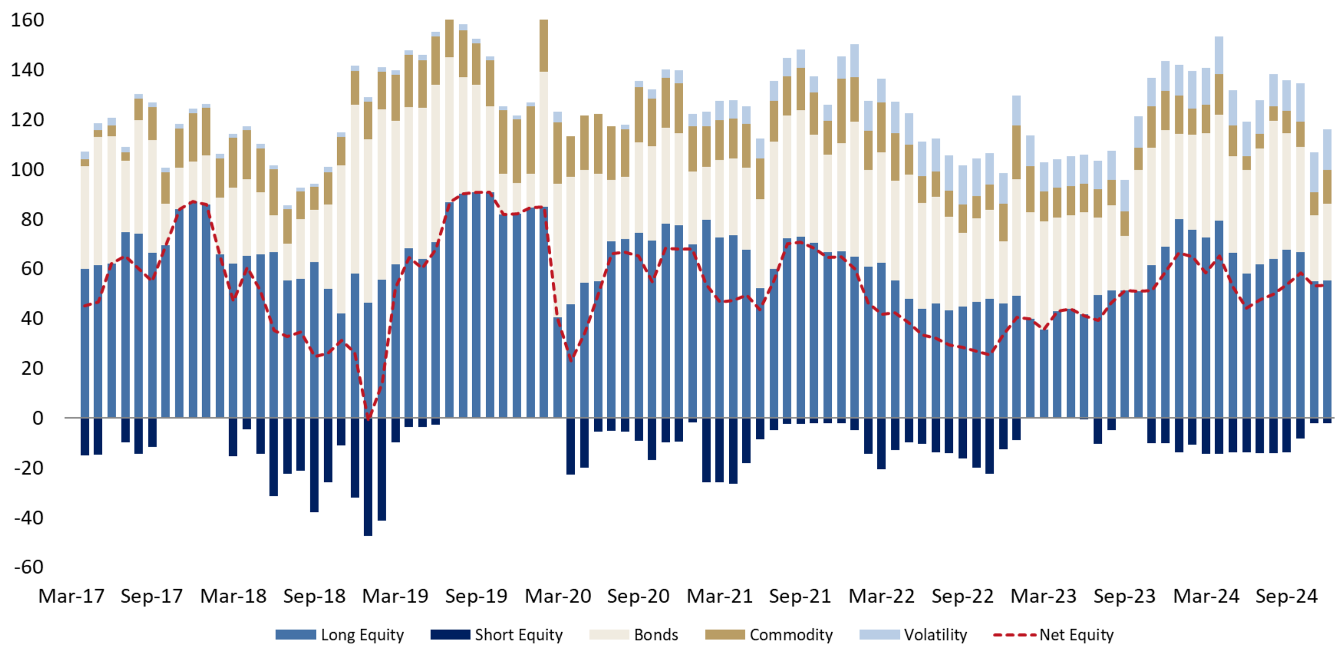
Performance shows the 0 Class until the fee structure was changed in May 2024 when the 1 class has been adopted.

GB Class Performance: The Somerston Multi Asset Fund (GB class) fell by -2.4% in the month and fell by -5.2% over the last three months.

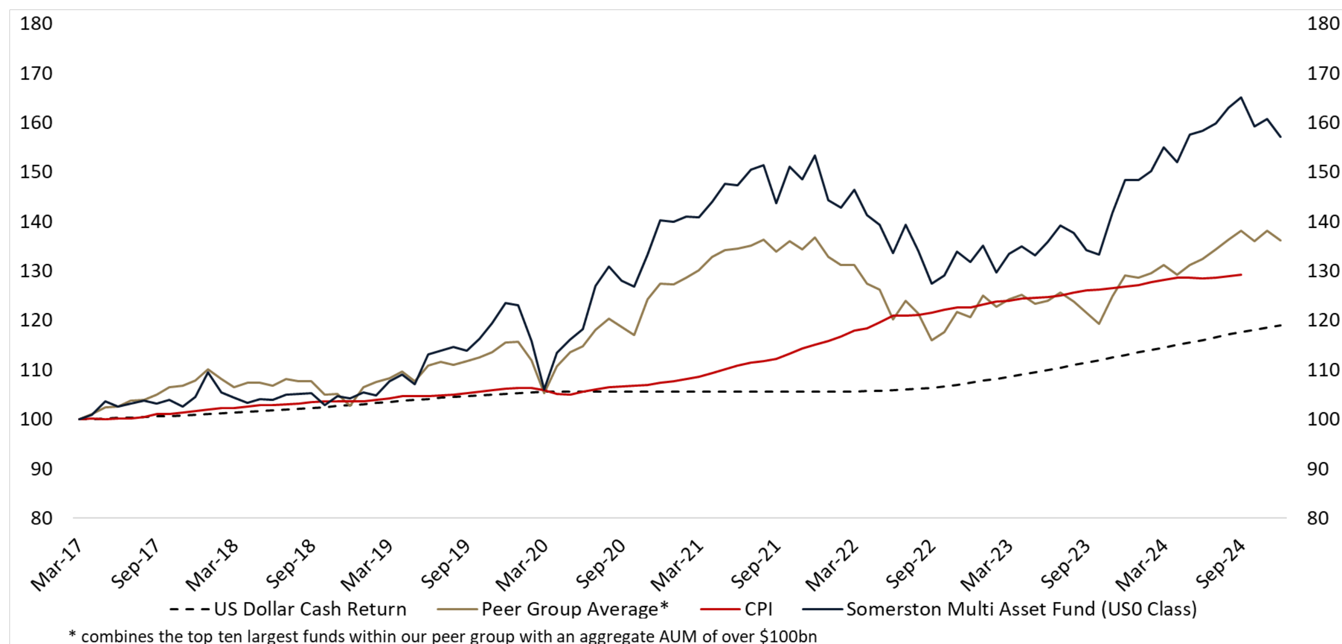
Performance (%) GB Class													
	Jan	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**	**Year**
2017				0.8	2.6	-1.0	0.5	0.5	-0.7	0.5	-1.3	1.6	**3.5**
2018	4.4	-3.8	-1.1	-1.2	0.6	-0.3	0.8	0.1	-0.1	-2.4	1.6	-0.6	**-2.2**
2019	1.0	-0.8	2.7	1.1	-2.0	5.4	0.5	0.3	-0.7	1.7	2.7	3.2	**16.1**
2020	-0.4	-6.2	-8.5	6.9	2.5	1.8	7.2	3.1	-2.3	-1.0	5.1	5.1	**12.4**
2021	-0.3	0.8	-0.2	2.3	2.4	-0.2	2.2	0.5	-5.2	5.1	-1.7	3.1	**8.8**
2022	-5.9	-1.0	2.6	-3.6	-1.5	-4.3	4.2	-4.1	-5.2	1.3	3.4	-1.6	**-15.2**
2023	2.4	-4.2	2.7	1.0	-1.4	1.9	2.4	-1.2	-2.6	-0.7	6.2	4.6	**11.2**
2024	0.0	1.2	3.2	-2.0	3.6	0.5	0.8	1.8	1.2	-3.8	0.9	-2.4	**4.8**

Total return since inception 42.1%

Evolution of Asset Allocation for Somerston Multi Asset Fund



Performance since inception



Performance

The fund endured a tough fourth quarter with the US1 class declining -5.0%. This is attributed to the following:

- **Equity Strategy**: Core Equity detracted -1.4% in the quarter. The mainstay of the equity strategy is to invest in 'quality' companies. The MSCI Quality Index that best represents this universe fell -3.2% in the quarter and our holdings performed in line. Alphabet (+14.3%), Visa (+15.1%) and Amazon (+17.7%) were the major contributors, while ASML (-16.6%), Novo Nordisk (-27.8%) and LVMH (-13.6%) were the major detractors in dollar terms. During the quarter, our macro equity sleeve focussed on low beta, defensive equities. Yet, defensive equities not only underperformed, but delivered negative returns. The yardstick we use to measure the performance of defensive equities was down -4.1% in the period. This caused the Macro Equity strategy to detract -0.6%.
- **Bond Strategy:** The fund has maintained low duration throughout the quarter with a focus on government inflation linked bonds. While this was indeed the right strategy, with US 30-year bonds down -10.7%, all parts of the bond universe experienced negative returns and the fund's strategy detracted -0.8%.
- **Commodities** were all lower across the spectrum in the fourth quarter. Silver was -7.2% lower, royalty companies fell -4.5%, industrial commodities were -3.5%, while gold was -0.4%. Overall, the commodity sleeve fell -2.8% and detracted -0.4%.
- Without any sustained move in volatility our long **Volatility** strategy detracted -0.5%.
- Finally, the **US Dollar** appreciated 7.6% during the period causing FX positions to detract -1.2%.
  This period of performance largely reflects the perceived dynamic of a Trump victory with cyclical and growth sectors the only areas that registered positive returns.

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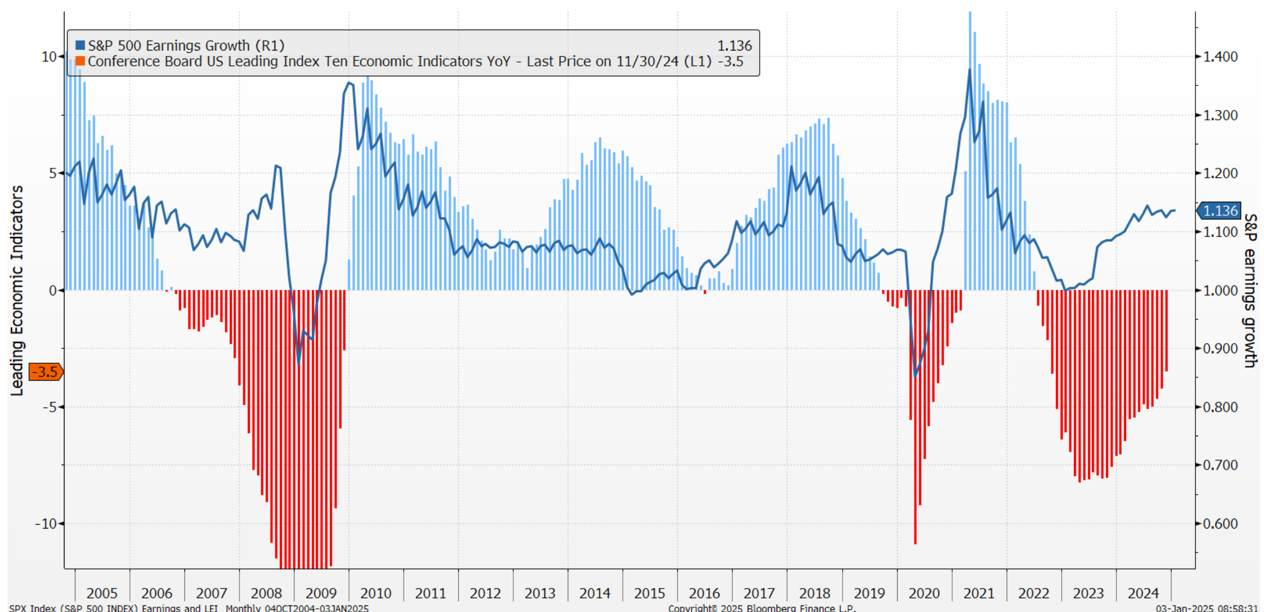
Somerston Asset Management Limited is regulated by the Jersey Financial Services Commission.

Commentary

In contrast to US equity markets that posted another year of stellar returns in 2024, large parts of the global economy were sedate or recessionary. The ever-increasing disparity between equity market and economic performance is striking. This type of anomaly is frequently seen in emerging markets but until recently, developed equity markets and their economies were broadly related.

The US 'Leading Economic Index' published by the Conference Board is intended to be a measure that leads the economy. As we would expect, this series has historically ebbed and flowed in harmony with earnings growth. More recently however, the Leading Economic Indicator remains firmly below zero (red bars) and is in stark contrast to the +13.6% earnings growth for the S&P 500 (blue line). Larger companies appear to be forging their own path, irrespective of the economy.

Chart 1 - The Leading Economic Indicator remains firmly below zero (red bars) and is in stark contrast to the +13.6% earnings growth for the S&P 500 (blue line). Larger companies appear to be forging their own path, irrespective of the economy.



Growth of datacentres, compute and AI has far **surpassed**, and been far more **resilient**, than any broad measure of economic growth. Technology continues to play an ever-increasing role in our lives and that trend seems unwavering. This sector is presently more represented in US public equity markets compared to the calculation of US economic performance causing this wide divergence between the economy and equity markets.

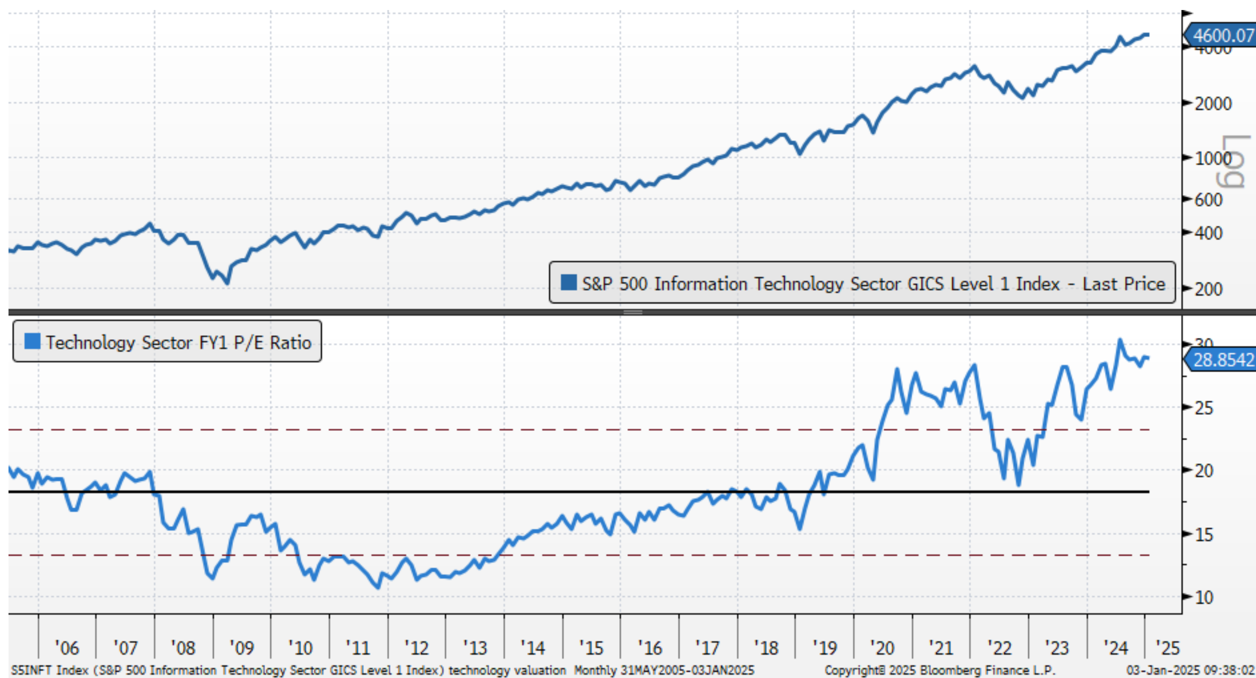
In contrast to previous waves of investment cycles, a large proportion of Technology investment is funded by **internally generated cash** of the Mega cap stocks with little or no reliance on capital markets. These huge investments drive corporate earnings of the entire datacentre/AI supply chain, spanning from semiconductor companies such as Nvidia to cooling companies such as Vertiv and power companies.

Valuation of Technology Companies

While the long-term dynamics of Technology are indisputable, there is growing concern from the investment community that the level of valuations indicate that technology equity investments currently carry elevated risks.

Often, we receive research notes illustrating 'overvaluation' by showing the price to earnings ratio (P/E) for the sector over time. For example, the chart below compares the performance of the technology sector (top) with its price to estimated earnings for the next 12 months (bottom). On this measure, the sector's valuation is approaching an all-time high relative to its 20-year history and is notably higher than the levels preceding the 45% pullback seen in 2022.

<u>Chart 2</u> - compares the performance of the technology sector (top clip) with its price to estimated earnings for the next 12 months (bottom clip).



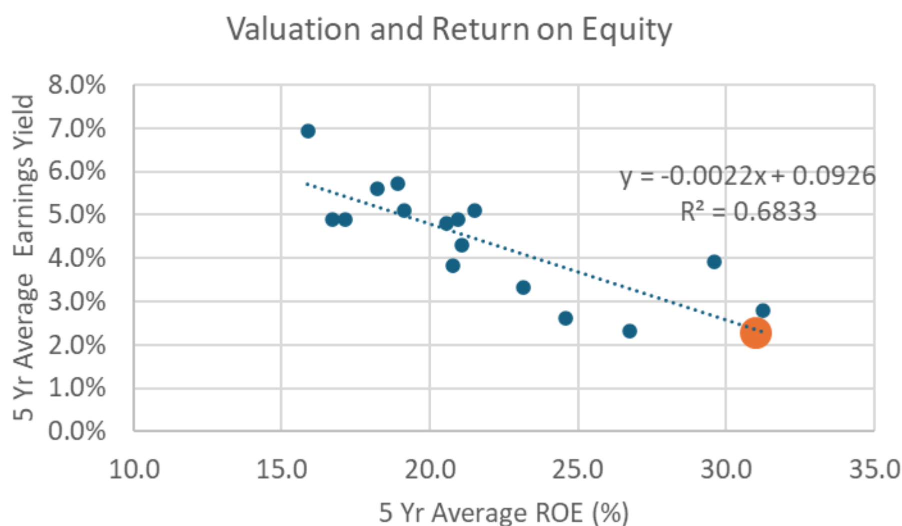
Valuing an investment is as much an art as it is a science. Nonetheless, even within the confines of the mathematics of valuation, the premise that a high P/E ratio versus historical levels equates to 'overvaluation' is flawed unless operating margins, capital intensity and growth remain constant over time. For many sectors these assumptions have held true. However, within the technology sector, for nearly two decades there have been persistent trends of improving operating margins and significantly reduced capital intensity. This has driven **returns on equity** (ROE) appreciably higher. If a company requires less capital to maintain its competitive position, free cash flow increases and, all else being equal, the company should be valued more richly, i.e. a higher P/E multiple is mathematically justified.

The chart below (Chart 3) shows that this is not just theoretically true but is being evidenced within the technology sector and has been the foundation for superior returns. In chart 3, the starting valuation is plotted on the vertical axis against the return on equity on the horizontal axis. Both measures are 'smoothed' over a five-year period to allow for short term fluctuations.

The technology sector now boasts a return on equity (ROE) of over 30%. Double its level in 2007, before the Great Financial Crisis. The P/E multiple attributed to a company with a ROE of 15% versus one with an ROE of 30% will, justifiably, be vastly different.

In 2007 the sector had a forward P/E of 20, today it is nearly 29. Transformational innovation and high barriers to entry should strengthen the case for continued high returns on equity for the sector.

Chart 3 – Improving ROE for the Technology Sector is pushing valuations higher (Earnings yields lower). The orange dot is where we stand today.



Using higher ROE as an input for a valuation model, we calculate the five-year annualized total return for the technology sector to be circa 9% (+/- 4%). This model forecasted 24.9% annualized prospective five year returns at the end of 2022, 15.3% at the end of 2023, and 10.5% at the end of last year, so **today's forecast of future returns is demonstrably lower** than recent years**,** and of course, this analysis says nothing of the path technology equity markets might take between now and five years' time. Indeed, at the end of 2021, this model forecast similar prospective returns to today, just before the sector fell 45%... despite that fall, the sector is far higher three years later.

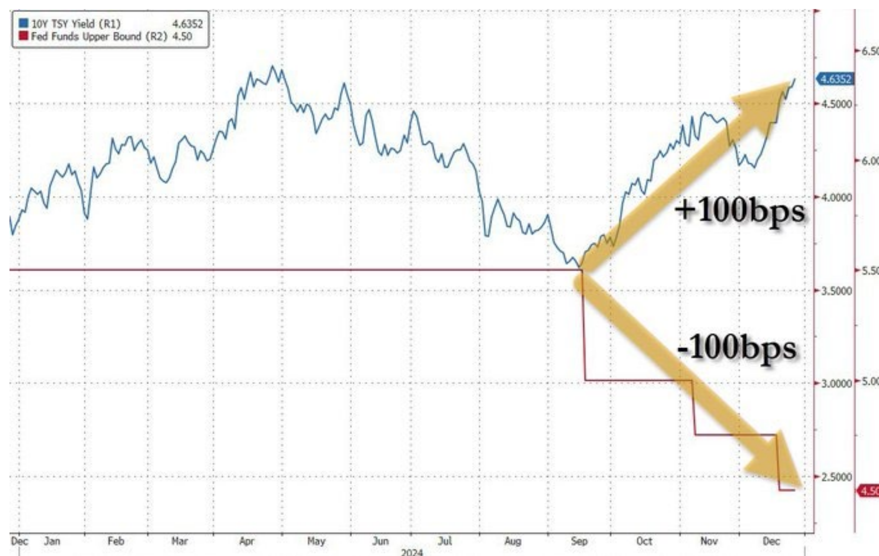
In summary, as far as valuation is concerned, we can see fundamental justifications for higher P/E multiples in the technology sector and, therefore, the US equity market. Valuations are not categorized as attractive, but equally, they don't pose the same risk we saw in 1999.

Macro Considerations

We are obviously waiting to hear the detail of Trade Tariffs once President Trump is inaugurated on the 20th of January. The bond market appears to be pricing in higher near-term inflation. Indeed, the most notable aspect of financial market performance in the last quarter has been the increase in bond yields since the US Central Bank started cutting interest rates in September. The chart below shows that while US interest rates have cut

1%, yields on the US government 10-year bond have risen 1%. Never has this degree of divergence happened in the aftermath of a rate cutting cycle. Indeed, the movement in bond yields has contributed to a decline in global liquidity and our global measure of M2 money supply is contracting. This is a concerning development. It has caused a scramble for US Dollars, causing the currency to rise appreciably.

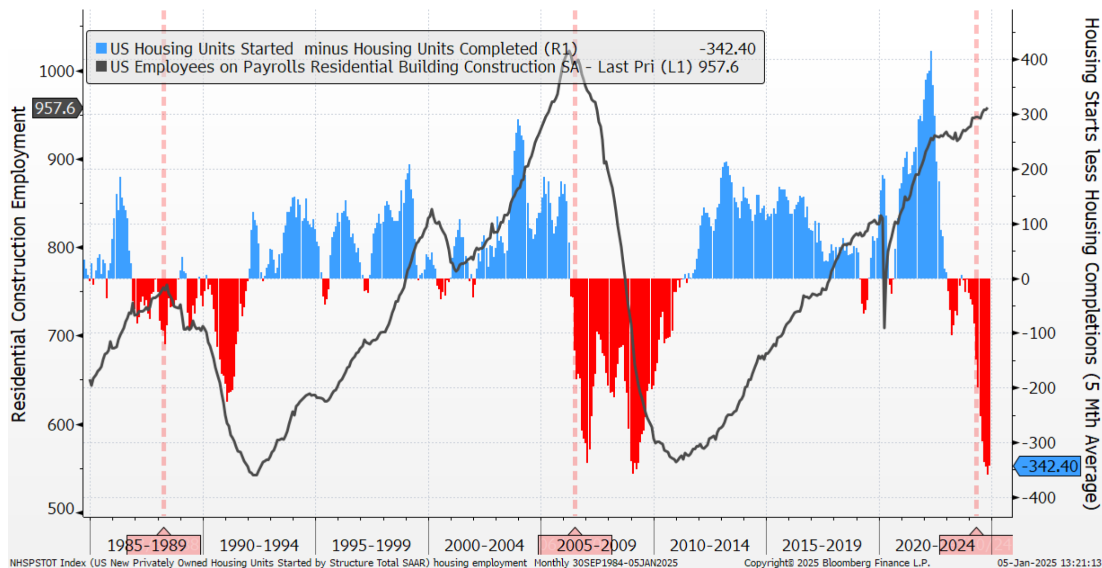
Chart 4 - while US interest rates have been cut 1%, yields on the US government 10-year bond have risen 1%.



Perhaps the best example of the impact of declining liquidity is in the US housing market.

Building permits continue to fall, and building starts are meaningfully less than building completions. There have only been two periods in the past 45 years where starts have been meaningfully below completions. If more houses are being finished compared to being started, there will naturally be a surplus of construction labour that will be at risk of losing their jobs and indeed, historically this dynamic has resulted in rising residential construction unemployment and eventual recession. In the month of December, US housing stocks fell 16.5% from all-time highs.

<u>Chart 5</u> – Housing starts less housing completion is deeply negative. We expect residential construction employment to fall sharply



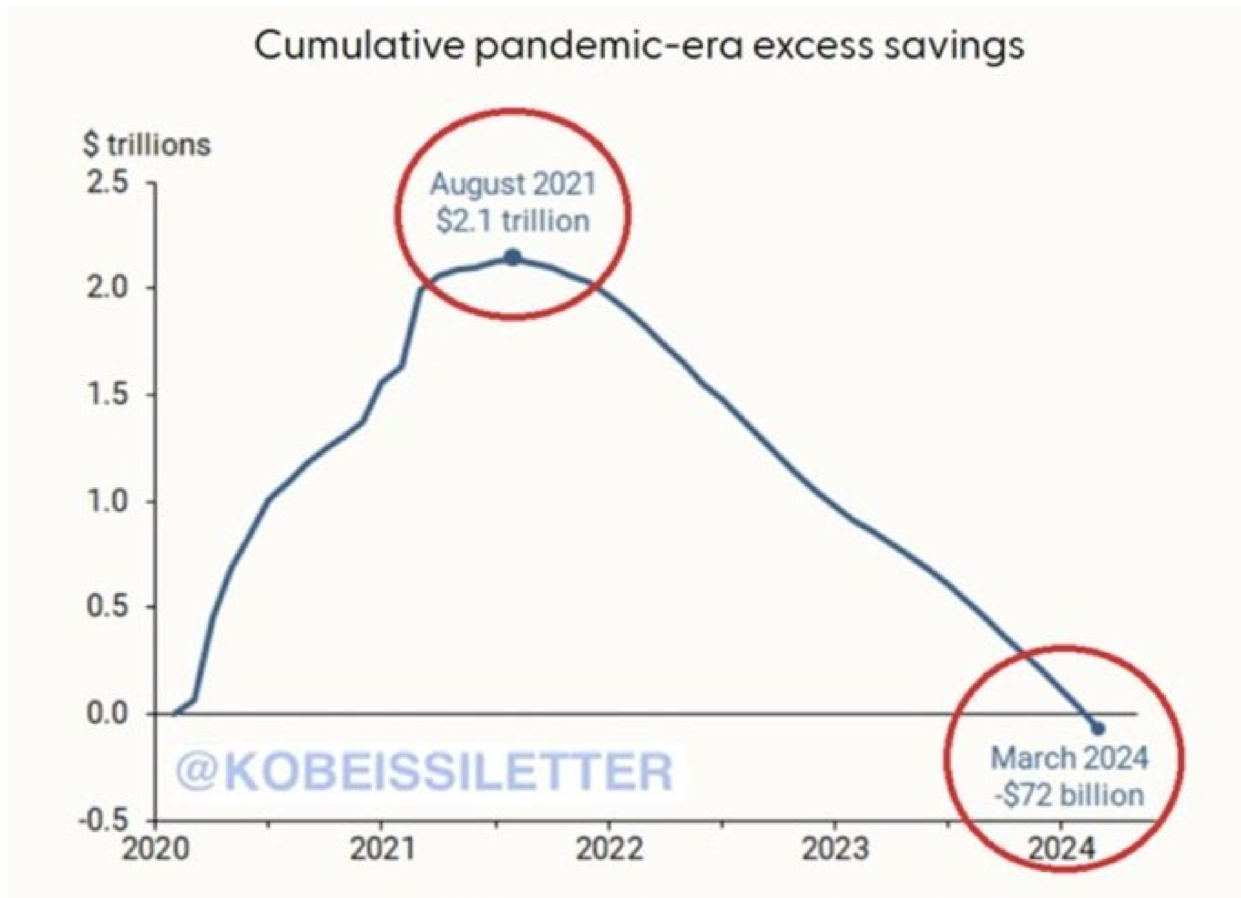
Potentially compounding the prospect of higher residential construction unemployment is the drive for government efficiency. Government employment has increased 22.4% in the last 20 years. This compares to the private sector that has harnessed technology to stem headcount growth. Private payrolls have added just 8.3% over the same period. The Trump administration is clear on their intent to get rid of excess 'government fat'. But without alternative employment, federal layoffs will push the unemployment rate higher.

Already 50% of US States are reporting higher initial unemployment claims than a year earlier. There appears to be several pressures on unemployment in the months ahead.

An Income Driven Cycle

One of the most notable features of recent economic strength has come from consumption. A vast personal savings pool was accumulated during the COVID era. A constrained ability to spend during lockdowns coupled with fiscal handouts, propelled a period of forced savings. In the US alone, we estimate that aggregate personal ***excess*** savings topped $2 trillion. This is a huge number and after three years, on many estimates, this excess savings is now depleted. Indeed, travel companies such as Royal Caribbean Cruises and Booking.com were amongst the best performers in 2024 and companies such as MasterCard and Visa have reported a sustained period of spending growth.

Chart 6 – Excess savings that built up during lockdowns appear depleted.

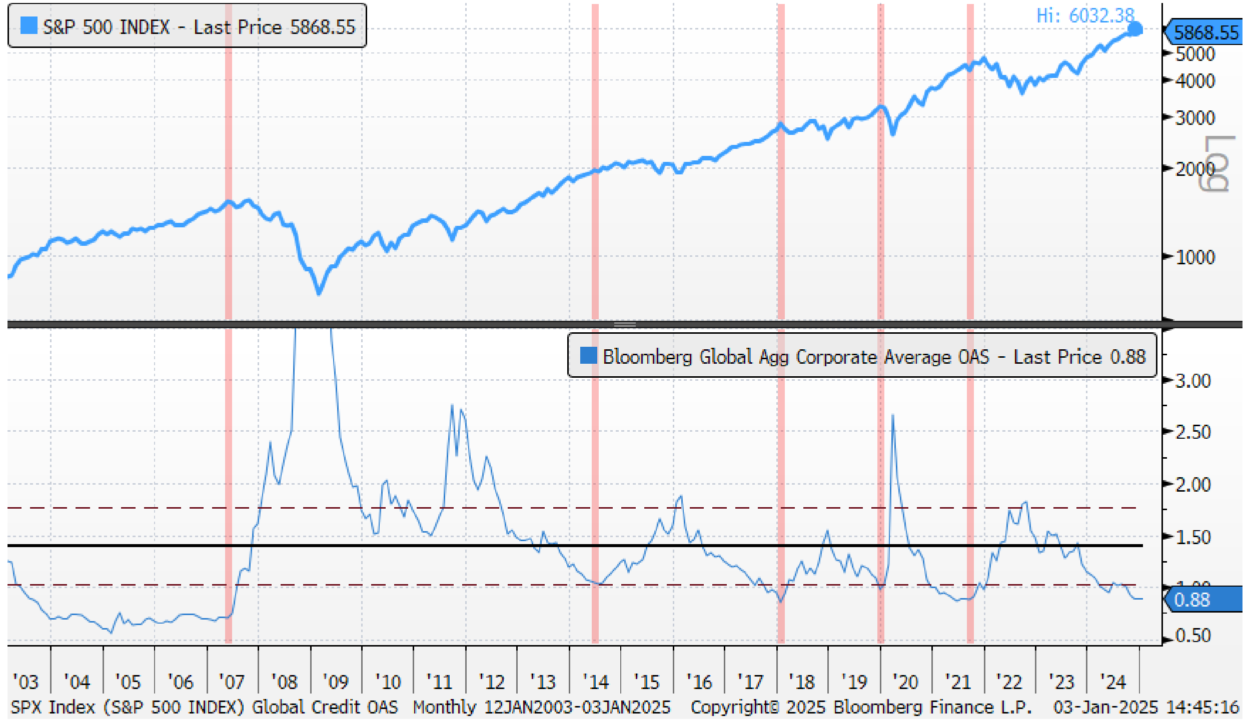


Contracting money supply, tighter financial conditions, the prospect of higher unemployment and the potential impact on economic growth by the depletion of excess savings and trade tariffs, are immediate concerns.

Technical Setup

The overall financial community is allocating capital with little regard to the potential risks these developments pose. Chart 7 compares the Global Aggregate Credit Spread with the S&P 500. The red lines are periods where spreads are low and turn higher. Investors seem entirely unconcerned and are prepared to receive very low premiums for taking credit risk. While this condition can exist for several months, it most clearly represents the general indifference towards the potential manifestation of any of these risks. Chart 8 illustrates the extent to which cyclical stocks have outperformed defensive stocks. Investors have been disinterested in defensive attributes. The extent of optimism this series represents indicates levels of optimism that are not supported by fundamentals. Lastly Chart 9 shows that long term volatility has become very cheap with investors unconcerned about buying insurance.

<u>Chart 7</u> compares the Global Aggregate Credit Spread with the S&P 500. The red lines are periods where spreads are low and turn higher.



<u>Chart 8</u> illustrates the extent to which cyclical stocks have outperformed defensive stocks. Investors have been disinterested in defensive attributes.

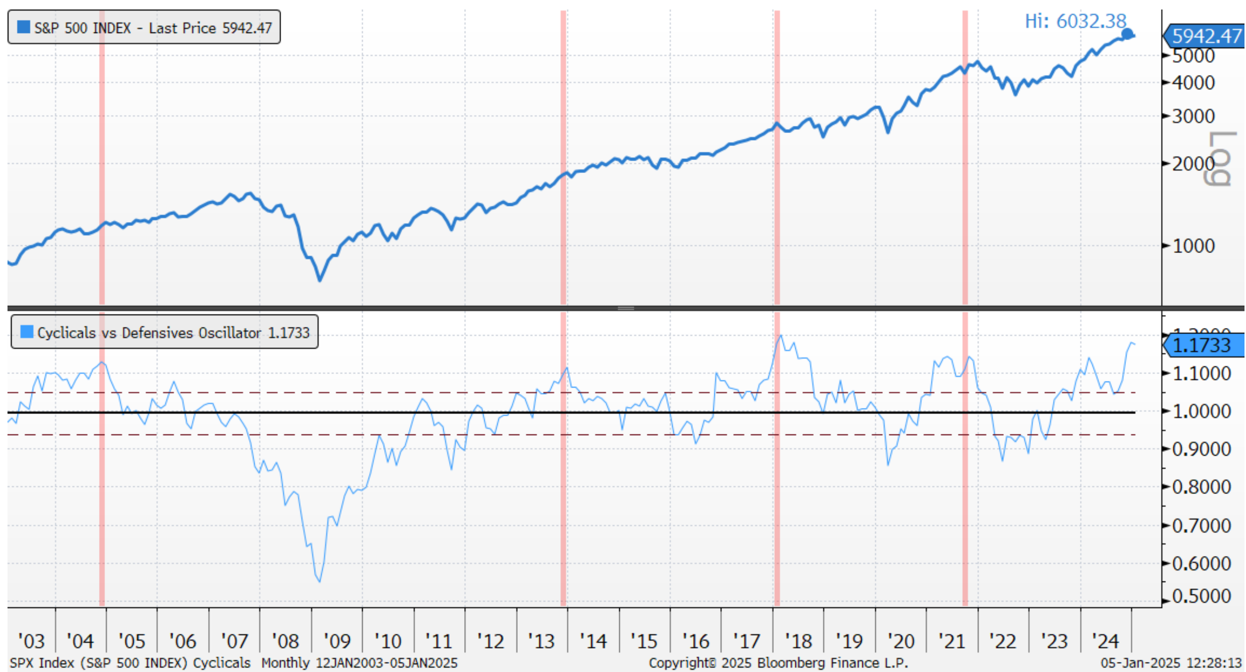
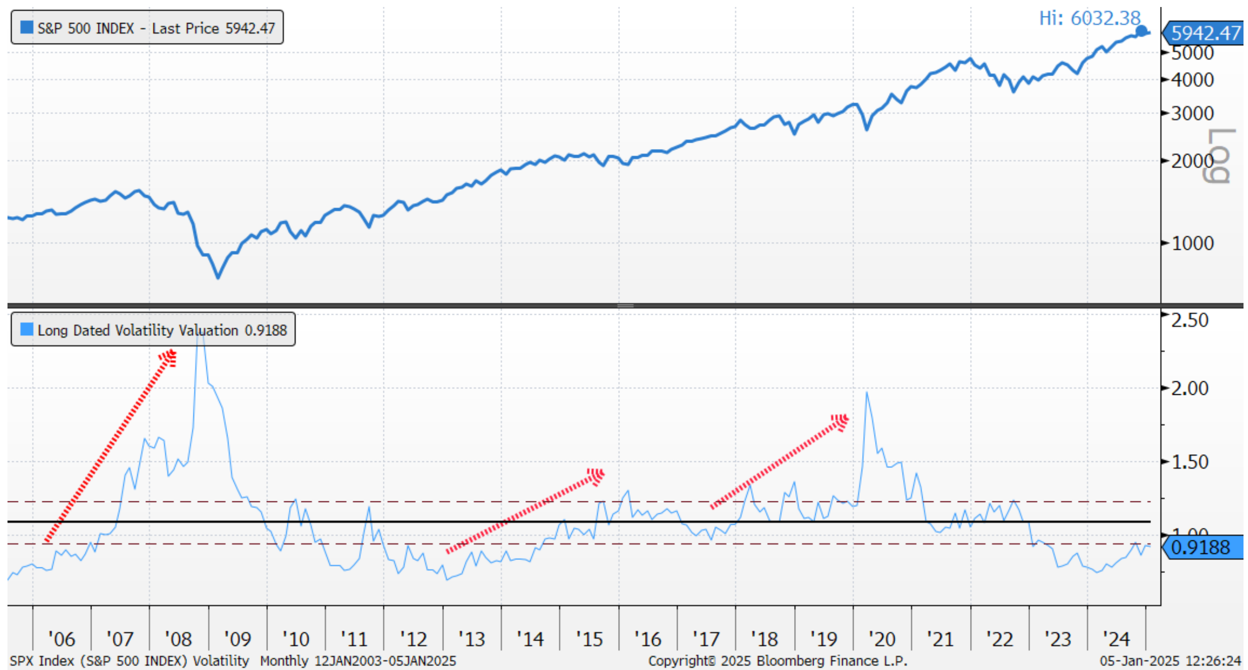


Chart 9 shows that long term volatility has become very cheap with investors unconcerned about buying insurance to protect from downside scenarios.



Strategy

With a 53.3% allocation to Equities, the fund remains underweight its benchmark. 7.9% is allocated to defensive equities which we expect to develop into a market neutral position by shorting cyclical equities in due course. This will reduce equities further.

With just 17.5% in bonds, we are significantly underweight. What we do have allocated to bonds are all in inflation linked bonds. We do see inflation-linked bonds offering very respectable terms and expect to add to this position over time.

While gold is perceived as a defensive asset, its outperformance in the past year means that both silver and gold royalty companies appear more attractive. Furthermore, the underperformance of energy and metals over recent years also offers a respectable valuation versus gold.

The fund has been increasing its allocation to strategies that benefit from increased volatility. Chart 10 shows how this basket has performed over the past 5 years. SMAF has only had small allocations to this strategy historically, but given the outlook, 16.6% of the fund is now allocated to this sleeve of strategy.

Chart 10 – The top is the US Equity Market (S&P 500), the bottom is a basket of strategies designed to benefit from increases in volatility.

Summary

Given the uncertain fundamental Macro backdrop and relatively extreme 'carefree' investor positioning, we are underweight risk assets. This strategy has been employed for several months and we continue to reduce exposures as long as these conditions persist.

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