

Cerno IQ

The Cerno Capital Investment Quarterly

Issue number 3

Allocation view:

Positive ▲

Negative ▼

Neutral ◇

Equities		
US	▼	We back the general view, that the recent softness in economic data is a temporary phenomenon, whilst disputing longer term growth expectations. Professional investor sentiment toward the US has softened, a direct consequence of the broad market's underperformance within the global universe in the year to date. In the process, market breadth has waned and key indicators have weakened. The outperformance of Financials is a classic later cycle development.
Europe	◇	Whatever the outcome on Greece, Europe has every chance of securing outperformance versus US equities over the full year. However, despite the obvious risks pertaining to the euro, European equities are not meaningfully cheap versus their global peers. There remains some relative value in deeper cyclical sectors but this requires a high measure of optimism regarding the recovery of European earnings.
India	▲	We believe in the structural domestic consumption growth story in India. Our view is based on favourable demographics and the country's drive for financial inclusion: a growing middle class, downwards trending dependency ratio and a largely unbanked society. Its current account deficit has shrunk to -1.4% of GDP (2013: -2.6%), as it benefits from the lower oil price. We favour the lower market cap range as it offers exposure to the attractive domestic growth story.
Japan	▲	The balance of evidence continues to decisively point to recovery in key economic fundamentals, represented by a tightening of the labour market and rises in wages, office rents and Tokyo house prices. All indicate a recovery in inflation expectations, even if headline inflation remains below target. The key investment metric, to our minds, is the continued recovery in corporate ROE from a low base. We believe, weakness of the yen will not be as significant going forward.
China	▼	China's stock markets have been strong against a persistently weak economic picture. Several aspects of this disturb us and capital flight now looks to be persistent. Disinflationary conditions appear to have become embedded and that points to weaker corporate fundamentals. When you consider the increased debt load, which helped sustain growth but has now ceased to do so, China has some severe issues that, in extremis, could challenge the strong RMB thesis.

Fixed Income, FX, Macro & Alternatives

G10 Sovereign Credit	▼	We believe long term yields have recorded generational lows, pushed there by excess demand for notionally risk free investments and gargantuan rises in bank reserves. The process of scaling to higher levels, more appropriate for longer range growth and inflation expectations, is likely to upset Emerging credit flows and prices.
Policy Interest Rates	◇	Although within policy committees caution still prevails, conditions are substantially in place for the first increase in Fed Fund rates in the US and UK Base Rates. Continued momentum in employment data, supported by increases in earnings, is the key variable. Our base case is that the upward path of interest rates will be very shallow as economic growth, on balance, will tend to disappoint and inflation will remain quiescent.
USDGBP	◇	Overlay activity in this key currency pair remains very active and hotly argued. By our thinking, GBP was held back by political overhang pre the 7th May election so it should not be a surprise that the generally firm (and firmer than the US) tone of UK data is rewarded by a retracement of pre-election weakness. Whilst we would not deny the possibility of a resumption of USD strength, we think it will be stronger against other pairs than against GBP.
Bond Market Liquidity	▼	Although we would condone the decision of bond investors to raise lines of credit to meet enhanced redemption flows, these are largely cosmetic gestures brought about by regulatory pressure. Market liquidity conditions are very poor indeed and a rising dollar alone will be sufficient to cause massive disruptions.
Cash	▲	In a world where the traditional benefits of a bond and equity mix will not be commuted, cash has become an important allocation once more. Cash provides a buffer against the risks of owning either overpriced or fully priced financial assets and provides optionality to reinvest at better prices.

Cerno Global Leaders Strategy

Securities added to portfolios 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 Benckiser	Reckitt Benckiser possesses a strong brand portfolio of over the counter health remedies, personal and home hygiene products. The company holds market leadership positions in its niche product groups and has a strong track record of innovation with new product launches accounting for 30% of current revenues. Management has shown strong capital discipline over many years and has consistently increased value for shareholders in the form of capital and dividend growth.
Coloplast	Coloplast is a global healthcare equipment provider specialising in ostomy and continence care. The company operates under a favourable oligopoly environment and has a sticky customer base due to the high social risk associated with its products. It is highly profitable and holds no debt. The company provides strong patient support, builds long-term relationships with healthcare professionals and is geared towards the ageing population trend.
Shimano	Shimano is a Japanese company with its core businesses in cycling componentry and fishing gear. The company dominates the bicycle parts industry, holding over 50% market share. Its fishing gear business also commands strong brand equity globally. Given the continued growth of the bicycle market, Shimano's earnings prospects are healthy considering its dominant market share, favourable industry structure (oligopoly), product competitiveness and ongoing efforts to boost profit margins.

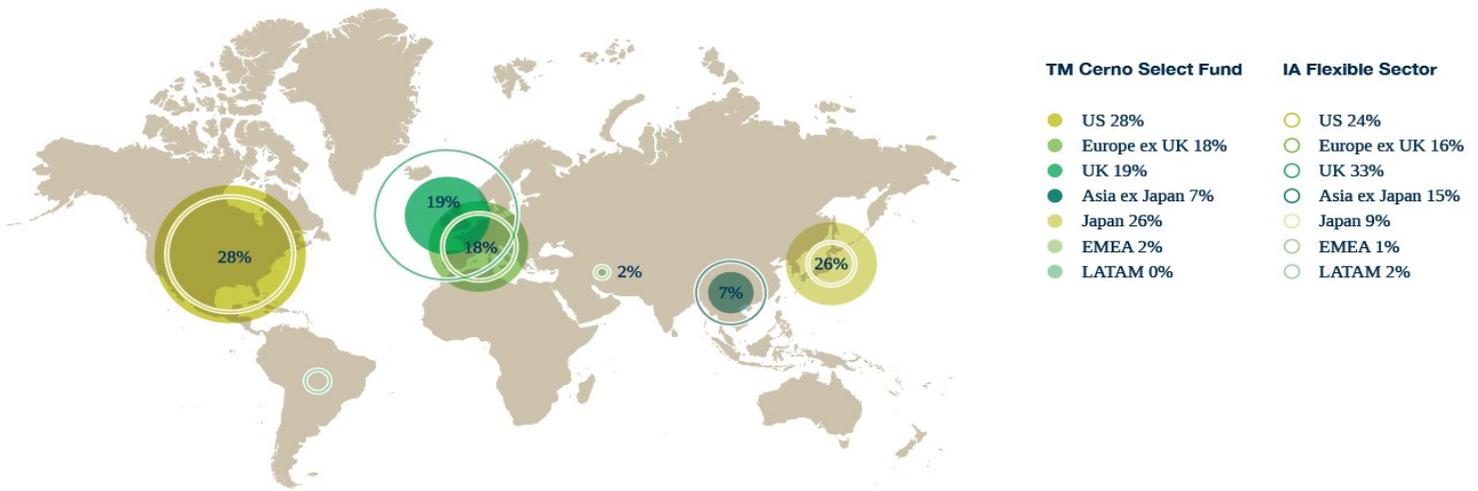
Cerno Global Leaders Strategy

Securities added to approved list this quarter

Novozymes	Novozymes is a global leader in bioinnovation. It produces enzymes which find application in a variety of products including detergents, foods, alcohol, pharma ingredients and biofuels. Novozymes controls 48% of market share in its product group whilst also operating in an oligopolistic industry structure. It is a highly innovative company with over 7,000 patents and 14% of revenues is spent on R&D annually to reinforce market leadership. The business is highly profitable and cash generative.
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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 68% 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 20.4% of net asset value of the fund (68% x 30% = 20.4%). Select weights are compared with the MSCI All Country World Index and the IA Flexible Sector.

Chart 1: TM Cerno Select versus IA Flexible Sector Average



Source: Cerno Capital, Morningstar

Chart 2: TM Cerno Select versus MSCI ACWI



Source: Cerno Capital, MSCI

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