CERNO CAPITAL

TM Cerno Global Leaders

UCITS Global Equity Portfolio (Class A)

Q3 2020

Investment Objectives

TM Cerno Global Leaders invests in global companies with sustainable competitive advantages delivering above average returns. Its target is to achieve long term growth in value. 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)	£13.92
Fund Size (£mn)	86.4
Strategy Assets (£mn)	129.2*
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*

Portfolio review

At the beginning of this investment report we make some comments about the attributions in what was a second successive quarter of strong returns for the portfolio. This is followed by some analysis of the change in consensus earnings estimates for portfolio companies, a comment on an interesting acquisition made by Microsoft and, finally, a profile of Aptiv, a new position in the fund that was added just after the quarter end.

3Q performance for the GBP 'A' class was +7.1% against the World Index (GBP) return of +3.2%. This brings year to date performance to +16.5% versus index of +4.2%, resulting in +12.3% outperformance.

There were no whole position changes made to the portfolio in the quarter.

The performance generated has been captured despite owning just three of the top 10 S&P and NASDAQ weighted stocks. Index comparisons are not a relevant factor for investment in this strategy which is dominated by considerations of industry structure and sustenance of return on capital in the long run.

Portfolio review

The result of this approach, which is entirely bottom up, is a portfolio which will have a very high active share at all times but not look like other portfolios that follow a similar quality approach. Notably, the focus on global industry leadership in a concentrated format does not translate into a desire to own every leader in today's industrial sectors. We are most comfortable owning shares in companies that are 'boring' to many and rarely feature in the financial press. Such companies account for roughly half the portfolio and we would have no qualm if this proportion were higher. The notion of 'hidden scale' is interesting to us – companies that occupy nodal points in industries: potentially if not actually supplying everybody and threatening nobody. Companies whose histories offer strength in knowhow and culture and have a proven record of adaption.

Within the quarter, 17 of the 24 holdings generated a positive return, which was led by Renishaw, TSMC, Nidec and PPG. Leading the small detractors were Heineken, Fresenius and Shimano.

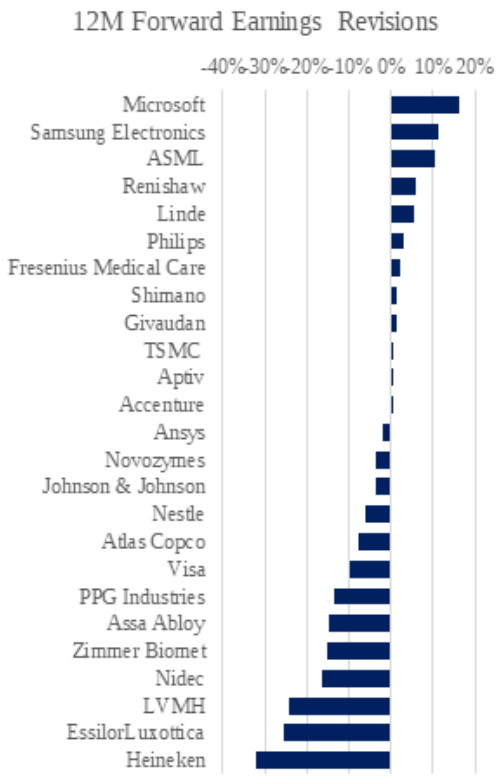
A second successive quarter of strong advances have left many quality equities looking fully or even over-valued against historical comparisons. Our general observation is that markets are disposed to look through what appears to be a worsening winter situation in respect of the virus to the possibility of further normalisation next year.

Furthermore, politics apart, this crisis is spawning more perceived policy certainty than is normally the case during a crisis: extending beyond expansive monetary policy into extensive fiscal measures.

It is a tricky exercise to measure what looking through the gap in earnings entails. The general pattern, is though, that valuations have moved up for many shares in many sectors. Under consideration is a possibility of taking a "time-out" on some marvellous businesses in the portfolio where growth looks fine but valuations are priced close to perfection.

James Spence

Earnings Revisions



Companies held within the portfolio have been affected to varying degrees this year by the crisis.

Earnings revision show the wide dispersion of current expectations compared to the beginning of the year. Positive revision trends compared with negatives runs to a rough 50/50 split.

To give some context to these numbers, consensus estimates for World Earnings for 2020 has fallen by -21% over this year (-40% for UK earnings).

The captioned graphic of individual company estimates is based on tracking consensus earnings estimates of 12 month forward earnings for each day from the beginning of the year to the end of the third quarter.

Companies at the top end of the spectrum such as Microsoft have seen their earnings revised up to 16%, driven by the wide adaptation of Teams, accelerated terminal purchasing and uptake on Azure Cloud offerings. Samsung has benefitted from share gains on the back of Huawei woes in their 5G base station business, as well as increased orders before further US restrictions hit Huawei.

TSMC has further consolidated its leadership position in chip manufacturing this quarter on Intel's admission on July 24th that they will need to outsource chip production to their main competitor.

On the other end of the spectrum, consumer businesses were negatively affected by movement restrictions such as Heineken (pubs, concerts, sporting events) and EssilorLuxottica, suffering from lack of outdoor events and holiday goers. These trends will likely continue as governments implement new lockdown measures on a new tide of rising cases. However, many of these trends will ultimately reverse. In long term equity investment it is necessary to separate temporal trends from more persistent trends.

In the third quarter, some of the companies that were initially hit hard in the industrials and materials sectors have seen share price recoveries, including Renishaw (metrology), PPG Industries (coatings) and Linde (industrial gas). Broad cyclical sectors (with the exclusion of energy) enjoyed a strong catch-up in Q3, with the Global Industrials and Materials Sectors both rising over 11% each. In this regard, our sector spread has been helpful. Whilst we remain positive on trends within Technology and Healthcare, we are not overly concentrated in these.

Fay Ren

Elder Scrolls and Nuclear Vaults – Microsoft's acquisition of Zenimax

Some of us have read the contents of an Elder Scroll and seen the flow of time itself twist on the parchment before them. Others may have gone toe to toe with a Deathclaw in the irradiated deserts of post-apocalypse Nevada with a rusty rifle.

What they both have in common is that they have likely played one of the Fallout or Elder Scroll series of role playing games (RPGs) created by ZeniMax Media Studios. The two titles are part of the sterling canon of western RPGs since the late 1990s, spawning new and equally successful iterations set in their respective worlds over four generations. The latest iteration of Elder Scrolls : Skyrim (2011) had sold 30 million copies to November 2016 and multiple titles from each series feature in the "Top 100 Games of All Time" rankings found across the internet.

On 21st September, Microsoft announced the acquisition of Zenimax Studios for US$7.5bn, making it Microsoft's 3rd largest acquisition behind LinkedIn and Skype and equal to its purchase of Github in 2018.

As a privately held entity, there had been intense market speculation for years over who would acquire Zenimax and expectations were focused around media conglomerates or gaming specialists such as Sony, Electronic Arts or potentially an IPO.

On the announcement, experts in the space compared the sale to Disney's acquisition of Pixar for US$7.4bn in 2006 and hailed it as one of the highest quality, if not the highest quality, independent studios left.

Being a privately held firm with minimal required disclosures, it is hard to assess the price paid. In an investment round by private equity firm Providence Partners in 2016, the studio was valued at US$2.5bn.

Microsoft, despite being known primarily as an operating system and commercial software behemoth, has a storied history as a games developer and publisher.

Around the time of the inception of the Xbox games console, Microsoft established Microsoft Games Studios (now known as Xbox Studios) as a stand-alone entity to develop and publish games for Windows and the Xbox.

This entity and its subsidiaries went on to release some of the most recognisable classics of the 2000s such as Age of Empires (collection of historical strategy games), Forza Motorsport (high fidelity racing simulators) and Microsoft Flight Simulator (the golden standard in its space).

One series in particular is credited with keeping the Xbox consoles programme alive almost single-handedly.

In the first generation of Xbox consoles, Microsoft attempted to break into the nigh-impregnable Japanese duopoly of Sony Playstation and Nintendo and faced severe difficulties in attracting gamers to a hardware platform bereft of “exclusives” and produced by what was seen as a stuffy commercial software giant.

In 1999, Bungie Studios was a small US developer facing financial difficulties whilst also developing a nascent sci-fi first person shooter (FPS)game, Halo. In June 2000, Microsoft acquired the team and made Halo the flagship launch title for the Xbox release. Microsoft demonstrated a clear commitment of resources to the Halo product, even supporting the publication of a novel based in the Halo universe weeks before the release.

The faceless genetically-engineered super soldier and his herculean last stand against a fanatically religious alien species tapped into the psyches of a generation of gamers.

John-117, the Master Chief, saved humanity and the Xbox programme with Halo exhibiting a very high attach rate to the Xbox console (50% of console sales were related to the title) and a long tail of sales years after the consoles release.

Continuing to today, we can see that there are similarly strong synergies for both parties in Microsoft’s latest acquisition.

The scarcity value of quality IP in the franchises that Zenimax has cultivated over the years can be considered equal to the acquisition of a catalogue of classic music hits or films. This is especially important for Microsoft to capture given its preparation to compete with other mega-cap technology companies (Google Stadia) in the provision of cloud based gaming services. Cloud based gaming (where the gaming hardware is hosted centrally rather than at the consumer level) is considered the future of gaming given the hardware demands of increasingly realistic videogames.

The breadth and depth of background content in each franchise (required to produce sufficiently immersive worlds with suspension of disbelief) can be levered for continuing titles either within the RPG space or subscription based MMO (massively multiplayer online) games.

Videogame lore, as it is colloquially known, has even been found to lend itself well to both the small and big screen, with series or feature length films based on videogame universes striking a tone of familiarity with audiences.

RPGs are also considered a game type with high “replayability” value, given the multiple stories or roles a player can take in different playthroughs.

Gaming (despite well voiced concerns about promoting antisocial hermitship and potentially unhealthy disconnects from reality) is undoubtedly a growth industry.

The global market value of gaming is expected to reach US$160bn by the end of 2020 (larger than Hollywood and the global music industry combined) and grow just under 8% CAGR to 2023 – 2025. Although a large portion of this is low complexity mobile gaming, the platforms that Zenimax titles have historically served (PC and console gaming) account for US$37bn and US$45bn respectively.

In Q4 2020 Microsoft reported gaming revenues of US$1.3bn (+64% YoY). This may be not that significant against the total of US$38bn of revenue in the quarter, but given Microsoft’s expectations of mid-teens growth into the foreseeable future this may rapidly become a not-inconsequential line item.

Microsoft CEO Sataya Nadella has repeatedly flagged his desire to focus on growth areas where Microsoft can achieve top 3 status and called gaming “the most expansive category in the entertainment industry” in the press statement of the Zenimax acquisition.

Through this acquisition, Microsoft has underscored its commitment to the highest growth sub-sector in entertainment.

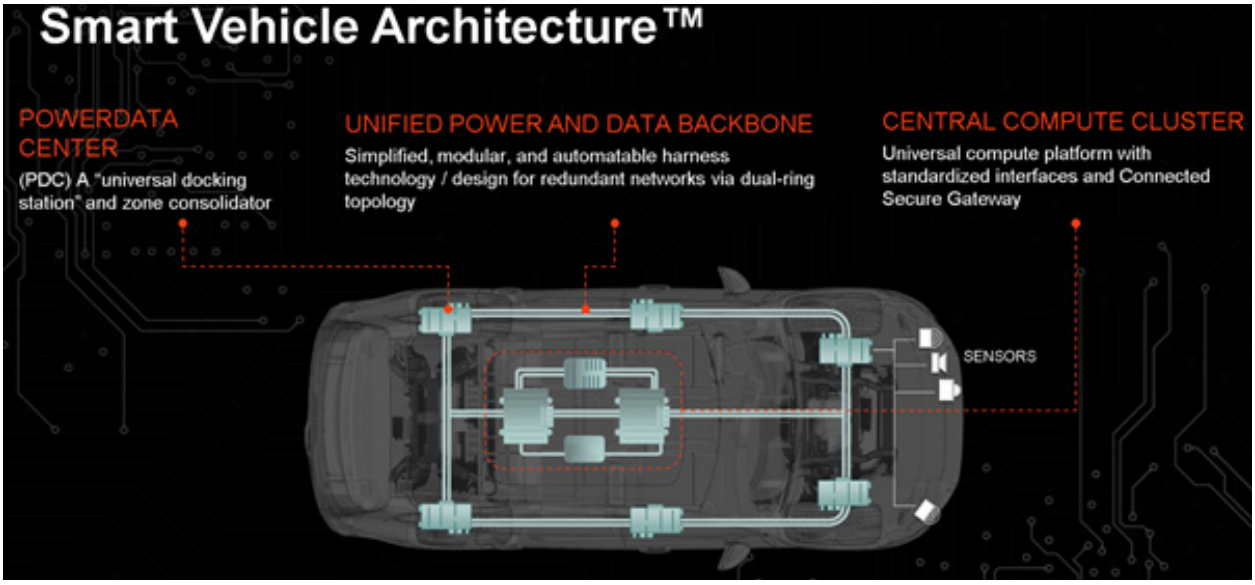
Ion Sioras

Aptiv: the autonomous architect

One of the more visible outcomes from rising chip processing power and the advent of 5G is inexorably rising connectedness. These connected smart 'things' are likely to proliferate as they ultimately make consumers' lives easier and/or better. The car is a logical participant of this convenience trend and autonomous driving the ultimate destination.

Fully autonomous vehicles are likely to be some time away still. Nevertheless, over the last 20 years vehicle functionality has been significantly enhanced. Improved safety features and richer consumer experience place increasingly arduous demands on the electrics of the car. So far auto OEMs have successfully bolted on incremental engine control units (ECUs) to existing systems for each additional feature. This approach has steadily introduced rising complexity, weight, and power drain. A tipping point is close to being reached. Electrical power consumption is up 60x since 1995 while signal distribution speeds have risen by a factor of 20. Today's vehicle data, signal, and power distribution systems rely on decades old technology. It seems unlikely that conventional architecture will cope with the next stages of this connected evolution.

Aptiv's business is focused on revolutionising vehicle architecture. Architecture in this context is conceived as the brain and nervous system required to enable autonomous driving. Autonomous vehicles of the future need to have networking capability to move vast amounts of data from the vehicle's eyes and ears (sensors) to the brain (compute platform) for analysis and decision making. Aptiv has expertise in both key domains, from connectors and distribution systems, to advanced software for passenger safety.



The breadth of Aptiv's expertise and its long history in the industry presents a unique offering. Aptiv emerged from when Delphi split in two in 2017. The internal combustion and powertrain businesses were spun out into Delphi Technologies and the core business renamed Aptiv. As a result, the group has relationships in the automotive chain built up over 25 years. This experience has embedded deep institutional knowledge in both design and engineering. Despite a cadre of almost nineteen thousand engineers and scientists the group has been open to partnerships to acquire competencies into their ecosystem. In 2016 they teamed up with Mobileye, leaders in vision systems for cars, to develop a turnkey autonomous driving solution for OEMs. The upshot is an ecosystem which is uniquely capable of integrating 'brain' and 'system' skills. Peers are either providers of ADAS (advanced driver assistance systems) or concentrate on the physical architecture. Aptiv is positioning itself as a chip-agnostic hardware/software integrator for all platforms.

These attributes have helped Aptiv establish a strong market position. In 2018 Aptiv products were found in 19/20 top selling US models, 18/20 in Europe and 14/20 in China. Aptiv is the market leader for ‘nervous systems’ with a 25% share. Competition in advanced safety systems is fierce, but the group believes they are on pace to be Top 2 by 2022.

Aptiv is well positioned to exploit three structural demand trends: safety, green and connected. To achieved top NCAP ratings automakers need to incorporate steadily rising levels of ADAS features. It is the ‘democratisation’ of ADAS, as safety features trickle down to mass market vehicles that will drive long term earnings. At L4 autonomy, old architecture is no longer viable but there is a continuum of content gains for Aptiv to that stage. Aptiv’s offering enables sustainability goals; cars with progressively higher ADAS produce fewer emissions, lower accidents, and ultimately lead to less cars on the road. Finally, connected cars provide a richer consumer experience, through both entertainment and continuous software updates.

Aptiv is another example of our ‘picks and shovels’ approach to disruption. We like companies who can profit regardless of the which consumer product ultimately ‘wins’.

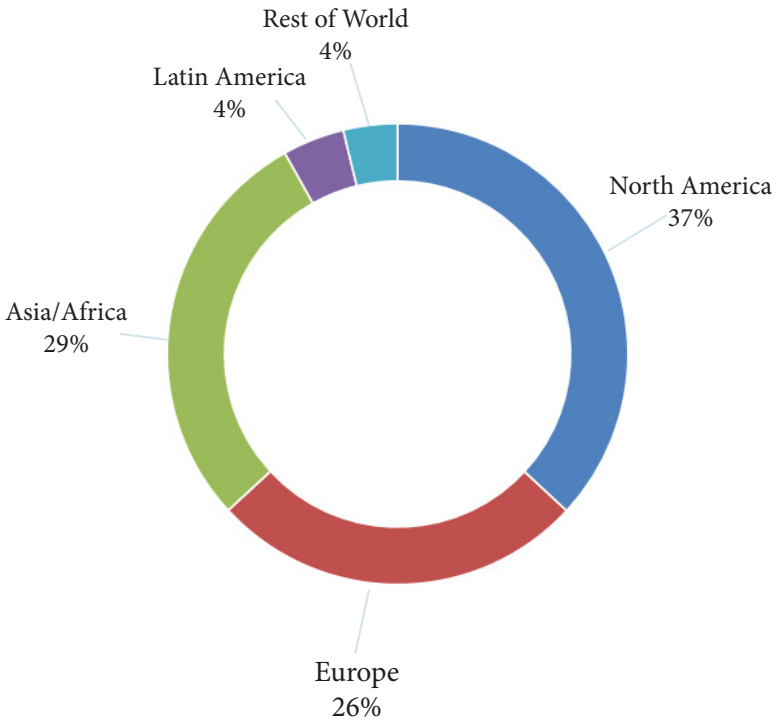
Michael Flitton

Holding History

Company Name	Description	Holding Period*
Samsung Electronics	Dominant in semiconductor memory chips and leader in smartphones	>7 years
Nestle	Diversified global food & beverage company	>7 years
Visa	Largest global electronic payments network	>7 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	>6 years
PPG	Coatings company leading in the industrial/specialty business	>6 years
Shimano	Dominant supplier of cycling componentry	>5 years
Givaudan	Leading player in the Flavours and Fragrance industry	>5 years
Novozymes	Produces enzymes which application in a wide variety of daily products	>5 years
Assa Abloy	World's leading manufacturer of security locks and automatic doors	>5 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	>3 years
Fresenius Medical	The foremost player in dialysis care active along the entire value chain	>3 years
Heineken	Brewer with a strategic bias to premium beer, interests in low alcohol/craft	>3 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 17% 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	Sep 2020	Sep 2019	Sep 2018	Since Inception*
Performance	+20.9%	+6.6%	+13.6%	+39.2%

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

Characteristics	Global Leaders*	S&P 500
Return on Equity (%)	17.5	11.5
Return on/Cost of Capital (%)	1.4	N/A
Gross Margin (%)	50.3	33.5
Operating Margin (%)	18.7	10.5
Net Debt/Equity (%)	22.6	75.2**
Dividend Yield (%)	1.7	1.8

* Based on strategy, i.e. invested companies currently invested in direct form within client portfolios

CERNO CAPITAL

Key Fund Information

Investment Objective	To achieve long term growth in value
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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