CERNO CAPITAL

TM CERNO *Global Leaders*

UCITS Global Equity Portfolio (Class A)

Q3-2021

Fund Data

NAV/Share (Class A Acc)	£16.75
Fund Size (£mn)	148
Currency Share Class	GBP (Base)
Investment Management Charge	0.65%
Ongoing Charges Figure	0.84%
Dealing Frequency	Daily
Legal Structure	OEIC (UCITS)
Number of Holdings	24
Active Share	99%
Lead Manager	James Spence
Inception Date Fund	2017
Inception Date Strategy	2014

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.

Portfolio Review

In this report we feature a short commentary on corporate profits, followed by two articles. The first looks at differential performance between stocks in the portfolio in the period since the global pandemic was announced by the WHO. The second is an article on corporate culture and ESG.

The second report was researched and written by Oscar Mackareth who has been working with us recently in an extended internship position. Oscar has a first class degree in Anthropology and History from the University of Sussex, a MSc in International Business and an MSc in Finance, both from the Hult International Business School. We plan to extend this study by incorporating metrics to measure culture and compare these with our own assumptions about individual companies ESG focus as well as that of external research bodies.

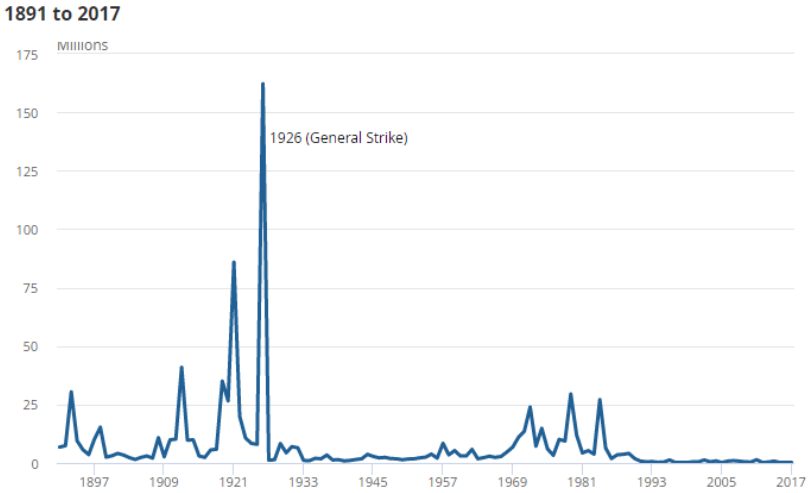
James Spence

Corporate profits

James Spence

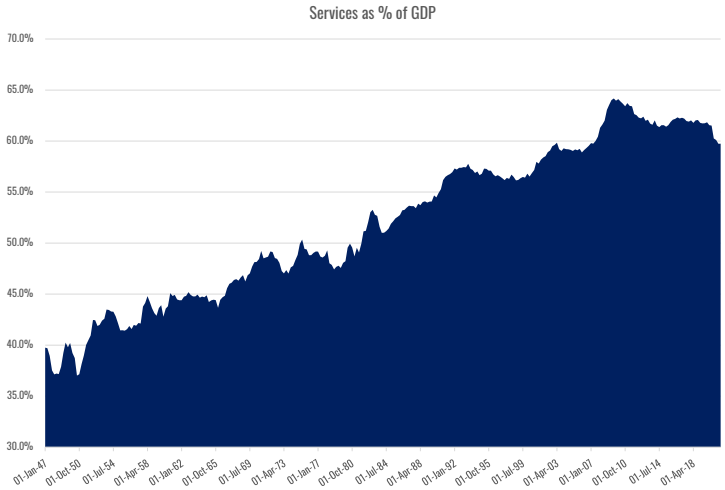
It has been jam for large companies worldwide in the past few decades. Several factors have conspired to help the corporate purse, we list these:

1) Labour has been quiescent. The high point for labour movements worldwide was many decades ago in the 20th century. In the UK, union membership has halved since 1979 and the days of strikes displayed in the below chart from the ONS are long behind us.



Source: Labour Disputes Inquiry. Office for National Statistics

2) Until recently, energy has been abundant and cheap. More critically the mass of large, listed companies have become less energy dependent, not through ecology but with the rise of services and internet enabled companies. Energy as a percentage of costs has been falling worldwide.

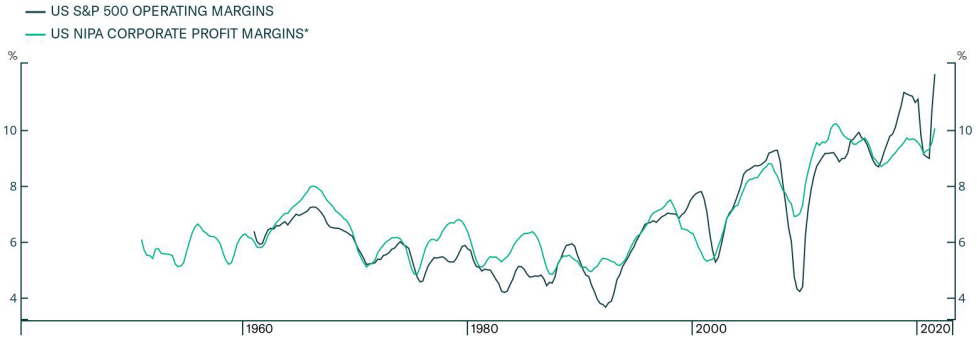


Source: Federal Reserve Economic Data

3) The rise of global supply chains and more efficient means of price discovery has optimized every process to a high degree.

Arguably these three factors are in reverse but we can't be sure for how long. Whilst unions may not make a big return, workers have every right to seek redress. Their security has gone down but their wages have not gone up. This may be adequately explained by the stalling of growth in productivity. The longer term path for energy provision looks clear enough but getting there in a politically expedient time frame is posing problems. Finally, supply chains are fragile in the face of hostile geopolitics.

With this big picture in mind, we are alert to systemic signals coming from the corporate sector, especially in the next few quarters of company results. All companies results are sensitive to their margin development and traditionally, this is the most difficult area to forecast. As a consequence, we might expect outsized reactions to any margin drops and perhaps undersized reactions to any gains. For the market has been fed on gains and has not experienced much in the way of drops.



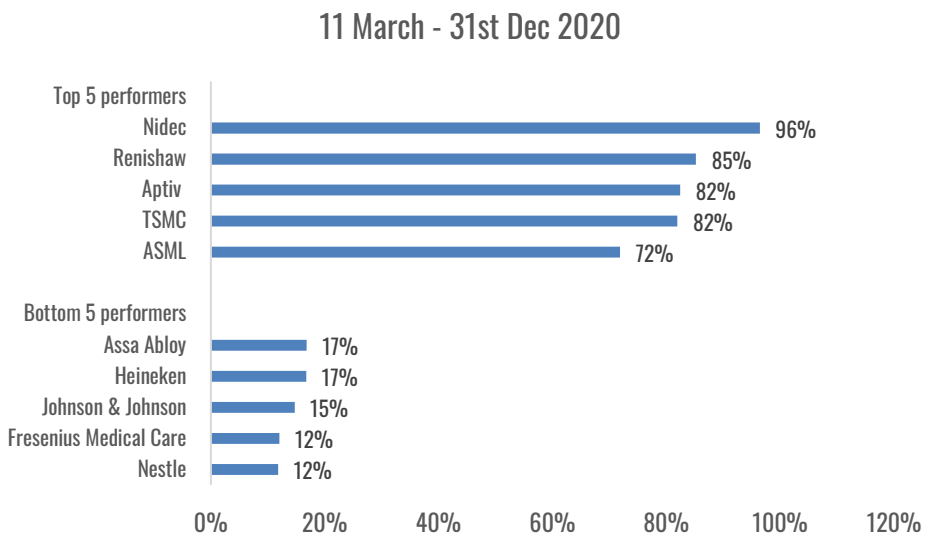
Source: BCA

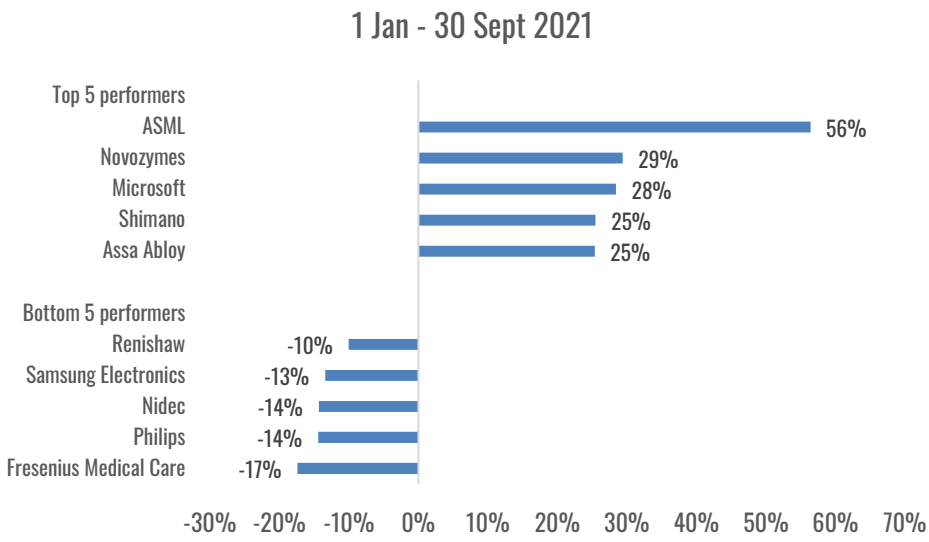
To our minds, ESG is a helpful tool for understanding risk. It is a facet, or facets, of the investment process, rather than an ivory tower apart. Responsible Investment at Cerno is about embracing complexity in how businesses approach the subject, whilst also acknowledging context and cultural inertia. Like Chaucer's motley protagonists on the road to Canterbury, companies come in all shapes and sizes. The upshot is an ESG continuum. Some companies are further along the path, and we can help chivvy them along. There is no end to the journey, no spiritual purity to be found at the shrine of Thomas Becket. ESG is an ongoing, iterative process, both for companies and Cerno Capital.

Differential performance in stocks held in the portfolio

To the end of this reporting period (30th September 2021) 569 days have elapsed since the WHO declared a global pandemic on March 11 2020. We roughly divide the period into two by considering the period from March 11 to the end of last year and then the first 9 months of this year.

The two charts below shows absolute price performance of the top and bottom 5 stocks for those periods.





Whilst the two periods in question are not separated by any measurable fault line in markets, these snapshots do reveal an enduring feature of the strategy in that we see little evidence of dominance in individual names. One company appears on the winners list twice: ASML and one company appears on the losers list twice: Fresenius. There are market and operating factors that adequately explain these double appearances: ASML is experiencing a steep ramp in sales for its cutting edge EUV microchip printing machines. Fresenius continues to be impacted by what is termed "missing patients" – patients who are diagnosed with diabetes and would benefit from treatment but are opting to skip treatment. Whilst the long term demand drivers for its industry remain intact, COVID has negatively impact normal patterns of both diagnosis and treatment. We can, over time, expect that adverse phenomenon to normalise.

Outwith these two, we also see a normal patterns of companies whose stock prices have risen far above the index or peers then retracing the following period part of those gains: this has been true for Nidec and Renishaw in the reviewed periods.

Of course, in the context of what are expected to be long periods of ownership of these companies, periodic ups and downs are not of much consequence. If a share price decline is accompanied by a material and long term change in the outlook for growth within the sector or something more pernicious affecting the overall sector, then that is of consequence but our assessment would be more driven by analysis of the adverse factor than the share price itself.

The other significant factor is how share price change marries up with attribution (or contribution to the portfolio return). As attribution (or contribution) is the share price change multiplied by the holding weight, our approach to weighting stocks has some bearing on breadth of returns. The equal weighting methodology means that, even in a fairly concentrated portfolio - currently 24 holdings – the breath of returns can be wide. This can be understood as a form of de-risking. In the normal run of things, equity managers are often tempted to back more on the horses that have shown recent form. There is nothing wrong, per se, with this type of momentum approach but it can drift into over concentration in a small number of themes or stocks. What my colleague Fergus Shaw calls "maximum exposure at the moment of minimum opportunity". By neutralising any temptation to chase momentum through equal weighting, portfolio returns should bear less risk.

Culture as a driver of sustainable operational and financial outperformance

Oscar Mackereth

Global assets managed in accordance with ESG principles are on track to exceed a third of global assets under management by 2025 . Proper scrutiny, in our minds, requires a blend of soft and hard factors. Correspondingly investors have become more concerned with the integration of non-financial metrics in due diligence.

In its infancy, ESG analysis was focused on environmental impact, driven by increasing concern about carbon, energy intensity, pollution and global warming. Since then, the scope of ESG discourse has expanded to other factors such as diversity, inclusion, pay discrepancy and community integration.

This evolution should be understood through the lens of society, which extends corporations their social licence to operate. Many of these issues resonate with the wider public. As social media acts to project and amplify so companies have come under pressure to act to preserve their social licence.

Regulatory initiatives have focused on the environment. The UNPRI, UN SDG and Paris climate accords have helped to develop a set of generally understood targets, through which an organisation's environmental impact can be assessed. Naturally, the development of this analytical structure, increased influence of environmental impact on investor sentiment and the growing expectation for organisations to report these Key Performance Indicators has incentivised organisations to prioritise their 'E' impact over other ESG metrics and engagements.

As responsible investors, we welcome increased corporate engagement, particularly around data provision and standardisation. However, we also seek to avoid reductive thinking. Excessive focus on universal metrics fails to capture the nuances of industrial, geographical, and organisational specificity. Currently, an organisation's immediate environmental impact is prioritised over more informative considerations such as: the intention or strategy of the organisation, how quickly they are reducing their negative impacts, how they compare to their peer group and the extent to which the organisation's operations are directly responsible for the impact.

Thus, our approach to ESG is to embrace complexity. Opportunity, and insight, can often lie in the grey in between. Culture may be the most complex issue of them all. Internal social factors, such as corporate culture are both less tangible and subject to fashion when compared to subjects such as environmental impact. However, we see these internal considerations as central enabling factors in the longevity of innovative and adaptive businesses. Therefore, the evaluation of these assets should improve our ability to identify organisations with competitive advantages in long-term operational, ESG and financial performance.

[1] *https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/*

However, engaging with an asset such as culture and quantifying it in a way that is both useful and true to its intangible nature is difficult and requires answers to several key questions:

What is culture?

Edgar Schein defined culture as 'a set of basic tacit assumptions about how the world is and ought to be that is shared by a set of people and determines their perceptions, thoughts, feelings and, to some degree, their overt behaviour'[2]. This is the basis of his organisational culture model, which argues that behavioural assumptions inform organisational values, which in turn shape the collective employee responses to problems of external adaption and internal integration. This model is a useful point of reference for framing our understanding of the relationship between intangible workplace social assumptions and their manifestation in visible organisational behaviours.

On a more practical level, Groysberg, Lee, Price and Cheng identify four generally accepted attributes of organisational culture[3]. Firstly, culture is a group phenomenon and therefore must be commonly shared and experienced by a group. Secondly, the culture is pervasive throughout the organisation, in that it informs 'action logics'[4] in a manner that permeates the entire staff hierarchy. Thirdly, culture is enduring through its influencing the thoughts and actions of group members over the long term. Finally, culture is implicit and subliminal, meaning that it functions as an extension of the written rules, regulations, and ethos of the firm. However, although implicit in nature, culture informs tangible action patterns of participant interaction and the organisational responses to its external environment

Why is it important for an organisation?

As stated in Schein's organisational culture model, culture informs an organisation's response to issues of internal integration patterns and external adaption. In this manner, the content of corporate culture is unique to that organisation and functions to guide responses to the problems posed by the external environment.

Consequentially, there is increasing evidence that culture functions as an intangible asset when managed properly, through the optimisation of financial and operational performance via cost reduction, staff retention and consumer engagement[5]. Furthermore, studies also suggest that cultural unity results in competitive advantage through the greater operational ability to respond to external stimuli[6]. Therefore, culture could be found to improve the internal generation of funds and creating more financially sustainable institutions.

On the other hand, a mismanaged or ineffective corporate culture can create pervasive and enduring negative operational patterns, through employee demotivation or incentivization of toxic workplace behaviours. One example of a negative culture that we have noticed through the lens of our Asian-Pacific fund is the growing trend of 'involution' or 'lying flat', which reflects a growing resigned or unmotivated sentiment amongst the millennial and Gen-Z workers in China[7]. These individuals have reported a lack of management appreciation and progression within their workplace, resulting in patterns of reduced motivation and productivity within the workforce. One individual described their particular corporate culture of being 'busy, but not fulfilled'[8], which has resulted in coasting behaviours where employees work long but unproductive hours.

[2] *Edgar Schein, Organizational Culture and Leadership, 2nd Ed.. 1992*
[3] *https://hbr.org/2018/01/the-leaders-guide-to-corporate-culture*
[4] *https://hbr.org/2005/04/seven-transformations-of-leadership*
[5] *https://www.emerald.com/insight/content/doi/10.1108/BJM-01-2019-0017/full/html*
[6] *https://journals.sagepub.com/doi/full/10.1177/2158244019835934*
[7] *https://radiichina.com/laying-flat-involution/*
[8] *https://radiichina.com/laying-flat-involution/*

What makes a good or bad culture?

Consequentially, what makes a 'bad' culture is a relatively straightforward question to answer. Any culture which is inefficiently managed or incentivises negative or 'toxic' behaviours within an employee base may be considered as bad.

One infamous example of such a culture can be found in the collapse of Baring's bank caused by the derivative trader Nicholas Leeson. Leeson made fraudulent and unauthorised trades using cover stories to disguise losses from his employers and avoid damage to his reputation within the firm. The absolute focus on financial performance and prestige here contributed to behaviours within the staff body which resulted in total bankruptcy.

On the other hand, 'good' culture is much more difficult to identify. As mentioned previously, what is considered 'efficient' or 'good' is dependent upon the cultures ability to guide the firm in meeting external stimuli. Therefore, there is no objectively 'best' culture, rather a collection of cultural styles, each of which has the potential to be efficiently managed as a firm asset.

However, there are several key characteristics that research suggests are consistently present in most effective corporate cultures.

Firstly, for a culture to be effective, it must be shared widely and deeply across the organisation and engaged with by employees in such a way that it impacts or influences their daily activities. Therefore, to ensure proper staff engagement, the culture must be communicated and engaged with consistently, regularly and in a transparent manner. This should allow it to be embodied within employee norms in such a way that both informs and reinforces the values of the firm.

Secondly, is the engagement and presentation of values through cultural communications. Whilst the consistent and clear communication of culture is essential, the content of said culture should consist primarily of values, which in turn act as mediums of expression for what an organisation collectively believes and the behaviour its stakeholders exhibit. Thus, values generally function to form the guiding principles and norms which should provide clarity and direction for the decision-making process.

Thirdly, is the presence of diverse groups of individuals throughout all levels of seniority within the businesses. The importance here is two-fold. Firstly, a key component of corporate agility is diversity and inclusion. It is increasingly evident that the representation of a mixture of gender, socioeconomic and ethnic backgrounds results in a better organisational ability to respond to challenges or opportunities with a breadth of perspectives that might otherwise be available from a mono-cultural organisation. However, correlation doesn't necessarily equal causation, in that increased diversity won't automatically translate to better operational or financial performance. A lack of diversity and inclusion within an organisation does generally correlate to lower operational efficiency due to lower levels of employee engagement and retention[9]. Consequentially, organisations that value gender and ethnic diversity and inclusion are statistically more likely to outperform those which don't[10], with that probability of outperformance increasing in conjunction with the level of representation.

[9] *https://hbr.org/2018/12/to-retain-employees-focus-on-inclusion-not-just-diversity*
https://www.achievers.com/blog/employee-engagement-and-retention-uk/
[10] *https://www.mckinsey.com/featured-insights/diversity-and-inclusion/diversity-wins-how-inclusion-matters*

How can we think about this and use it in investment due diligence?

Thus, apart from the values and behaviours it incentivises, organisational culture is generally intangible. However, these insights do demonstrate the importance of corporate culture in the generation of competitive advantage for the longevity of operationally and financially efficient businesses.

Therefore, the question remains – how can we make these conclusions actionable and relevant for our investment process?

It is difficult to objectively evaluate what 'good' and 'bad' cultures are, other than the unhelpful distinction between the incentivisation of good and bad operational behaviours. However, as discussed, there are several objectively 'good' cultural characteristics. Thus, whilst the identification of specific metrics and benchmarks of 'good' culture is difficult, it is possible.

We suggest that investors look for consistency in the communication of the corporate value proposition and quantitative and qualitative evidence that those values are being genuinely engaged. Human capital reports should be analysed with particular detail, due to the value of metrics such as churn, diversity and inclusion discrepancies and training costs, which often provide the best available insight into these issues.

On the other hand, a less abstract and potentially more useful assignment is the identification of negative cultural patterns. It is often easier to look out for 'red flags' in the form of high employee churn, diversity discrepancies, a lack of consistency in the 'core' values of the firm in each report, public controversies and disjunctions between the values and lived experience of the organisation's employees.

In this manner, we have constructed a cultural analysis framework that deploys top-down and bottom-up methodologies. Our intention is to isolate and exclude those firms which have a negative culture as well as identifying those that have efficient cultural structures. In this, we aim to utilise the competitive advantage that efficient culture has as a driver of sustainable operational innovation.

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FUND FACTS

Holding History

Company Name	Description	Holding Peirod
Samsung Electronics	Dominant in semiconductor memory chips and leader in smartphones	>8 years
Nestle	Diversified global food & beverage company	>8 years
Visa	Largest global electronic payments network	>8 years
Zimmer Biomet	Leading orthopaedic care specialist	>7 years
Linde	Largest industrial gas provider in the world	>7 years
Renishaw	Engineering specialist focused on equipment for precision measurement	>7 years
Johnson & Johnson	Global healthcare company spanning pharma, medical devices, consumer	>7 years
PPG	Coatings company leading in the industrial/specialty business	>7 years
Shimano	Dominant supplier of cycling componentry	>6 years
Givaudan	Leading player in the Flavours and Fragrance industry	>6 years
Novozymes	Produces enzymes which application in a wide variety of daily products	>6 years
Assa Abloy	World's leading manufacturer of security locks and automatic doors	>6 years
LVMH	The largest luxury goods conglomerate and most diversified	>4 years
EssilorLuxottica	Vertically integrated producer of luxury, fashion and sports eyewear	>4 years
Fresenius Medical	The foremost player in dialysis care active along the entire value chain	>4 years
Heineken	Brewer with a strategic bias to premium beer, interests in low alcohol/craft	>4 years
Atlas Copco	Dominant producer in air compression and vacuum techniques	>3 years
TSMC	World's largest pure-play semiconductor foundry	>2 years
ASML	Leading photolithography tools manufacturer for the semiconductor industry	>2 years
Nidec	Global top supplier of brushless DC motors for a diverse set of applications	>2 years
Microsoft	Dominant player in computing operating system and business software platform	>2 years
Philips	Healthcare technology company serving professional and consumer markets	>2 years
Accenture	Independent technology consultant and outsourcing provider globally	>1 year
Aptiv	Leader in smart vehicle architecture enabling autonomous driving	>1 year

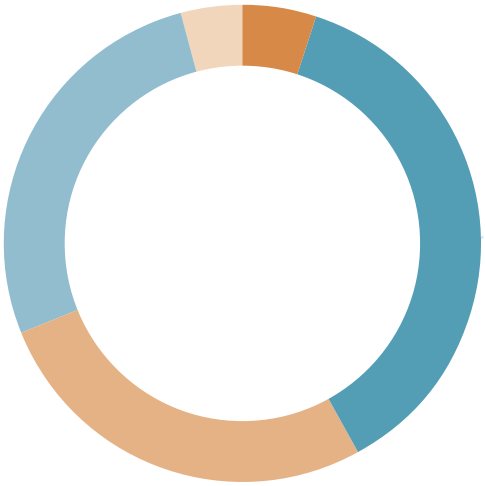
*Holding periods since inception of strategy

Sales by Geography

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 21% versus 14% 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).



Sales by Geography

- North America - 37%
- Asia - 29%
- Europe - 27%
- Latin America - 4%
- Rest of World - 3%

Performance

Year Ended	Sep 2021	Sep 2020	Sep 2019	Since Inception
Net Performance	+20.4%	+20.9%	+6.6%	+67.5%

*The fund was launched on 1st November 2017

Fund Codes

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

Key Fund Information

Investment Objective	To achieve long term growth in value
Sector Exclusions	Banks, Fossil Fuels, Commodities, Tobacco, Armaments
Authorised Corporate Director	Thesis Unit Trust Management (Authorised and regulated by FCA) Exchange Building St John's Street, Chichester, West Sussex PO9 1UP
Fund Custodian	The Northern Trust Company
Auditor	Pricewaterhouse Coopers LLP
Fund Legal Structure	UK OEIC (UCITS)
Inception Date - Fund	November 2017
Fund Saving Structures	SIPPs, ISAs & JISAs
Key Fund Documents	cernocapital.com/cerno-global-leaders
Ongoing Charges - Class B (incl. Management Fee)	Management Fee 0.65% Other Fees (incl. runnig costs) 0.19% OCF 0.84%
Initial Charge	5% - waived as standard
Contact	Tom Milnes 020 7036 4126 tom@cernocapital.com