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Investment Letter dated 22nd December 2016

2016 will go down as a treacherous year for punditry and predictions. Although many will have heard stories of friends of friends who successfully bet on Leicester for the league, Brexit and Trump, very few will have held this ultimate long-odds trifecta.

The Sun newspaper reported that £1 on this would have yielded £4.5mn. *Could have* would be more accurate as the calculation is based off the longest odds quoted on these three events by Ladbrokes, none quoted contemporaneously.

And, as even a casual gambler will know, trifectas operate by multiplication of odds so it was the 5000/1 on the Foxes that really delivered. Perhaps the only surprise within these numbers was that there ever were odds as wide as 5/1 quoted on Brexit, an event that was pregnant with possibility from the moment David Cameron announced the referendum in what is termed his *EU speech at Bloomberg* on 23 January 2013.

Most of us will have both voted on at least one of the recent seminal polls and offered casual or guarded or deeply felt predictions on the overall results. Some have gone as far as to reshape their personal futures in fear of, or as a consequence of the results. Cabins in remote parts of Canada have found their moment.

The wider relevance to investing in general and investing in public markets in particular is to point out to us the degree to which we overestimate our ability to predict the future. During the training of analysts and portfolio managers, insufficient time is spent in identifying where the horizons of knowledge lie and what it is reasonable to believe.

The relevant subject of study in this area is called Behavioural Finance and it consistently ranks as analysts' favourite module on training courses, for those lucky enough to be so trained. Conscious study makes sense as we are all frail in this regard. Wikipedia features a long list of common errors. https://en.wikipedia.org/wiki/List_of_cognitive_biases

Branches of Psychology have plenty to offer in this regard. Recent applications of Neuroscience have different things to say on relevant areas.

In his book, *Thinking Fast and Slow*, Daniel Kahneman describes the actual not the theoretical or psychologically ideal processes that take place in our brain as we make sense of our environment and make decisions. It turns out that we all possess more than one brain or, more accurately, two

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overlapping and interrelated cognition machines. <https://www.amazon.co.uk/Thinking-Fast-Slow-Daniel-Kahneman/dp/0141033576>

This subject area informs the study of what scientists call “decision making in conditions of uncertainty”: the very acme of what investment management entails.

2016 threw up plenty of that and 2017 promises more. How then to negotiate the prevailing uncertainties?

Part of the answer is to bolster belief in those trends that are currently extant that it is reasonable to believe will continue for the next few years. There is, to our minds, no better investment than in well managed, sensibly financed businesses operating in attractive industries.

The Cerno Global Leaders Strategy invests in an array of these companies spanning, for example, age related healthcare, industrial process calibration, international payments and logistics, integral material supplies and perennial consumption.

Inflation, which has been abeyant during the past 20 years as the global workforce grew, is edging itself back into the system. The consequences cut across asset classes and requires a set of answers. This can be theoretical in the case of gold, mechanical in the case of index linked bonds or contractual as in the case of long term infrastructure projects where the operator is incentivised and protected by price rises tied to inflation.

Areas to avoid investment would be those where it is becoming increasingly obvious that disruption is likely to take place. To our minds it is the energy and auto sectors where the greatest change is coming with the coming decline of the dominant role of fossil fuels. Given their scale and installed bases, the large, incumbent players will struggle to effectively resist these changes.

We would like to make an announcement to close the year, unrelated to investment. We have joined with Getty Images in co-funding a paid internship for a female sports photographer to join the professional staff at Getty Images, covering major sporting events. It is our hope that the winning candidate, selected through open competition, will eventually join Getty on a full time basis. More details of this collaboration with Getty Images, Women’s Sport Trust and the support of Canon can be found at: <http://cernocapital.com/cerno-capital-getty-images-sport-photographer-internship-2017/>,

God rest ye merry gentlemen and women.



James Spence
Managing Partner

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