SOMERSTON
ASSET MANAGEMENT

SOMERSTON TECHNOLOGY FUND

INVESTMENT LETTER No.16 AS AT 30 DECEMBER 2024

Portfolio Objectives: To grow capital over the medium term by investing in a concentrated portfolio of high growth companies and to outperform our reference index 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 20-30 high growth companies.

Performance: The Somerston Technology Fund (US1 Class) fell by -1.8% during the month and rose by +4.4% over the last three months. Our reference index rose by +0.5% during the month and rose by +14.9% over the last three months.

Performance (%) (US1 Class)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2017	6.1	3.9	4.2	4.5	7.7	-1.5	5.8	3.2	-0.1	8.5	3.8	-0.8	**55.1**
2018	12.3	-1.4	-4.1	1.0	8.0	-0.1	0.0	8.9	-1.8	-12.3	1.3	-7.5	**1.7**
2019	12.0	2.9	5.6	6.3	-8.0	8.2	4.1	-3.8	-1.8	3.1	6.1	3.8	**43.6**
2020	6.2	-3.8	-6.6	18.2	9.6	10.0	9.1	8.5	-6.2	-0.7	9.6	5.5	**73.4**
2021	-0.2	1.6	-6.5	8.8	-3.6	11.6	1.0	5.7	-7.9	6.2	-1.5	-5.0	**8.5**
2022	-13.8	-5.5	2.2	-20.2	-6.1	-11.2	13.8	-6.9	-13.0	2.1	4.9	-10.0	**-50.8**
2023	16.7	0.3	11.9	-1.1	13.2	4.6	6.5	-3.3	-6.3	-2.0	16.1	4.8	**76.6**
2024	6.0	7.8	0.8	-5.0	6.8	8.5	-5.3	3.4	2.6	0.0	6.3	-1.8	**33.0**

Total return since 2017: 392.6%

Geographical Allocation

Region	**% Fund**
North America	86.7%
Europe	5.9%
South America	5.9%
Cash and Equivalents	1.4%

Sector Allocation

Sector	**% Fund**
Information Technology	54.5%
Communication Services	20.4%
Consumer Discretionary	19.3%
Financials	2.6%
Health Care	1.7%
Cash and Equivalents	1.4%

Top Ten Holdings

Name	**% Fund**
Nvidia Corp	11.7%
Amazon.com Inc	11.0%
Meta Platforms Inc	10.6%
Alphabet Inc	9.8%
MercadoLibre Inc	5.9%
Microsoft Corp	5.7%
Shopify Inc	3.5%
ASML Holding NV-NY Reg Shs	3.3%
Crowdstrike Holdings Inc	3.0%
Apple Inc	2.8%
Total for Top Ten	**67.4%**

This factsheet shows the performance of Somerson's “Technology Equity Strategy” from 31 December 2014 to 30 November 2020 then the Somerston Technology Fund from its launch on 01 December 2020.

GB1 Class Performance: The Somerston Technology Fund (GB1 Class) fell by -1.9% during the month and rose by +4.3% over the last three months.

Performance (%) (GB1 Class)													
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2017	6.1	3.9	4.2	4.5	7.7	-1.5	5.8	3.2	-0.1	8.5	3.8	-0.8	**55.1**
2018	12.3	-1.4	-4.1	1.0	8.0	-0.1	0.0	8.9	-1.8	-12.3	1.3	-7.5	**1.7**
2019	12.0	2.9	5.6	6.3	-8.0	8.2	4.1	-3.8	-1.8	3.1	6.1	3.8	**43.6**
2020	6.2	-3.8	-6.6	18.2	9.6	10.0	9.1	8.5	-6.2	-0.7	9.6	5.5	**73.4**
2021	-0.2	1.6	-6.5	8.8	-3.6	11.6	1.0	5.7	-7.9	6.2	-1.5	-5.0	**8.5**
2022	-13.8	-5.5	2.2	-20.2	-6.1	-11.2	13.8	-6.9	-13.0	2.1	4.9	-10.0	**-50.8**
2023	16.7	0.4	11.4	-1.2	13.3	4.4	6.3	-3.4	-6.5	-2.0	15.8	4.8	**74.2**
2024	6.0	7.8	0.8	-5.1	6.7	8.5	-5.2	3.3	2.5	0.0	6.4	-1.9	**32.6**

Total return since 2017: 384.5%

* The GB1 class launched in February 2023, performance prior to this date is from the US1 class

Commentary

The Technology Fund US1 Class rose by +4.4% in the fourth quarter and gained +33.0% for the full year.

Top contributors for the year were **Nvidia** (+13.2%), **Meta** (+4.1%), and **Amazon** (+3.9%). Top detractors were **Adobe** (-0.9 %), **Zscaler** (-0.5%) and **Snowflake** (-0.4%)

Activity

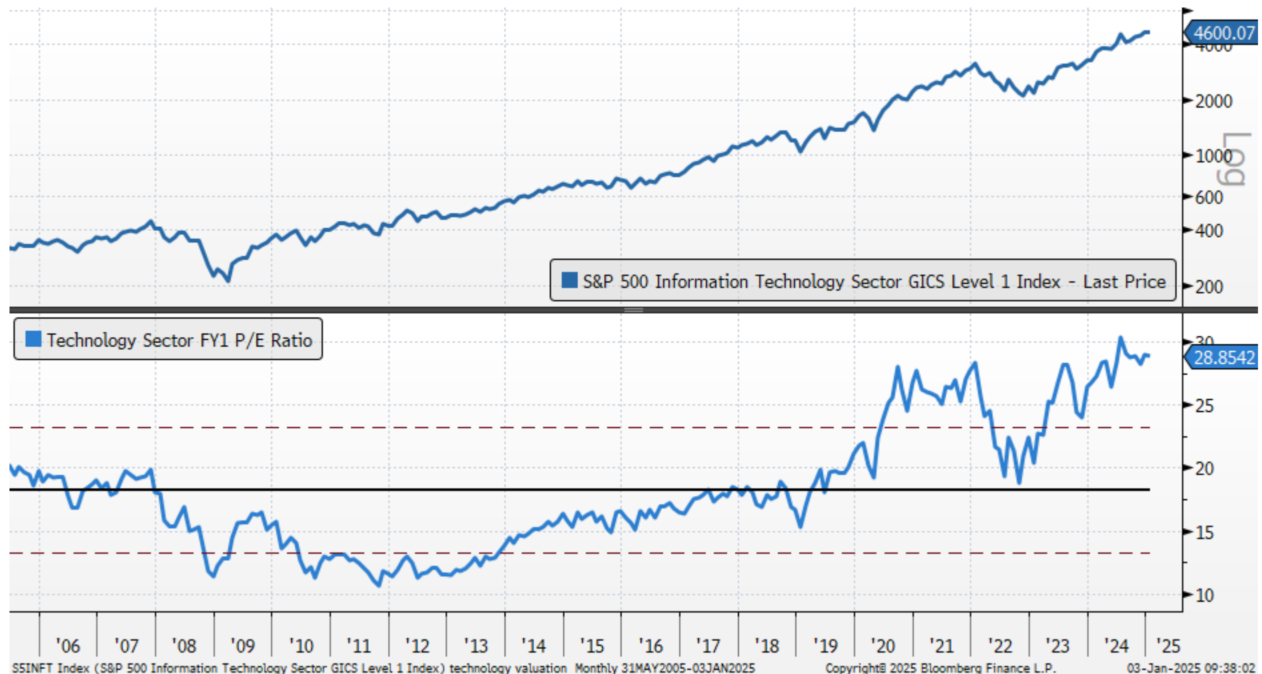
Since our Q3 letter we sold our position in **Airbnb** and **Palantir**. We established new positions in **Applovin**, **Oracle**, **Atlassian** and **Veeva**.

Comments

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.

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



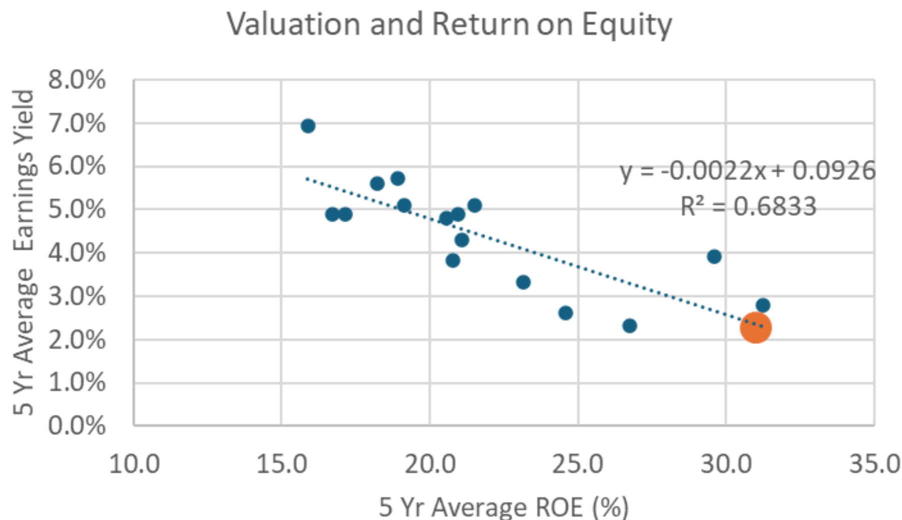
Valuing an investment is as much an art as it is a science. Nonetheless, even within the confines of the mathematics of valuation, the premise that a high P/E ratio versus historical levels equates to 'overvaluation' is flawed unless operating margins, capital intensity and growth remain constant over time. For many sectors these assumptions have held true. However, within the technology sector, for nearly two decades there has 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.

Stocks

The mega caps once again topped the performance table in 2024. The ten stocks that comprise the NYSE FANG+ index delivered a return of 50.5%. Once again, the best performer was **Nvidia** (+171%). The company delivered sales growth of 112% and GAAP earnings per share growth of 144%. The stock trades with a current P/E of 49 and based on analysts' earnings estimates for this year, the stock trades on a P/E of 33 times forward estimates. This is not excessive for a company with 30% + growth and a return on equity of 91%. These impressive financial results have been driven by a series of outstanding product launches. Nvidia's wave of innovation continues to surprise. A fortnight ago, **Nvidia** announced the launch of 'Jetson Orin Nano Super' which provides and exceptional, low cost, low power solution to provide AI solutions locally, without the need for datacentre infrastructure. In any event, the existing products which have been launched in the past 18 months remain, with little competition and in high demand.

Microsoft announced capital-spending plans of $80 billion in fiscal 2025 from $56 billion in 2024. This underscores confidence in near- to medium-term growth projections for Nvidia. As Nvidia's top customer, Microsoft's deployment of full-stack systems dominates these outlays.

Meta has also been a notable performer in 2024. The stock was 65% higher on the back of 53% earnings per share growth. **Meta** is a clear example of the revenue and profitability opportunities from integrating AI to provide solutions to customers. On the impression side of the platform, integrating AI into the feeds has led to an 8% and 6% increase in time spent on Facebook and Instagram respectively. Advertisers are using Facebook's AI tools (Advantage+) to create adverts which has led to a 7% increase in conversion. As Deutsche Bank have commented, "it is becoming increasingly evident that the scaled investments in core AI (and Gen AI) are having a tangible positive impact on advertising performance, driving an ever-widening gap between Meta and its peers". We agree and believe the integration of AI is strengthening Meta's relative position. Much like with our view on software, we believe the big companies are in the best position to benefit and widen their moats. This is because success in the AI space needs three things (1) capital, (2) data, (3) users.

Duolingo was another very strong performer in 2024. From our initial purchase in April, the stock was 60% higher. Duolingo enjoyed revenue growth of 40% and earnings growth of 483%. Daily Average User growth remains well within the 50-60% range and the conversion rate to paid subscribers was solid. 'Duolingo Max' is Duolingo's AI enabled service. It has several features, but the flagship tenant of the service is to video call and converse with the AI Agent, Lilly. There is a perception that Duolingo is good for learning the basics of a language, but less suited to intermediate and advanced learners. Max aims to change this by allowing learners to practise the language in a conversation. While the features are still new, testing by Duolingo has shown that it is used more by English learners (as they care more about conversation) and intermediate/ advanced learners. Max has been rolled out to around 50% of DAUs and pricing is twice that of its standard product providing visibility to growth for next year.

In the second half of the year, we saw a significant rotation from semiconductor stocks to software. We have been particularly impressed with how many software companies have already harnessed AI features to vastly improve their services. Moreover, the significant step change in these AI enabled products has allowed a similar step change in pricing. The most notable development in the software arena has been the introduction of 'Agents'.

Agentforce, is **Salesforce's** new AI initiative. Agentforce was unveiled at Salesforces Dreamforce conference on the17-19th September. It provides a platform for its customers to deploy AI 'agents' that can achieve a range of tasks. For example, at the Dreamforce conference there was a live demonstration of a Sachs customer telephoning to say the cashmere jumper he had bought a few days ago did not fit. The professionalism, courtesy and efficiency of the agent was exceptional, and the 'real life' delivery was impressive.

Satya Nadella, Microsoft's CEO, recently said "SAAS applications, as we know them, are going to be replaced by Agents…. We are moving into the Agent era". Hard coded business logic is becoming increasingly unnecessary. In his interview, he presented the idea that Excel as a user interface to a database may become entirely obsolete. He is essentially proposing that software in all senses is merely a user interface and AI agents are primed to succeed as a more expedient replacement to these user interfaces.

Software as a Service (Saas) has been the largest boom in the past 15 years. A disruption of this industry has wide implications. During the 2010s, evolving your business from licence to subscriptions was the only game in town. Moving from one-time perpetual licenses to recurring subscription revenue was a value accretive move for companies. It made sense for customers, too. Rather than buying version 1.2 of a software product with each update cycle, customers would buy a subscription and have the updates automatically pushed to them overnight. This provided stable recurring revenue for the software providers.

Rather than license sales being the important KPI, the number of ‘seats’ became the predominant KPI for software executive.

Introduction of Agents

With the growth of LLM technology, the discussion of AI-agents has been growing. Agents are ‘digital workers’ that can replace workers in call centres and the like. This poses interesting questions for the SaaS business model:

1. **Seats**: If companies can replace workers with AI agents, the number of seats each customer licenses will be reduced by falling headcount.
2. **Monetisation Models**: SaaS is not a consumption-based model (nor are perpetual licenses). If you pay for Office365 you pay the monthly subscription whether you produce 1 or 100 PowerPoint presentations in a year. This is not the case for agents. The need to inference an LLM for each request which requires processing power and has a very real marginal cost – a largely new concept for a software company!

This revenue model has generated highly attractive, stable, predictable cash flows for Saas companies. Under the Agent concept, the number of users will necessarily fall significantly, and the old, well established revenue model will need to be revised to a potentially more usage based model that will be more unpredictable.

How software executives navigate this shift will be important for both stock prices and economies. It will certainly drive significant efficiency, and we expect the nimble software companies will be able to evolve their revenue models to capitalise of provision of highly efficient services.

Shopify has also been a significant performer with its stock surging 42% in the last quarter. With the logistics acquisition and rapid divestment, and the obvious challenges that went with it, now fully behind the company, it has delivered on its core proposition. Same store sales are robust; Merchant wins are increasing – particularly with larger Merchants, most recently announcing Watches of Switzerland and Body Shop; and international expansion is still embryonic. Shopify is an integrated Retail solutions business, that while designed to enable entrepreneurship, offers an entire retail software solutions – ‘making commerce easier for everyone’. The recent Black Friday performance is notable:

Shopify merchants hit a record **$11.5 billion in sales** over the Black Friday-Cyber Monday (BFCM) weekend—up **24%** from last year with strong sales momentum…

From early Friday in New Zealand to late Monday in California, **76+ million customers** around the world bought from brands powered by Shopify.

The shopping frenzy peaked at **12:01pm** EST on Friday when sales reached a dizzying **$4.6 million per minute**.

Crowdstrike hit the news in July with its global outage for Microsoft applications. Its share price sank 50% in four weeks. This incident, while unfortunate, was not a breach nor was it a glitch in its core services. As a consequence, we held our position. While we will know the true impact of customer retention in the coming quarters, we have been very impressed with managements style of dealing with the crisis. They have been honest, communicative and proactive. As a shareholder, we are also very keen to see if their strategy of providing extended services to their affected customers as a goodwill 'freebie', will in fact lead to these customers choosing to buy these services at the end of the free period and thereby, becoming more closely aligned to Crowdstrike in the future. It is pleasing to note that its share price has recovered all lost ground from the reaction in July.

Lastly, we should bring attention to the Department of Justice activity. The DOJ are furiously working on resolving what they see as anti-competitive behaviours. Alphabet is the most prominent and first in the crosshairs, but all the large Technology companies have their own battles to fight. These are complex cases. For many, while potentially 'anti-competitive' practises are being employed, the services are often best in class and they are in customers best interests.

Bloomberg recently reported that the DoJ is looking to ask the judge to force Alphabet to sell the Google search engine as remediation.

In response, Kent Walker, president of global affairs and chief legal officer at Google and Alphabet, posted a blog describing the DoJ's proposals as "staggering", "interventionist" and micromanagement of Google search.

"The DoJ chose to push a radical interventionist agenda that would harm Americans and America's global technology leadership," he said. "DoJ's wildly overbroad proposal goes miles beyond the Court's decision. It would break a range of Google products – even beyond Search – that people love and find helpful in their everyday lives."

The Somerston Technology Fund has harnessed some incredible growth themes in the past few years and the pace of innovation and change will provide excellent opportunities in the years ahead.

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