

# Cerno IQ

The Cerno Capital Investment Quarterly

Issue number 4

Allocation view:

Positive ▲

Negative ▼

Neutral ◇

Global Equity Allocation	
Emerging vs. Developed	◇ Value is beginning to appear in Emerging Markets. Many EM currencies have already devalued. Headline valuations are interesting, but mask regional differences. During times of distress, Asian equities historically traded at book value, but on aggregate still trade on a price to book ratio of 1.3. We also highlight the general deceleration in growth and profits across the region.
Europe vs. US	▲ Optimism towards Europe requires a belief that earnings will catch up. With Europe, the picture is mixed: corporate earnings in the UK and Nordics have recovered whilst the others continue to lag. Looking at valuations, cyclical, domestic oriented businesses are more compelling than quality franchises, which already trade at similar levels than their US counterparts.
Japan	▲ Japanese equities remain compelling, despite patchy economic data. We construct our thesis on a bottom up basis and see Japan's current return on equity (ROE) at 9% as a staging post on the way to higher levels of profitability. We continue to expect profit margins to expand and corporate tax rates to decline. The virtuous cycle of rising dividend payouts and share buy backs will continue.
Style Trends	◇ Deep value shares have fallen further than any other styles this year, primarily because of <b>weakness in the energy and commodity sector</b> . Domestic value plays have fared better, witness financials and property in general. For the next 12 months, a key allocation decision will be the allocation between styles and how to blend global growth and value, international and domestic.

Fixed Income, FX, Macro & Alternatives	
Policy Interest Rates	▼ The commentary emanating from the US FOMC poses issues. If the chief reasons for delaying rate rises lie "abroad", the Fed will now have to extend its expertise well beyond the US and it too has become a China watcher. As nominal rates reside at zero, any further deflation will cause real rates to rise and this threatens consumption patterns. <b>We continue to hold to a less worrying prognosis summarised as: low growth, long cycle.</b>
Chinese RMB	▼ On a real effective exchange rate basis, the RMB value has deviated by more than two standard deviations above its mean. It is not the probability but the possibility of further devaluation and the resulting payoff that make a RMB short attractive. <b>With the August 11-14 experiment behind it, China's rulers will not wish to reach for the currency lever any time soon. However, they are likely to at a later stage if growth craters.</b>
Gold	◇ Since the advent of QE, we have been unimpressed by arguments for higher inflation. We view deflation as a greater threat, although we attach a low probability to this outcome as well. <b>Gold may act as a hedge against exhausted monetary policies and has typically been strong in times of high market volatility.</b> Gold is currently trading at 5 year lows and speculative interest has declined.
Cash	◇ <b>We wish to remain constructive towards our identified themes, whilst flexible in our overall portfolio settings.</b> Throughout 2015 and until the time of writing this has entailed holding a portion of assets in cash while value emerges.

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.

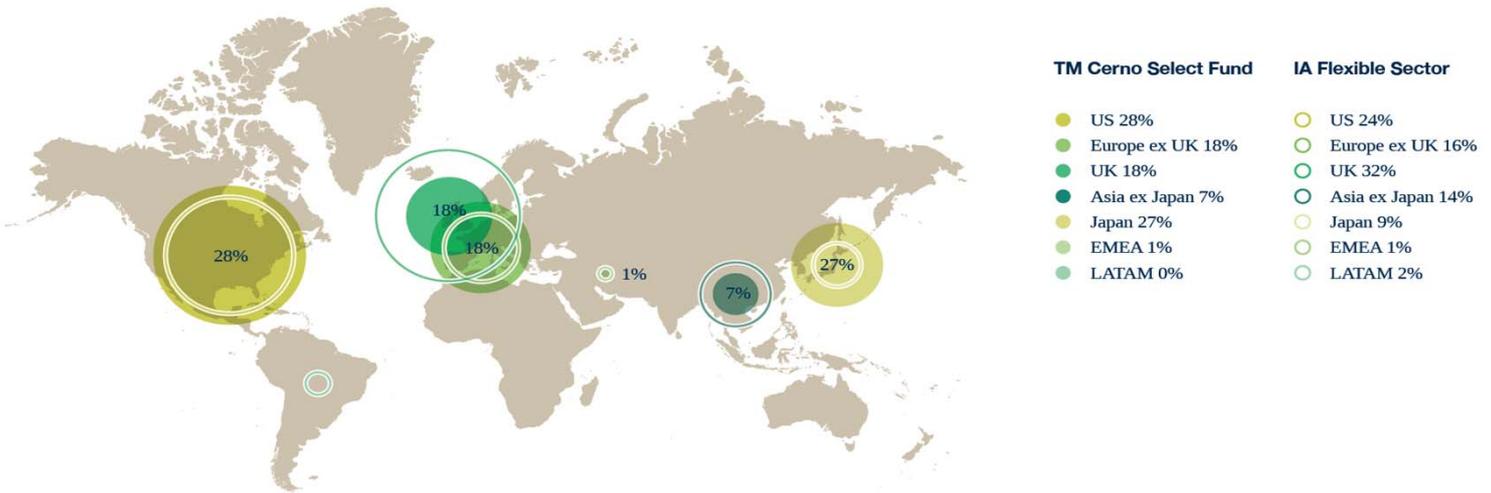
Assa Abloy	<ul style="list-style-type: none"> <li>Assa Abloy is the <b>world leading manufacturer of security locks and automatic doors</b>.</li> <li>The company has the <b>largest installed base world wide</b> and its products have wide applicability and a diversified customer base.</li> <li>It <b>embraces new technologies</b>, investing in the growing area of secure identity solutions; its products are <b>highly patented</b>.</li> </ul>
Givaudan	<ul style="list-style-type: none"> <li>Givaudan is the <b>largest global manufacturer of flavours and fragrances</b> with a market share of 25%.</li> <li>The company operates in an oligopolistic environment <b>with high barriers to entry</b> and a relatively sticky customer base.</li> <li>It is well positioned to <b>benefit from a growing middle class</b> and rising demand for packaged foods and healthcare products.</li> </ul>
Novozymes	<ul style="list-style-type: none"> <li>Novozymes is the <b>global leader in bio innovation</b>, controlling 48% of the market.</li> <li>Enzymes produced find <b>wide application</b> such as in detergents, foods, alcohol, pharma ingredients and biofuels.</li> <li>The company spends 14% of revenues per annum on R&amp;D to reinforce its market leadership <b>and holds over 7,000 patents</b>.</li> </ul>

Cerno Global Leaders Strategy Securities added to approved list this quarter

3M	<ul style="list-style-type: none"> <li>3M manufactures a <b>wide portfolio of industrial and consumer products</b> including brands such as Post-it®.</li> <li>3M is <b>highly innovative</b> and leverages its technological core competencies across the firm to achieve economies of scope.</li> <li>It is a <b>high margin business</b> with a robust balance sheet and a proven creator of shareholder value.</li> </ul>
Luxottica	<ul style="list-style-type: none"> <li>Luxottica is <b>leader in the design, manufacturing and distribution of luxury, fashion and sports eyewear</b>.</li> <li>The company holds a <b>strong portfolio of proprietary brands</b> (RayBan, Persol, Oakley, Sunglass Hut) and licenses others.</li> <li>Luxottica <b>controls the entire value chain</b> and therefore benefits from an operational advantage and economies of scale.</li> </ul>
Rockwell Automation	<ul style="list-style-type: none"> <li>Rockwell is the <b>largest pure play in industrial automation and control processes</b>.</li> <li>The company's competitive advantage is its <b>compatibility with 3rd party systems</b> and its <b>vast installed base</b>.</li> <li>Rockwell is a <b>highly cash generative business</b> with strong free cash flow conversion and high profit margins.</li> </ul>

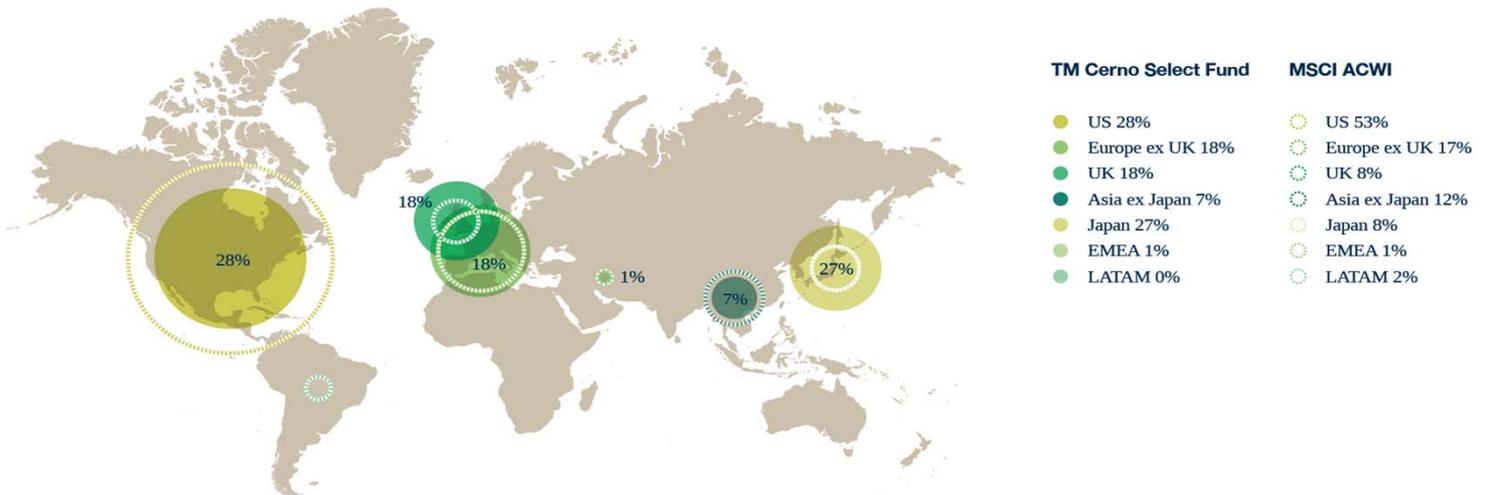
**Explanation of the below:** the charts below depict the average geographic allocations of the equity portion of the TM Cerno Select Fund over a 3 year period. Where the disks are wider than the circles, we are overweight and vice versa. Equity allocations accounted for 55% of the fund's net assets 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 16.5% of net asset value of the fund (55% x 30% = 16.5%) . 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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