CERNO CAPITAL

TM Cerno Global Leaders

UCITS Global Equity Portfolio (Class A)

Q2 2020

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 no more than 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)	£13.00
Fund Size (£mn)	80.4
Strategy Assets (£mn)	120.5*
Currency Share Class	GBP (Base)
Investment Management Charge	0.65%
Ongoing Charges Figure	0.87%**
Dealing Frequency	Daily
Legal Structure	OEIC (UCITS)
Number of Holdings	24
Active Share	97.2%
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*

In this Investment Report, which covers the second quarter of 2020, we revisit the format of the previous quarter whereby we make some comments on performance, fund strategy and activity in the portfolio. In the sections that follow, we offer some thoughts on the issue of pricing power and the prospect of higher inflation, should that feature in the future economic picture. We conclude by displaying elements of the Morningstar Risk Model as they have mapped the Global Leaders Fund.

There were no whole position changes in the 2Q and only one hard rebalance in the quarter (triggered when a holding's weight moves +/- 20% from target weight). Shimano was trimmed back to neutral weight on 19th June, a holding which rose 34% in the quarter.

Some comments on performance

In the second quarter, the fund's NAV rose by 21.0% to place YTD performance at +8.8%, following a 10.1% decline in NAV in the 1Q. By comparison, the World Equity Index which the fund is designed to beat in the long run rose by 19.8% in the second quarter to stand at +1.0% YTD (MSCI World GBP). The level of first half outperformance was therefore +7.8%. This is above the long run rate of outperformance which dates back to the inception of the strategy in October 2014 of 3.4% per annum. We provide some reasoning behind this recent period of enhanced outperformance below.

The strategy invests in no more than 30 companies world-wide and currently owns 24, chosen from a global universe and equal weights these companies. The equal weighting discipline keeps our eyes focused on long term drivers as we do not have to jockey positions up and down in response to temporal themes which may or may not have traction in the long run. When analysing attribution by stock, what we prefer to witness is broad contributions across the portfolio as that helps reinforce the process. Even in portfolios with longer lists of securities, one often finds quite narrow attributions as weighting flexibility incentivises managers to bet more heavily on winning shares. The risk is a descent into momentum trading where share prices create behavioural biases.

The backward look is that all 24 of the holdings made positive contributions in the 2Q and 18 out of the 24 holdings made positive contributions over the first half. Over the six month period, these ranged from +1.5% (Microsoft) down to +0.11% (Nidec) on an attribution basis. The deepest negatives were PPG Industries (-0.79%) and Zimmer Biomet (-0.67%) and Heineken (-0.44%) on a 6 month view. The short to medium term impact of the virus on these three companies is clear enough: PPG makes coatings used on aircraft and cars, Zimmer provides equipment for orthopaedic procedures which have been delayed, Heineken's taps are not running in many countries.

Given our 10 year view on these companies and the industries in which they operate, we have not felt motivated to consider their place in the portfolio. There is something to be said for owning companies whose demand profile has been raised by changing patterns in the crisis (e.g. a Microsoft) but there is also something to be said for companies that experience a hit but then recover nicely on the other side. We think the same way about capital intensity: there is much to admire in some capital light business models but, at the same time, we are not detracted from ownership in capital intensive industries. We own many and think that sets us apart from many other strategies within what is called the "quality" equity sector. What we don't know yet - as the forces of creative destruction have been placed in abeyance by Treasury support - is which industries will be reshaped either by credit distress or long term demand patterns.

Cross sectional style analysis on markets and the portfolio reveals that the single most powerful factor in markets this year has been balance sheet with stronger balance sheet companies outperforming weaker balance sheets by a wide margin. Interestingly this did not change much even with the prop of corporate debt purchasing by the Federal Reserve. The markets smell weakness. It is a particular matter of emphasis in our process for, if you want to own a restricted list of companies because you believe that is the best way to outperform and weight each company fully (or equally in our case), the last thing you want is to be kept up at night by liquidity or financing issues. It has been our belief for sometime that when the next big bump came, it would create a series of credit events in the corporate sector. The big thing has come and maybe the credit events will be deferred or even not happen. If they are only deferred, the portfolio is in very good shape but if they don't happen at all it will be by the continued intervention of governments, or more precisely, the Treasuries of these governments. If that proves to be our future then we (and all managers of financial assets) will need to mediate hard on how the governments of large economies process this debt load. This thinking will be drawn out in forthcoming Investment Letters.

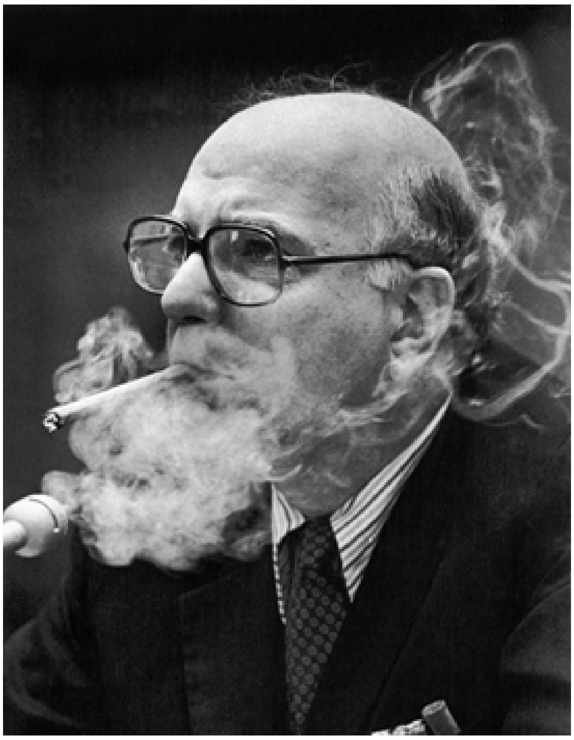
James Spence

Inflation, pricing power and leading companies

We will feature our thoughts about the prospects of inflation, whether we should expect any change and if there is a change whether it could be moderately higher or something more substantial in forthcoming Investment Letters. In this report we set down some initial markers about how to think about inflation in the context of equity investment and more specifically, investment in leading companies.

The reason why inflation is consequential for equities is two-fold: first it would represent a weather change for equity markets that have become inured to a lengthy period of disinflation. Global interest rates broadly peaked in 1982 and, with the opening of China in 1990, a second powerful disinflationary force was unleashed. Equity markets of the past 38 years have known nothing but either falling interest rates or super-low interest rates. One would normally expect an interest rate reaction (upward), both in policy rates and market traded rates (bond yields) if inflation rises but there are reasons to think that this would not be the case this time. Firstly, key Central Banks have signalled that they are prepared to tolerate a period of above target inflation and secondly the burden of debts taken on via the GFC and the coronavirus crisis suggests that they will wish to control or cap yields along the curve.

If we assume that to be the case, then we need to consider the question of what would happen to corporate earnings and equity valuations should inflation prospects change without a corresponding rise in interest rates. This is classic financial repression set up.



Paul Volker – the Inflation Slayer

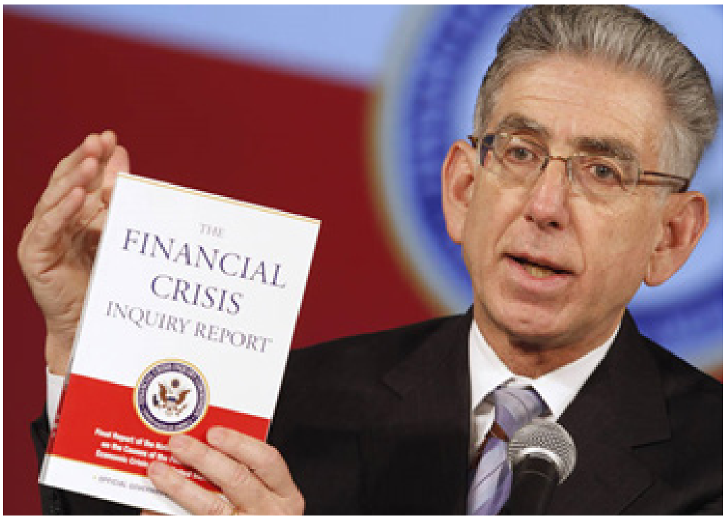
The obvious period for comparison which draws comparison and has the attention of macro strategists such as Russell Napier is 1966-82. This was a poor period for equity returns. The inflation took place in that period is visible in the difference between nominal US earnings of 5.8% per annum and real earnings of -0.8% over the period. Ten years into the process, Warren Buffett was moved to write in his 1977 Annual Letter to Berkshire Hathaway about how inflation steals returns from equity holders. His then explanation was that equities, fundamentally, are more like bonds than most people think. What we understand him to mean is that equity returns are more fixed in their financial returns on assets than was commonly perceived.

Buffett's exhumed view is perhaps too pessimistic but after 11 long years of the index going nowhere, it is perhaps not surprising. The big cost to investors was the decline in the valuation ratio on the market. The Price to Earnings ratio on the S&P500 fell from 14.8x in 1966 to 10.2x. The bad run was curbed by the appointment of Paul Volker as chairman of the Federal Reserve in 1979 and his tenure lasted until 1987. Not for nothing was he known as the Inflation Slayer.

At the other end of the debate, some investors offer the idea that equities are real assets. We find it hard to entirely back this casual theory that equity assets of themselves adjust adequately for inflation. If these opposite theories are somewhat simplistic, the truth probably lies in the middle and is more complex.

We also note the considerable amount of slack thinking that surrounds the concept of "pricing power".

Inflation, pricing power and leading companies



Buffett’s most widely reported comment on the issue of pricing power reads as follows:

“The single most important decision in evaluating a business is pricing power. If you’ve got the power to raise prices without losing business to a competitor, you’ve got a very good business. And if you have to have a prayer session before raising the price by 10 percent, then you’ve got a terrible business.”

It of tangential interest that this comment was made in 2009 and embargoed until 2016. This is because the comments were made to the Financial Crisis Inquiry Commission established by the US Congress following the GFC and of which a transcript was not released until 7 years later.

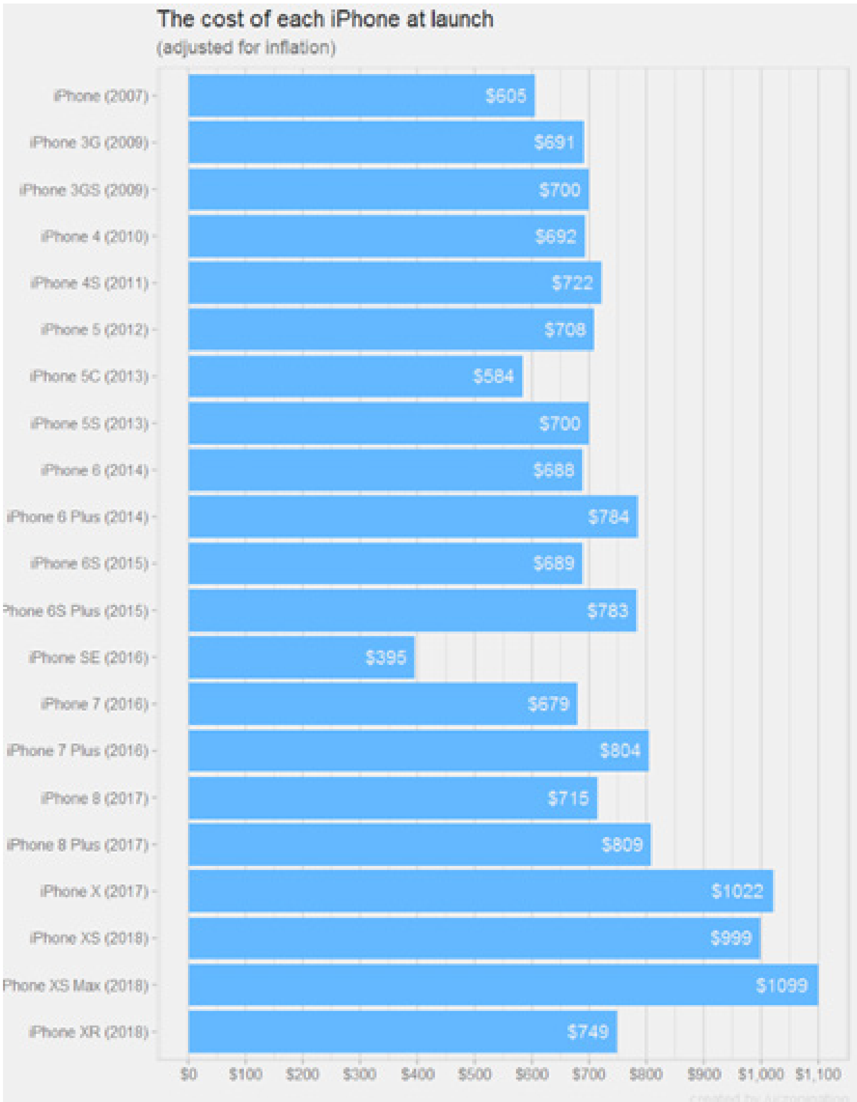
It is hard to find examples of 10% price rises without divine intervention. The manager can think of one as a consequence of developing a nasty addiction to a Berkshire Hathaway subsidiary product: See’s Candies to which he was introduced in San Francisco some years ago.

See’s Candies was bought by Berkshire in 1972 for US$25mn when Berkshire net assets were just US$8mn. Buffett was very involved in pricing from the beginning and is quoted as having said: “If you own See’s Candies, and look in the mirror and say, ‘Mirror, mirror on the wall, how much do I charge for candy this fall?” and it says, ‘More’, it’s a good business.” In the first 10 years of ownership, the business grow sales value by 295% off a 42% increase in sales volume.

What the younger Buffett and Munger spotted was that Pasadena based See’s, which had been in business since 1921, was priced off a Californian counterpart whereas it could command a premium. They turned a middle of the road company into a luxury company. See’s Candies is a wonderful example - and spawned Buffett’s interest in brands - but such examples are relatively rare.

Turning to luxury products companies in general, we await confirmation via financial results, but we are aware that the large luxury groups: LVMH (which is owned in the portfolio), Hermes, Kering, Richemont have been holding the line on pricing and, in places, increasing prices by up to 25%. Whilst demand has been negatively impacted, this strategy is a confident message to their less price sensitive customers that their products retain cachet and value. In a world of uncertainty, price can confer value, in some eyes.

These examples apart, we find pricing power a nebulous concept in the modern world. From a microeconomic theory perspective it is defined quite simply as “the ability to raise prices without reducing demand for your product”. But as with many well-meaning concepts from the dismal science, it doesn't well survive the journey across the border into the real world. Pinpointing the precise impact of a change in price amongst the cross currents of factors which influence demand for a company's product is difficult. Pricing is often a function of product generation so you need to account for mix. Apple Computer, with and without Jobs and his activities at NeXT, is a good example of how the high ground on pricing can be reached and what happens when you fall short.



Many years before the many successful releases of iPhones I to XI, when Steve Jobs resigned from Apple in 1985 he joined Ross Perot’s NeXT Computer with the view of dominating the higher end educational computing space. Their first significant desk top product was priced at US$9,999 and despite having the honour of being the computer on which Tim Berners-Lee launched the world wide web, it proved a commercial failure. The company was absorbed into Apple in 1996.

Other things conspire to prevent a clear take on pricing power. Consumer behaviour and fashion are constantly in movement. Companies have multiple product / service lines with pricing cycles uncorrelated to each other so discerning their effect for an external investor is hard.

One way to think of the issue is to turn it on its head. Where does pricing power not exist? The table below offers a guide:-

- Low perception of value add
    - Low value add contribution to end product
    - Low relationship value
        - Presence intermediaries reduces proximity to final OEM / customer
        - No brand value
- High realised or latent competition
    - High substitutability
        - Similar/homogenous product
        - Availability of substitute product (mining companies can go achieve periods of pricing power)
    - Low barriers to entry
    - Fragmented industry

The switch or substitution decision either has high or low friction. As an example of high friction, most iPhone users fret about purchasing hardware outside the Apple ecosystem even if they know other phones are faster, have better cameras and batteries. For many years Apple has worked consciously to build and augment the walls of its enchanted garden. On the other hand, a 2018 survey by Diffusion Group suggested that 16% of Netflix customers would downgrade their plan if plan costs rose by just US$1 a month.

Ultimately we conclude that you know pricing power when you see it. It can be deduced from the consistency of margins through challenging times. We will therefore be paying particular attention to the margin structures of companies within the strategy as they report throughout this year.

James Spence & Mike Flitton

Style Mapping with Morningstar Equity Risk Analysis

Within the suite of tools offered by the global investment data company Morningstar is a package that locates fund strategies by certain style metrics. The universe size is 45,000 funds globally.

Cerno Global Leaders is located within their global universe as a large cap strategy which, as an overall portfolio, straddles the Blend and Growth universes. Of current holdings in the portfolio, Morningstar locate 33% of holdings as large cap growth, 20% as large cap value and 42% within their middle universe, labelled Blend. The balancing item is 4% located within Medium Cap Growth.

On the more detailed metrics, the portfolio displays characteristics of having:

– High economic moats for the underlying names (+0.95 standard deviation)

– Above average financial health (+0.30)

– Biased towards large cap companies (-0.37) and growth style (0.40)

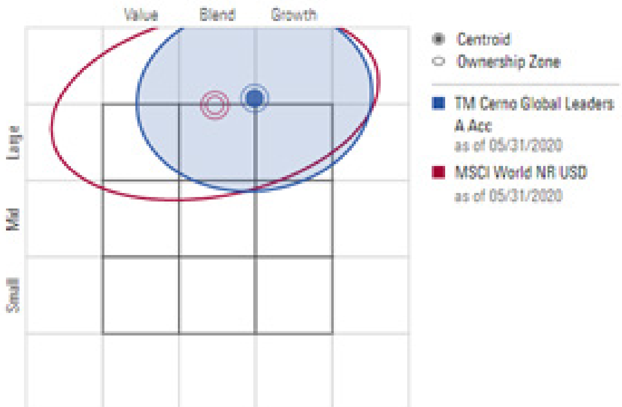
– Less crowded into the most popular names favoured by the market (e.g. FAANGS), given by low relative Ownership Popularity (0.1) of the underlying names

As we might expect, this form of screening confirms the resultant output of our process which is to invest in quality companies with strong industry positions and solid financials. It is no surprise that the largest deviation from the global equity universe is to be found in the overall ranking of economic moats as our process seeks to identify strength and sustainability of companies' competitive advantages and the enduring structure of its industry. This is not reliant on picking consumer companies as we also favour 'picks & shovels' type businesses that are deeply embedded into the value chain of their customers, particularly in the B2B space.

The focus on balance sheets and cash flows provides comfort in times of market stress, as witnessed in the first quarter of this year. Valuations are higher than the World Index but lower than a typical out-and-out Growth portfolio. This is a consequence of our Growth at a Reasonable Price (GARP) methodology and willingness to look deep into the ecosystem of industries and locate nodal players which are not necessarily adjacent to the end consumer.

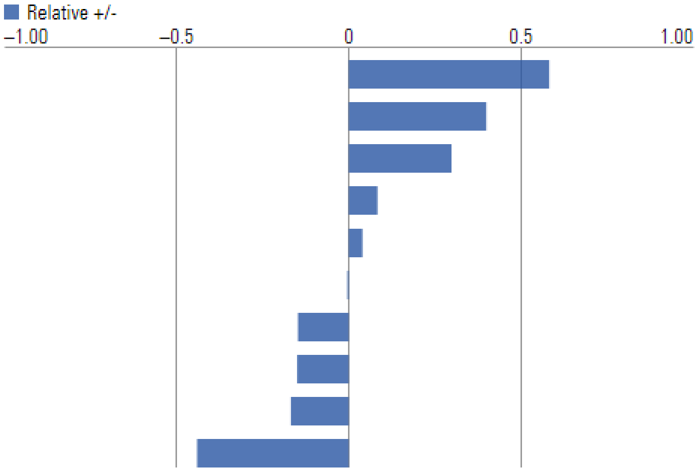
Finally, in period of outperformance we should expect a positive reading on momentum which is derived from 12 months index relative data.

Equity Style Box



Global Equity Risk Exposures Snapshot (relative to MSCI World Index)

Risk Factors	Portfolio Exposure	Benchmark Exposure	+/-
Economic Moat	0.95	0.37	0.58
Value Growth	0.40	0.00	0.40
Financial Health	0.30	0.01	0.30
Momentum	0.12	0.03	0.08
Size	−0.37	−0.41	0.04
Ownership Popularity	0.09	0.09	−0.00
Ownership Risk	−0.26	−0.11	−0.15
Volatility	−0.27	−0.12	−0.15
Valuation Uncertainty	−0.29	−0.12	−0.17
Valuation	−0.50	−0.06	−0.44



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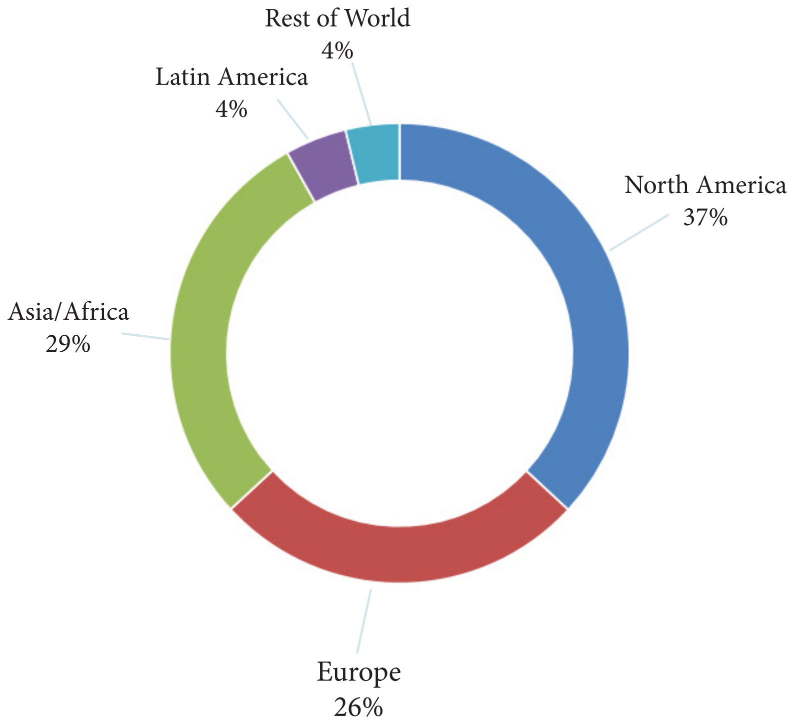
Holding History

Company Name	Description	Holding Period*
Samsung Electronics	Dominant in semiconductor memory chips and leader in smartphones	>6 years
Nestle	Diversified global food & beverage company	>6 years
Visa	Largest global electronic payments network	>6 years
Zimmer Biomet	Leading orthopaedic care specialist	>6 years
Linde	Largest industrial gas provider in the world	>6 years
Renishaw	Engineering specialist focused on equipment for precision measurement	>6 years
Johnson & Johnson	Global healthcare company spanning pharma, medical devices, consumer	>5 years
PPG	Coatings company leading in the industrial/specialty business	>5 years
Shimano	Dominant supplier of cycling componentry	>5 years
Givaudan	Leading player in the Flavours and Fragrance industry	>4 years
Novozymes	Produces enzymes which application in a wide variety of daily products	>4 years
Assa Abloy	World's leading manufacturer of security locks and automatic doors	>4 years
LVMH	The largest luxury goods conglomerate and most diversified	>3 years
EssilorLuxottica	Vertically integrated producer of luxury, fashion and sports eyewear	>3 years
Ansys	Leading developer of digital simulation software for product development	>2 years
Fresenius Medical	The foremost player in dialysis care active along the entire value chain	>2 years
Heineken	Brewer with a strategic bias to premium beer, interests in low alcohol/craft	>2 years
Atlas Copco	Dominant producer in air compression and vacuum techniques	>2 years
TSMC	World's largest pure-play semiconductor foundry	>1 year
ASML	Leading photolithography tools manufacturer for the semiconductor industry	>1 year
Nidec	Global top supplier of brushless DC motors for a diverse set of applications	<1 year
Microsoft	Dominant player in computing operating system and business software platform	<1 year
Philips	Healthcare technology company serving professional and consumer markets	<1 year
Accenture	Independent technology consultant and outsourcing provider globally	<1 year

**Holding periods relate to the entirety 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 19% versus 11% 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).

Performance

Year ended	**June 2020**	**June 2019**	**June 2018**	**Since Inception***
Performance	+16.2%	+10.6%	+1.2%	+30.0%

**The fund was launched on 1st November 2017*

Characteristics	Global Leaders*	S&P 500	MSCI World
Return on Equity (%)	18.9	13.4	10.5
Return on/Cost of Capital (%)	1.3	N/A	N/A
Gross Margin (%)	50.3	33.3	31.6
Operating Margin (%)	20.1	11.7	10.5
Net Debt/Equity (%)	22.2	75.0**	54.4**
Dividend Yield (%)	1.9	2.0	2.4

* Based on strategy, i.e. invested companies currently invested in direct form within client portfolios
**MSCI World/S&P500 ex. Financials

CERNO CAPITAL

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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