

Cerno IQ

The Cerno Capital Investment Quarterly

Issue number 2

Allocation view:

Positive ▲

Negative ▼

Neutral ◇

Equities		
US	▼	We remain of the view that the US stock market's current valuations indicate poorer returns over the next 5 to 7 year period. Other than within the Cerno Global Leaders Strategy detailed below, our sole direct investments are via niche exposures to US banks and merger specialists.
Europe ex UK	◇	QE apart, European macro variables have begun to indicate a bottoming out of eurozone's economies. The fall in the oil price is, to our minds a clear benefit. Marginal improvements are better news for Europe than the US and within markets, European cyclicals are measurably better value on a relative basis than US cyclicals.
UK	◇	The UK economy is on a strengthening path, however the General Election presents a possible hindrance. The political overhang is undeniably large as the public is resentful and the parties are riven. To foreign investors, the UK now screens as a political risk.
Japan	▲	Our conviction is that Japan is a micro story and the key variable to watch is the domestic profit cycle. In truth, Japanese corporate prospects have been on an improving path for several years with a new found focus on economic value add, dividends and buy-backs. The improving trend in corporate governance and the promulgation of the JPX Nikkei 400 supports this. Valuations continue to appeal on a global basis.
Asia ex Japan	▼	History relates that the best time to enter Asian equity markets is when the price to book value rating is below 1.5x and the US dollar is weakening. Neither is the case now and the strengthening USD acts as a garrotte around the neck of many of these economies. The notable improvement in India's current account acts as a buffer for investors and we are long term positive here.
GEM ex Asia	▼	The BRICs are troubled, each with its own issues, none quickly resolvable. The most pronounced trend of the 1990s and early noughties was the outperformance of LATAM, a process that is now decisively in reverse. We continue to be concerned about the deleterious effects of a strengthening dollar and the prospect of higher US rates on most of these financial markets.

Fixed Income, FX, Macro & Alternatives

G10 Sovereign Credit	▼	Yields to maturity are tempting only to ardent deflationists. Current prices reflect excess demand for "risk free assets". Nominal yields are very poorly placed for any change in inflation expectations. The fall in the oil price has acted as a purge in this regard. Future moves may well be inflation positive. We cannot rid ourselves of the suspicion that bonds are mispriced.
EM Bonds (Sovereign & Corporate)	▼	The last 10 years, issuance has been very strong and EM bond markets have very poor liquidity attributes. The open ended nature of funds in this sector suggests that they are at risk from a turnaround in sentiment. This could come about from further strengthening of the USD and/or a rise in US rates.
China Currency	▼	Chinese real GDP increased by 7.4% in 2014, the slowest rate of growth since 1990. The official manufacturing PMI remains below 50, the property market is in decline and sentiment weak. With the authorities unable to significantly loosen monetary or fiscal policy, one of the few remaining policy tools is to allow the currency to weaken. This is in stark contrast to the US, where employment levels are suggesting that interest rates need to rise and economic prospects are improving.
FX and FI Macro	◇	Forward looking return expectations for macro practitioners must surely fall. Yield curves remain subdued and it is very hard to bet against Central Banks when they are prosecuting QE. This drives investors into currency trading where there has been one "fat pitch" in the strengthening US dollar. Crowding into the USD is now a significant risk.
Cash	▲	Cash is an underappreciated, if not undervalued, asset class at this juncture. The challenge of accessing properly underwritten returns in frontline asset classes will conspire to improve the case for cash.

Cerno Global Leaders Strategy

Securities added to approved list this quarter

We invest a portion of portfolios in the equity of companies who are leaders in their respective industries. Invested companies possess wide economic moats and are able to fend off competition for an extended period of time to generate above average returns. They also offer a margin of safety in times of distress. We apply a quantitative screen based on size and profitability. We then select according to 7 key criteria and invest subject to valuation. Below are the securities added to the Cerno Global Leaders Strategy in the most recent quarter.

Reckitt Benkiser	Reckitt Benkiser possesses a strong brand portfolio of over the counter health remedies, personal as well as home hygiene products, holding market leadership positions in its niche product groups. The company has a strong track record of innovation with new product launches accounting for 30% of current revenues. Management has proven strong capital discipline over many years and has consistently increased value for shareholders in the form of capital and dividend growth.
Ingenico	Ingenico is a leading supplier of payment technologies and solutions (hardware & software) worldwide. The company undertakes a high level of R&D, leveraging the global trend towards electronic/mobile payments and e-commerce. In particular, it is diversifying away from hardware (POS machines) towards software (transaction services) in an effort to capture a larger portion of the payment ecosystem. The growth in the latter enables the firm to become a one-stop solution for clients across the entire payment value chain.
Amadeus IT Holdings	Amadeus IT Holdings is a provider of distribution and IT services for the travel industry. The business is highly cash generative. Revenues are earned by clipping a small percentage of every transaction processed via its network. Its technology is second to none after years of reinvested earnings spent on building its hard and software. The two offerings are highly synergistic, benefitting from a network effect. As more customers adopt, Amadeus reinforces its leadership position.
Assa Abloy	Assa Abloy (AA) is the world's leading manufacturer of security locks and automatic doors. Few truly global players exist and AA has the largest installed base worldwide. Its products have a wide applicability and customer base. Its intellectual property is highly patented and it embraces new technologies with investments into the fast growing segment of secure identity solutions such as access control via biometric readers, government ID card encoders and readers as well as mobile phone security.

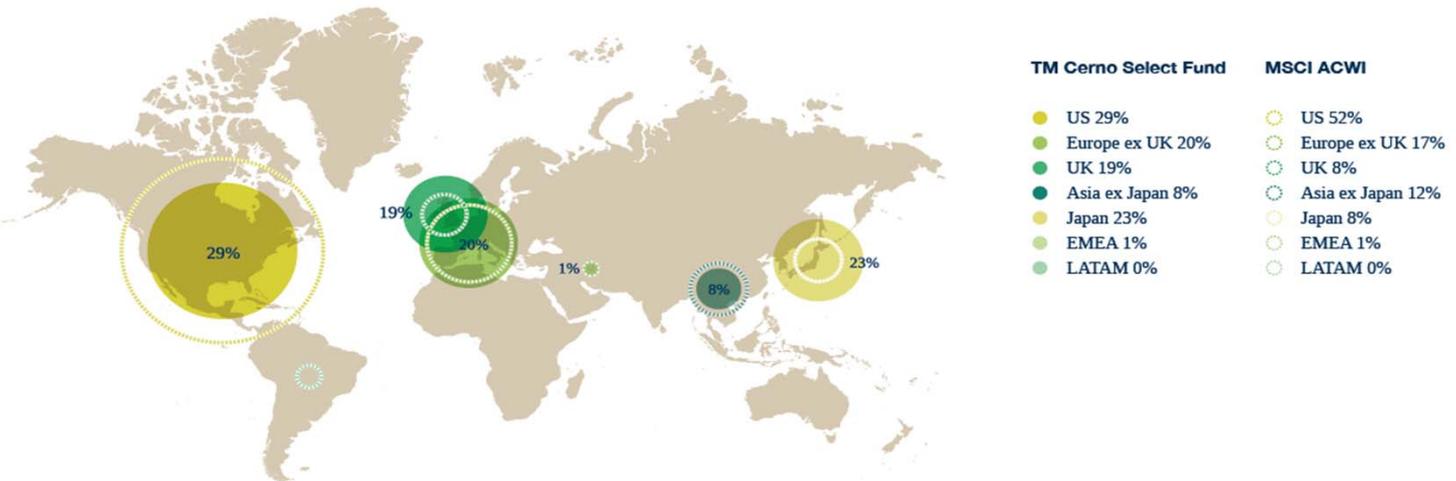
Explanation of the below: the charts below depict the geographic allocations of the equity portion of the TM Cerno Select Fund. Where the disks are wider than the circles, we are overweight and vice versa. Equity allocations accounted for 60% of the fund's net assets at the time of production. The percentages below will add to 100% as they are calculated as a percentage of the equity allocation. Therefore, for example, an equity weight of 30% in the below graphic would correspond to 18.9% of net asset value of the fund (63% x 30% = 18.9%) . Select weights are compared with MSCI All Country World Index and the IMA Flexible Sector.

Chart 1: Select versus IMA Flexible Sector Averages



Source: Cerno Capital, Morningstar

Chart 2: Select versus MSCI ACWI



Source: Cerno Capital, MSCI

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