CERNO CAPITAL

February 2016

Cerno IQ

The Cerno Capital Investment Quarterly — *Issue number 5*

Allocation view: **Positive** ▲ **Negative** ▼ **Neutral** ◇

Global Equity Allocation

Emerging vs. Developed	◇	Treating the broad emerging market complex as one block is increasingly dangerous given that headline valuations suggest significant opportunity relative to developed markets. The headline valuations are distorted by the commodity producing countries and are also a consequence of aggregate declines in profitability. Increasing levels of leverage are a further threat. Areas of opportunity exist, for example India is helped by declining energy prices with significant opportunities for the investor in domestically focused businesses.
United States	▼	Profits underpinning US equities have benefitted from ultra low interest rates, quiescent labour, low energy prices and efforts to improve margins. Share prices and valuations have clearly been boosted by QE and buy-back activity. Valuations are sufficiently full that any loss of momentum, or outright falls in earnings will be met by significant price corrections. Internal market dynamics of the US markets deteriorated last year with the main indices being driven by progressively fewer stocks. Sector participation was selective. Expectations in the US have furthest to travel in this bear market.
UK Dividends	◇	The UK equity market remains attractive to the equity income investor; however a highly selective approach is required given the pressure on cash flows created by lower commodity prices. High profile dividend cuts and restructurings have already occurred (Anglo American and Glencore for example). Yields for the Oil majors suggest significant doubt over their ability to withstand prolonged extension of the current oil price environment without cutting dividend payments. Oil and Gas service companies and engineers also face a difficult operating environment and optically high yields should be treated with caution.
Style Trends	◇	Cyclical stocks have been underperforming defensives globally as a consequence of the turmoil in the commodity sector, in particular this divergence has reached extreme levels (-2SD) in both Europe and the Emerging Markets, and has surpassed -1SD in Japan. The only region where this trend is still benign is in the US. Value has underperformed growth for the longest streak in history, and recent market volatility means that low beta defensive stocks will perform better than their high beta counterparts.

Fixed Income, FX, Macro & Alternatives

Fed Policy	▼	In its most recent policy statement the Fed offered little but a nod to financial market conditions, tacitly orienting towards market expectations that there will be no more interest rate increases this year. What a difference a month makes. Key indicators to watch in the near term are employment and wages trends, industrial ISM, corporate bond spreads and volumes in the housing and auto sectors. The stock market and industrial sectors are already pointing to risks of a recession however policy makers will be hesitant to flag these risks.
Chinese RMB	▼	Having pushed the currency down to the weaker end of its recent REER range, the Chinese authorities are on pause. The main problem is that China is pursuing inconsistent objectives with regards to the opening of its capital account versus control, stability versus competitiveness, its role in the world economy and its domestic political prerogatives. Ultimately, economic logic will hold sway and this increasingly points to a larger, one step depreciation of the RMB. Current policy to creep the currency down makes no sense as it encourages capital flight and requires reserves to be burnt in braking the adjustments. Reserves may be needed to recapitalise the banking sector which is woefully under provisioned.
Gold	▲	Until recently, gold faced two headwinds: the prospect of normalisation of US interest rates and the strong dollar. At this stage in the cycle we are more drawn to gold's ability to counter financial stress as we see the prospects of stress in several areas. The financial risks in today's world are multi-polar. We regard our current allocation to gold - which was initiated in 4Q15 and added to in January – as an element of our currency mix. In a generically low return world, where large intra-regional stresses exist, gold can play a role in a defensive currency mix.
Cash	◇	Cash has played an increasingly important role within Cerno portfolios in the past few months. Cash is a defensive asset in all circumstances and an asset that increases in value in a deflationary environment. We envisage 2016 as a year where playing defence is important and containment is the objective. We actively allocate between currencies within the context of the cash balance and current holdings consist of a mixture of GBP, USD, JPY and gold.

Cerno Global Leaders Strategy: Focus on Healthcare

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.*** *In the section below we will introduce our healthcare holdings, which represents the largest sector within our Global Leaders Strategy.*

Johnson & Johnson	• J&J is a leading global pharmaceutical, medical devices and consumer goods conglomerate with a highly diversified revenue base • Its scale, breadth of product offering, brand equity and strong R&D capabilities anchor its wide economic moat • The group benefits from intellectual property in drugs, switching costs in devices, and strong brand power in the consumer segment • Solid cash flow generation has enabled the company to increase dividends for the past 50 years and make accretive acquisitions
Novo Nordisk	• Novo Nordisk is a pioneer in diabetes treatments and claims the largest piece of the global US$40bn market (27%) • The company has a long presence (85yrs) in the business, with superior offerings that can maintain pricing power • The oligopolistic market structure and Novo's innovative pipeline will serve to maintain Novo's competitive advantage in the long-term • The prevalence of diabetes is expected to climb in the future driven by an increasingly obsese and aging population (6% growth p.a.)
Sonova	• Sonova is the largest global producer of hearing instruments, with 25% share of a market controlled by six major players (~90% share) • It enjoys a growing patient pool stemming from an aging population, increasing noise pollution and low penetration in both DM & EM • Around 46% of their products lie in the high-end spectrum, which is less price-sensitive and less prone to commoditisation • The firm's key advantage lies in its technological prowess and sticky relationships with audiologists who drive purchasing decisions
Coloplast	• Coloplast is a leader in ostomy and continence care with a dominant position in Europe and gaining traction in the lucrative US market • It operates under a stable oligopoly, and is poised to benefit from the long-term aging demographic tailwind • It focuses on products that can profit from innovation and have been strategically discarding commoditised low-tech lines since 2005 • Their patient-centric approach, coupled with a reputable brand, forms a sticky customer base as their products carry high social risk
Zimmer Biomet	• Zimmer Biomet is an orthopedics specialist with a dominant position in hip and knee reconstruction, among other areas of expertise • It benefits from innovation (4.5k patents), high switching costs (surgeon loyalty, steep learning curve), and aging baby boomers • The industry operates as an oligopoly with a few large players, and has undergone considerable consolidation in recent years • Competition is generally stable, but Zimmer is focused on integrating the recent Biomet merger, which may cause short-term concerns
Fresenius Medical Care	• Fresenius is a leader in dialysis care, offering products and services along the entire value chain for patients with chronic kidney failure • A duopoly sees the top two players controlling 63% of the US dialysis market, however, globally Fresenius is the clear leader • The company runs a large network of diaylsis clinics and is the largest dialysis equipment provider with 33% global market share • Its vertically integrated operations allow the company to enjoy economies of scale while enabling it to protect market share

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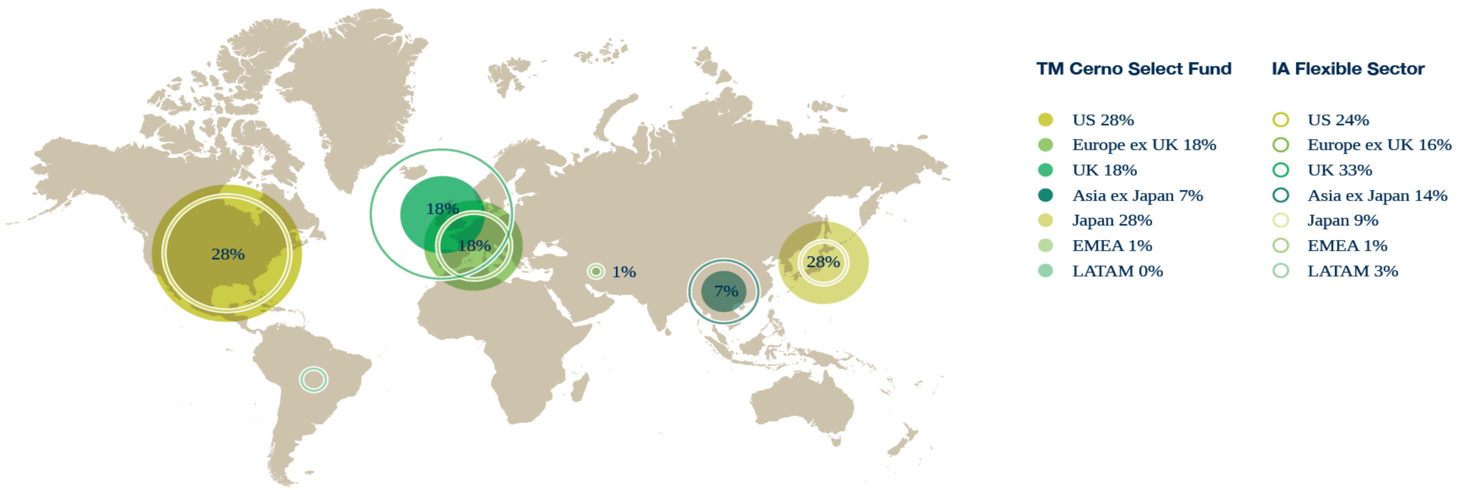
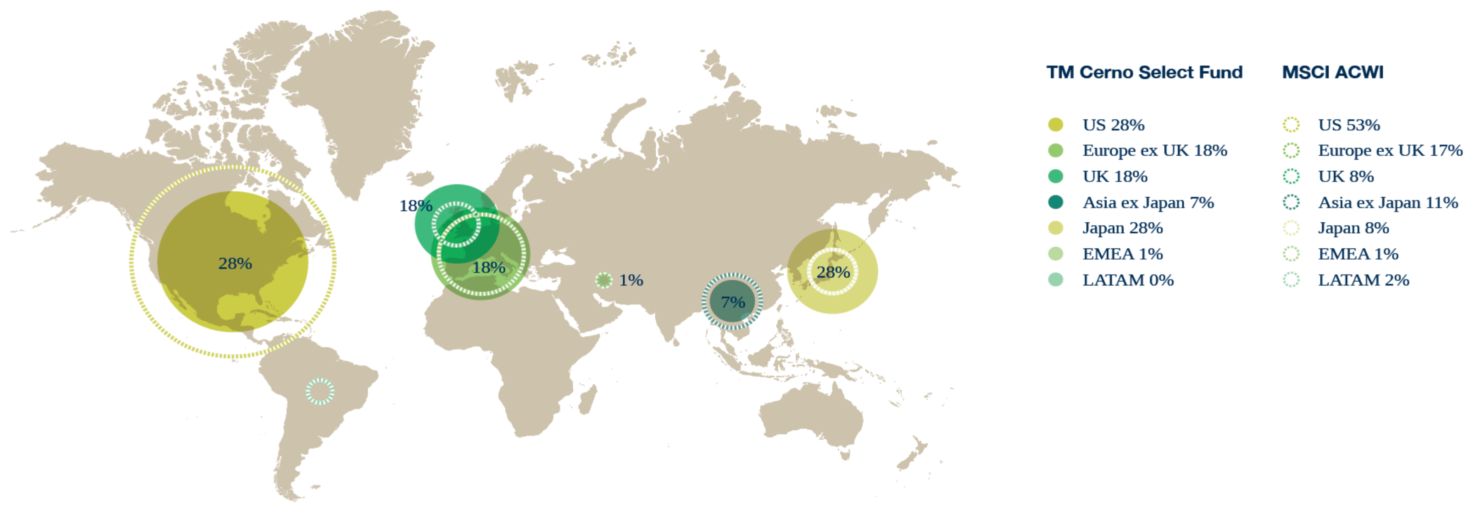
Explanation of the below: *the charts below depict the average geographic allocations of the equity portion of the TM Cerno Select Fund over a 3 year period. Where the disks are wider than the circles, we are overweight and vice versa. Equity allocations accounted for 33% of the fund's net assets at 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

Cerno Capital Partners LLP 34 Sackville Street, London, W1S 3ED
Telephone +44 (0) 20 7036 4110 Facsimile +44 (0) 20 7036 4122 Website www.cernocapital.com

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