CERNO CAPITAL

TM Cerno Global Leaders

UCITS Global Equity Portfolio (Class A)

Q1 2019

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 Acc)	£10.49
Fund Size (£mn)	63.7
Strategy Assets (£mn)	92.7*
Currency Share Class	GBP (Base)
Investment Management Charge	0.65%
Ongoing Charges Figure	0.94%**
Dealing Frequency	Daily
Legal Structure	OEIC (UCITS)
Number of Holdings	26
Active Share	98%
Lead Manager	James Spence
Inception Date Fund	2017
Inception Date Strategy	2014

**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*

Fishing In The Right Waters

For the active manager, a necessary feature of the method of generating better than index returns over the long run is to operate a portfolio that looks nothing like the index itself. As most benchmark indices are market cap weighted (the price weighted 30 stock Dow Jones Index being an exception) the closer a portfolio resembles the larger cap register - in name and weighting - the more the portfolio will resemble the index itself, and underperformance becomes more probable.

Therefore, to our minds, a clear line to outperformance is somewhat predicated on an investment philosophy that accents selectivity. This can be by virtue of running a “concentrated” portfolio, operating sector restrictions, emphasising smaller and medium capitalisation shares and/or a particular style bias.

Styles, in investment, are often used in a shorthand way to describe a preference for “value” shares over “growth” shares or vice versa. There is no settled definition of what constitutes value or growth other than the understanding that value stocks are relatively cheap on basic valuation measures, of which price to earnings and price to book are the most frequently used.

Fishing In The Right Waters

When quantitative analysts segment a universe of stocks into value and growth, they tend to either run the sample as a continuum with the lower values labelled value and the higher, growth. Of course, overall valuations of markets change: lifting or sinking all boats and a simple ranking to determine what is growth and what is value may not take that into account. An alternative method is to segment by top and bottom segments (for example, quartiles or quintiles), segregating the extremes and discarding the mass of indeterminately valued companies in between.

A broader consideration of style in the investment management context describes how a given manager invests: manager style is a question of preference, not relative valuation. What kind of business models appeal and what to steer clear of. Eclectic managers who believe that there is a price for everything are tempted to invest in all manner of businesses, trusting in their skill to buy shares which are adequately discounted for risk.

The Cerno Global Leaders strategy occupies a space close to the other end of this continuum. We require candidate businesses to have visibly high margins, commensurate with their leadership status, generate economic value through the cycle, make smart decisions about resource allocation and to have exhibited adaption through their histories. The median year of incorporation of the companies currently held is 1919 – providing a sense of the span over which these observations are made. We favour what Charlie Munger describes as "great companies at reasonable prices".

The corollary to this is that many sectors are problematic for this investment strategy and therefore left out. For the purposes of the industry comments that follow, we have followed Industry Groups under GICS (the Global Industry Classification System which was co-developed by the index providers S&P and MSCI).

On this basis, companies held in Global Leaders currently occupy 11 of the 24 sub-sectors. On a 5 year look back, 9 of these have outperformed their respective sector index. The 11 sectors have generated 1.9% per annum outperformance against the world equity index, suggesting that we have been fishing in the right ponds. Excluded sectors lag the world equity index by 0.2% per annum over those 5 years.

2 of 13 sectors not currently represented are hard exclusions: Energy and Banks. Energy has been excluded since inception as energy companies are tied to a commodity price – they are price takers.

GICS INDUSTRY	REPRESENTATION
Auto & Components	*No*
Banks	*No*
Capital Goods	*Yes*
Commercial & Professional Services	*No*
Consumer Durables & Apparel	*Yes*
Consumer Services	*No*
Diverse Financials	*No*
Energy	*No*
Food & Staples Retail	*No*
Food, Beverage & Tobacco	*Yes*
Health Care Equipment & Services	*Yes*
Household & Personal Products	*Yes*
Insurance	*No*
Materials	*Yes*
Media & Entertainment	*No*
Pharmaceuticals, Biotechnology	*Yes*
Real Estate	*No*
Retailing	*No*
Semiconductors & Semiconductor	*Yes*
Software & Services	*Yes*
Technology Hardware & Equipment	*Yes*
Telecom Services	*No*
Transportation	*Yes*
Utilities	*No*

Fishing In The Right Waters

When they are not so directly tied (such as nascent green energy), they are subject to differential and temporal government rules. Banks are unusual in the corporate realm as they are inherently highly leveraged and therefore subject to extreme global and national macro risk. We invest in unleveraged or moderately leveraged returns. Banks cannot qualify.

This then leaves 11 sectors which are not currently represented. It should be stressed that sector definitions and sector representations do not form a part of our investment process with respect to Global Leaders. Were it to do so, it would risk undermining the bottom-up process by introducing considerations of necessary or minimal representation by sector.

The modern argot contains the term Fear of Missing Out (FOMO). We do not suffer from this. The approach is entirely bottom-up and as such sector classification is not a driver for selection. The total number of companies we will own at any one time is 30. We build and then need to sustain conviction to invest in a company. That consideration is reinforced by the equal weighting discipline, making it impossible for stocks to “sneak in” to the portfolio. The potential for whim is absent.

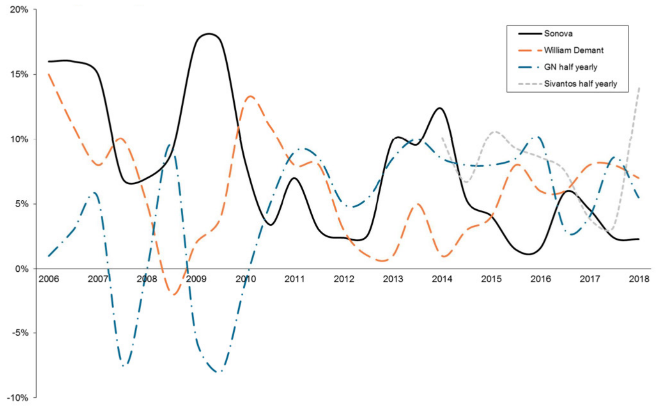
- *James Spence*

Sale: Sonova

We have sold the Sonova position in full within the Global Leaders Strategy. This is due to a significant expected change in industry structure that we think will negatively impact Sonova.

Sonova is a leader in audiologist advised hearing aids. Historically Sonova's moat has been a function of two key factors: fundamental product leadership and entry barriers via the regulated nature of their business. Both supports have weakened.

We have been concerned over declining product differentiation for some time. The weakening profile of the company's products has been reflected in growth below peers for several years (figure 1).



Hearing Aid Market Growth Model
Source: JPM

This concern had led us to hold the stock under review. However, it has taken time to accumulate the data points to confirm our observation of a loss of leadership given extended length of the product cycle. Unfortunately, the Belong platform, which completed its roll out in 2017/18 failed to catalyse market share gains. The most recent platform is Marvel, which combines rechargeability and Bluetooth into the same product. It is too early for meaningful datapoints however it is our belief that the offering holds limited differentiation to competitors. From a position of clear innovation leadership when we initiated our holding the pack has caught up with Sonova, in our view. Over time this will result in sub-par growth.

Understanding industry structure is a core component of how we assess the long-term prospects of a business. The hearing aid industry is facing significant upheaval. In 2020 the FDA will introduce an OTC category enabling people to purchase hearing aids outside of the traditional audiologist channel and 'self-fit'. The industry view is that these will be 'gateway' products for those who would not normally seek medical help. We are less sanguine. The entry of Bose into this market place highlights that new products are more comparable to established brands than initially thought. We envisaged Sonova could bridge the gap to become a multi-purpose hearing device. It now appears more likely that the bridge will be made from the other side.

The audiologist channel has proven itself an effective protector of the interests of hearing aid manufacturers, but less so the consumer. By some reports the audiologist channel raises the product cost for the consumer by 5x. There is a service provided in return, of course, but we can't help feeling the utility is lopsided. As the FDA is increasingly focused on consumer outcomes this entry barrier appears increasingly brittle. Consequently, we believe the risk of market share losses to new entrants and consequent margin erosion is material.

The stock entered the Global Leaders strategy in October 2014, delivering an annual return of 9% in GBP over our period of ownership.

New position: Taiwan Semiconductor Company

TSMC (Taiwan Semiconductor Company) is the world's leading semiconductor foundry. Formed in 1987, the group's focus is solely on the physical manufacturing stage of the chip-making process. Indeed, the establishment of TSMC was the catalyst for a broad specialisation of the semiconductor value chain, which had been dominated by Integrated Device Manufacturers (IDMs), like IBM and Intel. The rising technological expertise and capex commitments required to compete with TSMC at the foundry level has driven many IDMs out of the industry while also lowering the barriers to entry for so called fabless (design only) houses, such as Nvidia. TSMC is now the dominant global semiconductor foundry player with a market share of 56% and revenues greater than 6 times the nearest pure play foundry competitor.

It is likely that TSMC's share will continue to increase over time given their leadership at the technological frontier. TSMC is currently the only player capable of producing the most recent 7nm generation, or node, of chip. Samsung is likely to follow sometime in 2019. As chip scaling continues to reduce dimensions towards the atomic level companies are coming up against the limitations of existing materials and architecture. Even Intel, historically at the forefront of driving change, is struggling. Its 10nm node (broadly equivalent to TSMC's 7nm) is expected to be released in 2020, 3 years behind schedule.

The cost in capex and R&D to move to each incremental node is rising relentlessly. The next generation of photolithography systems from ASML, essential to maintain Moore's Law into 2030, each cost 4x more than those on foundry floors today. Weaker players are tapping out. GlobalFoundries announced in June that it would step away from 7nm and focus on older nodes. Remarkably this leaves just 3 firms in pole position to reap the rewards of the digital age.

TSMC's economic moat is rooted is not only in its deep technological expertise but also its unique customer orientation. With the exit of GlobalFoundries, TSMC is the only remaining independent foundry operating at the technological edge. Intel and Samsung offer advanced products, but they also compete with their fabless customers. This confliction makes TSMC a unique proposition allowing it to develop the broadest IP library in response to the demand from a diversified customer base. The resulting economies of scale from serving such a large cohort underpin the groups cost advantage over Intel of some 25-30% per wafer.

A production site for Taiwan Semiconductor Manufacturing
Source: TSMC

The growth for the industry will be cyclical and the global economy sits at an uncertain juncture. However, the secular trends underpinning demand for TSMC's products are here to stay, notably Artificial Intelligence and the Internet of Things.

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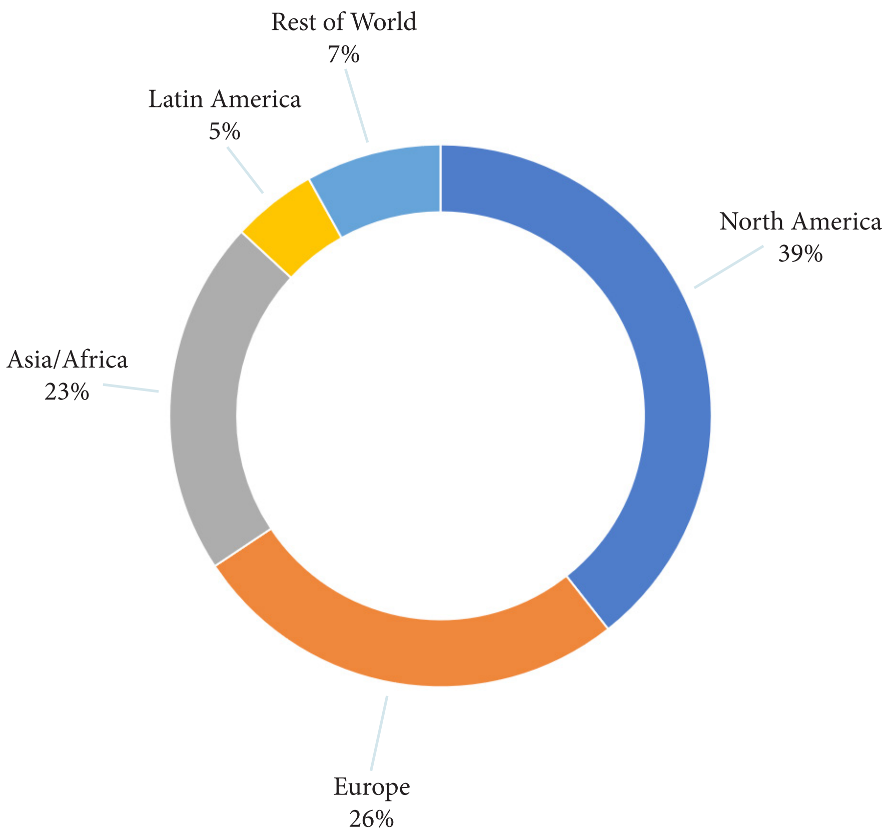
Holding History

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
Linde	Largest industrial gas provider in the World	>4 years
Renishaw	Engineering specialist focused on equipment for precision measurement	>4 years
Johnson & Johnson	Global healthcare company spanning pharma, medical devices, consumer	>4 years
Fedex	Leading provider of Express Delivery services in the US	>4 years
PPG	Coatings company leading in the industrial/specialty business	>4 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	>3 years
Novozymes	Produces enzymes which application in a wide variety of daily products	>3 years
Assa Abloy	World’s leading manufacturer of security locks and automatic doors	>3 years
LVMH	The largest luxury goods conglomerate and most diversified	>2 years
Rockwell Automation	Largest pure play in industrial automation and control processes	>2 years
Luxottica	Vertically integrated producer of luxury, fashion and sports eyewear	>2 years
Oracle	The largest database and enterprise software company in the world	>1 year
Ansys	Leading developer of digital simulation software for product development	>1 year
Fresenius Medical	The foremost player in dialysis care active along the entire value chain	>1 year
3M	Manufacturer with leading brands in industrial and consumer products	>1 year
Waters	World leader in speicalty measurements focused on the life sciences sector	>1 year
Heineken	Brewer with a strategic bias to premium beer, interests in low alcohol/craft	>1 year
Atlas Copco	Dominant producer in air compression and vacuum techniques	>1 year
TSMC	World’s largest pure-play semiconductor foundry	<1 year

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

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 24% versus 13% for the World Equity Index.

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

Characteristics	Global Leaders*	S&P 500	MSCI World
Price/Earnings (1Y Forward, x)	20.0	15.3	14.3
Return on Equity (%)	24.3	16.1	13.0
Return on/Cost of Capital (%)	1.6	N/A	N/A
Gross Margin (%)	53.8	33.9	31.5
Operating Margin (%)	22.4	13.3	12.1
Net Debt/Equity (%)	25.5	67.7**	46.1**
Dividend Yield (%)	2.0	2.2	2.8

* 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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Cerno Capital Partners LLP 34 Sackville Street, London, W1S 3ED Telephone: +44 (0) 207 036 4110 Website: cernocapital.com