

TM Cerno Global Leaders

UCITS Global Equity Portfolio (Class A)

Q2 2018



Investment Objectives

TM Cerno Global Leaders invests in global companies with sustainable competitive advantages delivering above average returns. Its target is to deliver performance in excess of MSCI World Total Return (GBP) on a 3 year rolling basis. The fund will hold 25-30 securities, equally weighted, selected according to a distinct investment thesis that accents industry structure, the sustenance of return on capital and secular growth. The fund does not invest in banks, commodity, fossil fuel or tobacco companies. The portfolio is fully invested at all times.

Fund Data

NAV/Share (Class A accum.)	£10.15
Fund Size (£mn)	64.5
Strategy Assets (£mn)	92.8
Currency Share Class	GBP (Base)
Investment Management Charge	0.65%
Ongoing Charges Figure	0.96%**
Dealing Frequency	Daily
Legal Structure	OEIC (UCITS)
Number of Holdings	26
Active Share	96%
Lead Manager	James Spence
Inception Dates	2017 (Fund) 2014 (Strategy)

**Includes all assets within the fund as well as other Cerno-managed assets invested directly in to this strategy*

***OCF includes the Investment Management Charge*

Custom Option

Conducting big business in the decades following the industrial revolution normally entailed the marshalling of labour and resources in a profitable sinecure. Fur trappers and tin miners, agriculture and energy, railroads and steel all fit this model.

These industries persist today but are becoming scarce in the pantheon of very top companies measured by market capitalisation or economic value addition. Labour has mobilised, a thicket of laws exists to prevent excessive exploitation and monopolies of international scale are prohibited.

Only perhaps in the world of software and social media have we seen the kind of recently accrued market share power that breeds exploitative practices: Microsoft's dominance of operating system software is a matter of historic fact and Facebook's control of the network effect across its platforms are prime examples of predatory corporate behaviour: rabid until checked.

Outside these large and unusual cases, successful companies conducting business across multiple continents need to balance of standardisation against customisation.

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Standard so often entails stand-still which is a death curse for companies. At the other end of the spectrum, few businesses can adopt a fully bespoke offering and hope to grow beyond their artisanal roots.

There is another category, companies and sometimes just one-person offerings, inevitably small that provide a service but in a highly personal way. Our favourite example of this was the now defunct Omotesando Koffee in Tokyo. Eiicho Kunitomo ran a coffee show like no other. He allowed only one customer in at a time and that customer was asked only one question. “Sugar or not?”

The Japanese have a saying for this type of offering: Ichigo Ichie (once in a lifetime). The very point of this service is the restricted scale and hobbyists of all stripes will testify to the special experience of having a custom-made bike frame made or a cricket bat or a pair of shoes.

Kunitomo-san’s offering was ephemeral. The contact between the maker and the customer, the drinking of the coffee. Even his business, which he set up as a pop-up in 2011 and remarkably traded for 5 years.*



Omotesando Koffee, Tokyo

Staying on coffee for a moment, for it is a business of great relevance to **Nestle**. Nestle’s range spans the drink in instant form (Nescafé, which is brewed and consumed 5,500 times a second worldwide) through to the ineffably upper-end Blue Bottle which began in San Francisco and has over 50 cafés in America and Japan today. Nestle occupies a broad waterfront and has further extended its territory with a deal to distribute Starbucks products worldwide. “Roasted by us, distributed by Nestle, made by you.” It could as well read.



*Blue Bottle's first store in Oakland, California.
Source: Blue Bottle*

Givaudan is the largest player in the flavour & fragrance industry serving global and regional FMCG producers, including Nestle. Remarkably, given the industry’s scale, there is no standardisation; every product is customised to the demands of the brief provided by the client at a particular time. Thus, Givaudan’s product offering morphs in response to the shifting tides of demand transmitted through the consumer companies.

As social media has enabled stronger feedback loops from consumers, product life cycles have drastically shortened as Fast Moving Consumer Goods (FMCG) companies have struggled to keep pace with changing tastes. Upstart indie brands, also Givaudan customers, have exploited this vacuum to take share.

Far from slowing down, this cycle keeps finding new gears as new trends emerge leaving the detritus of past fads in their wake. This process of iterative customisation means the entire top line of a Flavours & Fragrances (F&F) company can refresh in 4-5 years.

Custom-made, non-standardised products based on ever shorter product cycles means that the threat of imitation is low in F&F. The value delivered by the leading companies is as much in their ability to interpret a given brief, in sympathy with knowledge of demand trends, as it is the molecules that confer taste or smell.

As we study the activities of the companies we own within the strategy it is true of many, if not all, that their appeal to their customers and enduring relevance is their ability to supply to

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order. In this way, these companies have fused standard with bespoke to operate in a distinct way for each customer.

Luxury conglomerate **LVMH** has a particular challenge: how to sell increasing quantities of very well-made products across the world. How to stimulate the individual subsidiary brands and their designers but retain financial discipline at the centre. How to be French but not too French.

The fashionable thought is that it is the experience and not the stuff that matters. How can that be bridged if the experience is not what you charge for?

Furthermore, gospels on de-cluttering appears to be pointing to a new religion. This also has Tokyo as its spiritual home. A city where the need is great: the gentleman in the below image needs some help.

The movement has its high priestesses such as Marie Kondo.



Source: Kyoichi Tsuzuki

The New York Times ran a piece entitled “Marie Kondo and the Ruthless War on Stuff” and the WSJ chimed in with the more aggressive “Should You Kondo Your Kids?": a media barrage which found its crescendo in the Huffington Post’s “The Psychological Benefits of ‘Kondoing’”.

Despite the tireless eves-dropping on millennials - both acquisitive and not - there is no evidence that checked-shirted and hobnailed-booted parsimony is going anywhere, in aggregate.

Our view that this is all a myth. The need to badge our selves

via objects lies deep within us, Buddhism and Kondoism offer valuable critiques but books on these eventually become clutter too.

Mike Martin, in his book *Why We Fight*, posits that the most basic human drive is to seek a sense of belonging and this is hormonally driven since early humans. Once you have identified how you belong, this is recognised via tokens. In the age of money, luxury has status because it demarks what somebody can buy that all others cannot.

LVMH is attuned to this phenomenon. Being a luxury goods conglomerate, it faces the task of retaining a necessary cachet in the items it sells whilst achieving and maintaining scale in its subsidiary businesses. The magic mark for such businesses is €1bn in annual sales. Last year its wine and spirits businesses sold €5.1bn in aggregate, fashion and leather €15.5bn, perfumes and cosmetics €5.6bn, watches and jewellery €3.8bn.

In the world of prescription eyeglasses, a degree of bespoke is elemental to serve the wide needs of different levels and combinations of eye correction.

Whilst eye testing remains a traditional activity, it has been conducted in shops rather than eye specialists for some time. Specialists have also converted their premises to more resemble shops.

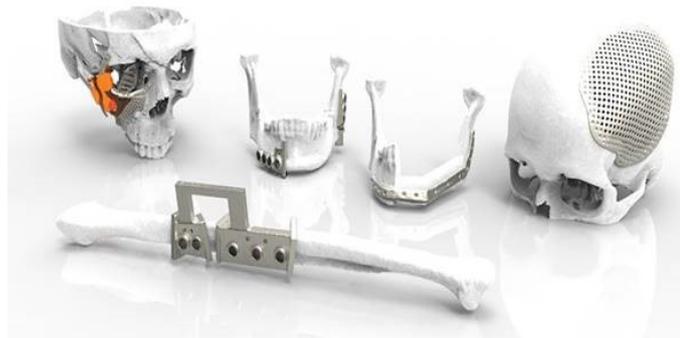
Synchronous with this is the extension of large, specialist retail chains into online retail portals. However, despite the size of the global eyewear and sunglasses market, valued at US\$167bn expected sales this year, online represents less than 10% of this total, suggesting that for **Luxottica** and others, the customer experience of trying on frames in a shop where they may also obtain advice and eye testing services will remain the paramount method of connecting with customers for some time. Luxottica are dismissive of the applicability of 3D printing in this market as frame making is a multi-step process entailing a complex interaction of materials, specialist machines and human supervisors and crafters.

Bespoke-made goods in the age of mass production often comes attached with an elevated price tag, be it a high-end Swiss watch or components inside a jet engine. However, this

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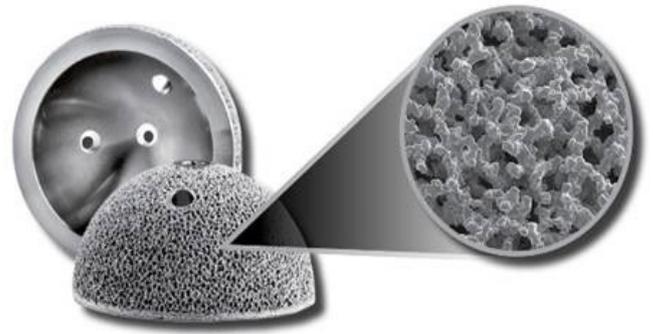
Swiss watch or components inside a jet engine. However, this is set to change with a maturing 3D printing industry, as lower unit costs are unlocking a new spectrum of possibilities that were previously commercially unfeasible due to complexity. By removing the constraints from traditional manufacturing such as milling, casting or fabrication, designers can create high precision, high performance products, whilst driving cost, time and resource efficiencies.

The technology has been around for many years, although it was primarily confined to low volume specialist applications and prototyping. **Renishaw**, a UK based engineering company specializing in metal 3D printing, is seeking to encourage higher adoption to once again bring customisation to the masses. A third of all metal 3D printing systems on the market were sold in the last 12 months, according to them. Their RenAM machines replace moulds and casts with lasers and metal powders to construct geometric structures layer by layer in a process known as 'laser powder bed fusion', for an array of industries including healthcare, industrial and consumer.



3D Printed Cranium, Mandible and Femur
Source: Renishaw

The industry where perhaps the most impact can be realised is in healthcare, given the subtle variances between human anatomies that demands customisation. Doctors and surgeons can now print directly from 3D scanners, with absolute accuracy, everything from orthopedic parts (e.g. knee caps and hip disks), dental implants, to cranial plates (see above image) and bone structures used in reconstructive surgical procedures that tailor-fit each patient. Newer break-throughs in the field even allow for the printing of organs and other delicate biological parts including the human retina.



A Prosthetic Hip Cup Replacement
Source: Renishaw

Unusually, and perhaps surprisingly given the staid reputation of the industry, hearing aid companies were early entrants into the arena of mass customisation. Since the turn of the millennium it has become increasingly likely that if you wear a hearing aid it has been 3D printed. Indeed, **Sonova** were the pioneers of adoption collaborating with Belgium-based Materialise in 2000 to develop Rapid Shell Modelling (RSM) for their flagship Phonak brand. Now all the shells for in-ear and ear canal hearing aids, as well as other ancillary components, are 3D printed.

For the user the product experience is vastly improved. 3D printed shells fit precisely and can be tailored to the individuals level of hearing loss. The traditional, manual method of moulding and trimming tended to result in a uniform outcome which fitted everyone broadly and no-one well.

For the company there are gains as well. While upfront capex can be US\$20,000-150,000 per machine the payback is felt through improved product consistency, the re-use of digital moulds and a supply chain which is digitised and localised.



A 3D Printed Hearing Aid
Source: Renishaw

Custom Option

In the consumer space, objects with intricate geometries such as a mechanical watch that used to require the skilled hands of a Swiss watchmaker, or an Italian artisan for high-end bicycle frame catering to the rider's contour can now all be built inside a 3D printer, at a fraction of the time.

The Industrial sector is another area that is seeing advanced applications of 3D printing. Machines are capable of printing components with complex topologies demanding the most stringent level of precision for optimised performance: engine turbine blades, fuel systems and guide vanes for aerospace, or components inside industrial machinery, such as Renishaw's RenAM printers, which they print using their own machines. It was once said that a respectable artisan is one who knows how to craft his own tools, this certainly rings true of Renishaw.

While business schools may discuss stylised factories with raw material inputs placed onto a production line and finished goods driven out of back door, every factory is in fact unique. The vintage of the plant, type of good being produced and any variations thereof, the environment in which the plant sits and its proximity to suppliers and customers are all variables that determine the attributes of a production line. Factory owners are particularly interested in the consistency of the output and the operational efficiency of the line. Therefore, any supplier of service to factory owners must be able to tailor their solutions to the unique characteristics of the factory.

Rockwell Automation delivers factory automation services to its customers. Rockwell can install sensors and monitors that allow for the real-time monitoring of factory performance, as well as specifying equipment that will integrate with existing installations. A factory which has received the Rockwell treatment will allow operators to constantly monitor the production line and identify problems as they occur allowing maintenance to be undertaken on the fly which minimises downtime. The data collected from each sensor can be analysed to optimise production line characteristics.

For Rockwell, each client project is a customised solution which effectively embeds Rockwell's technology, including their own brand Allen Bradley equipment, into their customers infrastructure. As customers develop new product lines,

they return to Rockwell to adjust their production facilities accordingly. For example, Arnott's, the Australian biscuit manufacturer famous for its Tim Tam brand has worked with Rockwell for 20 years. Arnott's engaged Rockwell to improve the flexibility and operational efficiency of its Adelaide factory which produces 10,000 tonnes of biscuits annually. International growth had resulted in Arnott's requirement to customise biscuit recipes to different countries Rockwell was able to simplify the order loading protocols which improved consistency whilst also introducing software which allowed different recipes to be stored, selected and produced on the same production line. The net result of the project was a production line with greater flexibility in in output and reduced margin for human error. In addition, Rockwell staged the implementation of the upgrades to ensure downtime was minimised.

Observations & Conclusions

The emboldened company names in this article are constituent members of the Global Leaders strategy, selected for their strong market positions, long term relevance and ability to adapt and compete in the world of global business.

Looked through the eyeglass of customisation as a phenomenon, we can clearly see that many of the companies we invest in have distinct and complex ways in serving their customers. The complexity arises from the wide array of materials, advancing technological processes and the needs of their customers.

We would argue that success in customisation - whether mass or more bespoke – breeds success. The learning process which drives technological advances is applied across the customer base in an organic manner.

Examples, such as described, provide strong corroboratory evidence for how invested companies achieve and retain leadership.

- James Spence, Fay Ren, Fergus Shaw & Michael Flitton

**You can't keep a good man down as Kunitomo now operates Koffee Mameya in Shibuya:*

<https://www.timeout.com/tokyo/restaurants/koffee-mameya>

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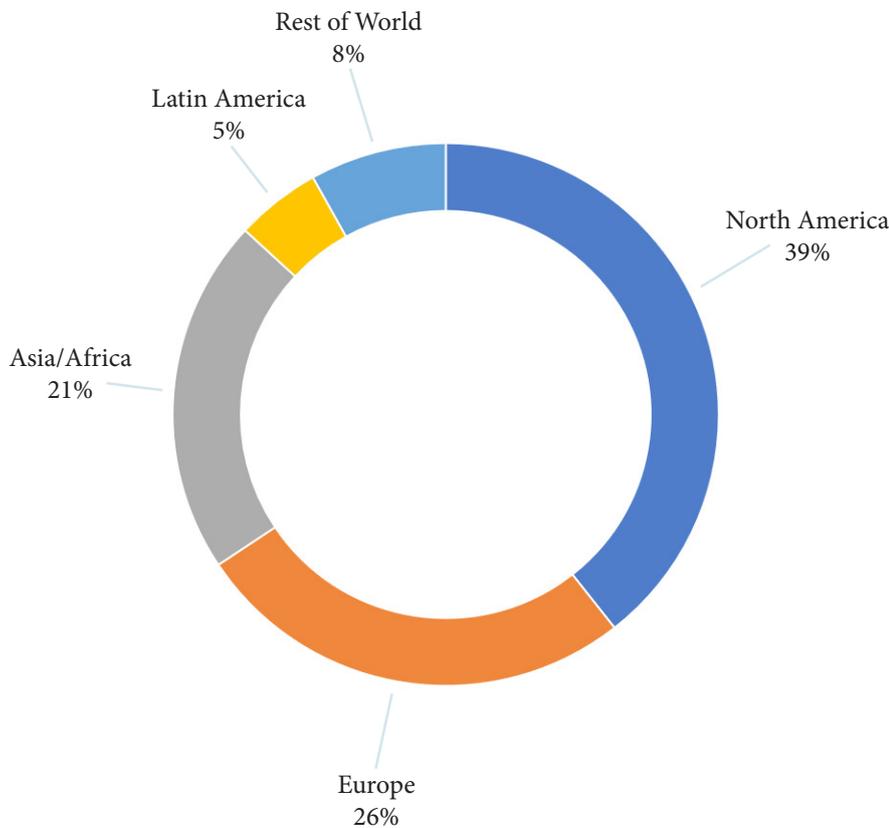
Holding History

Company Name	Description	Holding Period*
Samsung Electronics	Dominant in semiconductor memory chips and leader in smartphones	>5 years
Nestle	Diversified global food & beverage company	>5 years
Visa	Largest global electronic payments network	>5 years
Zimmer Biomet	Leading orthopaedic care specialist	>4 years
Praxair	Largest industrial gas provider in North and South America	>4 years
Renishaw	Engineering specialist focused on equipment for precision measurement	>4 years
Johnson & Johnson	Global healthcare company spanning pharma, medical devices, consumer	>3 years
Fedex	Leading provider of Express Delivery services in the US	>3 years
PPG	Coatings company leading in the industrial/specialty business	>3 years
Sonova	Largest global producer of hearing instruments	>3 years
Reckitt Benckiser	Innovative leader in consumer health, hygiene and home products	>3 years
Coloplast	Global healthcare provider focused on ostomy and continence care	>3 years
Shimano	Dominant supplier of cycling componentry	>3 years
Givaudan	Leading player in the Flavours and Fragrance industry	2-3 years
Novozymes	Produces enzymes which application in a wide variety of daily products	2-3 years
Assa Abloy	World's leading manufacturer of security locks and automatic doors	2-3 years
LVMH	The largest luxury goods conglomerate and most diversified	1-2 years
Rockwell Automation	Largest pure play in industrial automation and control processes	1-2 years
Luxottica	Vertically integrated producer of luxury, fashion and sports eyewear	1-2 years
Oracle	The largest database and enterprise software company in the world	<12 months
Ansys	Leading developer of digital simulation software for product development	<12 months
Fresenius Medical	The foremost player in dialysis care active along the entire value chain	<12 months
3M	Manufacturer with leading brands in industrial and consumer products	<12 months
Waters	World leader in specialty measurements focused on the life sciences sector	<12 months
Heineken	Brewer with a strategic bias to premium beer, interests in low alcohol/craft	<12 months
Atlas Copco	Dominant producer in air compression and vacuum techniques	<12 months

*Holding periods relate to the entirety of the strategy within Cerno Managed Assets

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Sales by Geography and Valuations



Global Leader companies are, by definition, global in their sales. Their domiciles are not an investment consideration and most of the companies have outgrown their home market base many decades ago.

The perceived reliability of the earnings of constituent companies and the fact that they have commanding market shares in their industries means that they will trade at a premium to wide equity market aggregates. The question is how much? The portfolio has an aggregate Return on Equity of 23% versus 12% for the World Equity Index.

We aim to rationalise margins, earnings consistency and economic value against the price paid. The fund's approach to valuation could be described as growth at a reasonable price (GARP).

Valuations and Margins Global Leaders* MSCI World

Price/Earnings (1 Y Forward, x)	20.3	14.7
Return on Equity (%)	22.4	12.3
Return on Capital/Cost of Capital (%)	1.4	N/A
Gross Margin (%)	56.0	31.8
Operating Margin (%)	22.2	12.5
Debt/Equity (%)	58	73.5**
Dividend Yield (%)	1.9	2.7

* This data refers to the underlying holdings
**ex financials

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Key Fund Information

Investment Objective	Returns in excess of MSCI World Equity Index (TR) on a three-year rolling basis
Sector Exclusions	Banks, Fossil Fuels, Commodities, Tobacco, Armaments
Savings Structures	Suitable for SIPPs and ISAs
Key Fund Documents	https://cernocapital.com/tm-cerno-global-leaders
Counterparties	Authorised Corporate Director: Thesis Unit Trust Management Trustee: NatWest Trustees Custodian: Northern Trust Auditor: Grant Thornton UK LLP
Contact	Tom Milnes 0207 036 4126 tom@cernocapital.com

Fund Codes

	ISIN:	SEDOL:	Bloomberg:
A Acc	GB00BF00QK62	BF00QK6	TMCGLAA LN
A Inc	GB00BF00QJ57	BF00QJ5	TMCGLAI LN



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