CERNO CAPITAL

TM CERNO *Pacific*

UCITS Regional Equity Portfolio (Class B)

Q1-2022

Fund Data

NAV/Share (Class B Acc)	£16.38
Fund Size (£mn)	83
Currency Share Class	GBP (Base)
Investment Management Charge	0.75%
Ongoing Charges Figure	0.96%
Dealing Frequency	Daily
Legal Structure	OEIC (UCITS)
Co-Managers	Michael Flitton & Fay Ren
Inception Date Fund	2013
Inception Date Strategy	2009
Share Type	Acc & Inc
Ratings	CITYWIRE AAA

Investment Objectives

The Cerno Pacific portfolio is a geographically specific fund, which invests primarily across the Pacific area but also the wider emerging markets. The fund's objective is to produce capital growth over the long term through a focus on companies that are judged to be innovators or are beneficiaries of innovation through their products, services or business models. The optimal route to access the full benefit of innovation is likely to be, directly or indirectly, in the form of equity, which will be the predominant asset class in the portfolio. The manager takes an active approach to currency exposures and may hedge where deemed appropriate.

Q1 Investment Report

Fund Activity

Michael Flitton provides performance commentary and details position changes during the quarter.

Taking Stock

Fay Ren re-examines the characteristics of the businesses we own.

Fund Activity

Michael Flitton

The fund delivered a negative return of 20.1% in the first quarter against the comparator index decline of 2.1%. This takes the rolling 3-year performance to +44.7% against +19.9% index return.

Unprecedented is a dangerous term, particularly considering the last two years, but Q1 2022 certainly laid a claim. Russia's invasion of Ukraine led to a rapid recalibration of the probability of hitherto extreme outcomes. The expanding spread of scenarios for inflation, energy, and security led to a febrile market environment. Investors were jaw boned one way and another as speculation dominated. Moves in Asia were outsized. At the intraday extremes in March the Hang Seng Index entered both a bear market (down over 20%) and a bull market (up over 20%).

The immediate catalyst for the risk off environment in Q1 is clear but the underlying fragility has been building for eighteen months. The events in Ukraine have highlighted how far behind the curve the Fed is. How policy evolves is still unclear, but recession lies at the end of an uncomfortably high number of interest rate paths.

For China, the events in Ukraine represented the fear crescendo after a year of risks ratcheting higher. On top of the regulatory crackdown, ADR delisting noise, and negative side effects of China's zero-Covid the possibility that China would become a target for international sanctions was the trigger for broad based capitulation across security markets. In Q1 China declined 14.2% in US$ terms against global equities down 5.3%. Overlying this was a considerable disparity of returns by sector as investors fled for the relative safety of companies positively exposed to rising inflationary pressures. On one side of the barbell Energy was up 20% while Healthcare and Technology declined 20-30%.

The fund's performance was disappointing. The portfolio's inherent bias to growth (the pay-off from innovation tends to be further in the future) and China (the richest opportunity set) created a challenging environment. CSL (+3bps) was the one position to positively contribute during the quarter given its defensive nature and positive leverage to reopening. The top detractors were Sea Ltd (-184bps), Sunny Optical (-177bps), and Kingdee (-147bps). Sea delivered a layup for a market fretting over 'unprofitable growth' businesses. While results showed continued strength in ecommerce the core cash generating gaming business exhibited the first signs of deteriorating momentum as global reopening shifted consumer behaviour. Sunny Optical faces several headwinds including slowing smartphone growth, mix shift in demand to lower quality lenses, and a new price insensitive competitor. For Kingdee, results continue to show strong execution in its transition to SaaS delivery of its software. The stock suffered from broader sector multiple compression.

Fund Activity

Our tendency during periods of extreme volatility is to take care not to exacerbate negative short-term performance through moves that prove not to have been prudential. As Howard Marks of Oaktree Capital observed, market timing is a source of risk not protection. However, during March the prospect that China would become the focus for global sanctions over its stance on Ukraine caused us to raise cash to just under 10%. This was driven purely by practical fund implementation considerations. After the statement on the 15th of March by the Chinese ambassador to the US this risk materially diminished, in our view. As such we reinvested half of the available cash in several of our highest conviction China names.

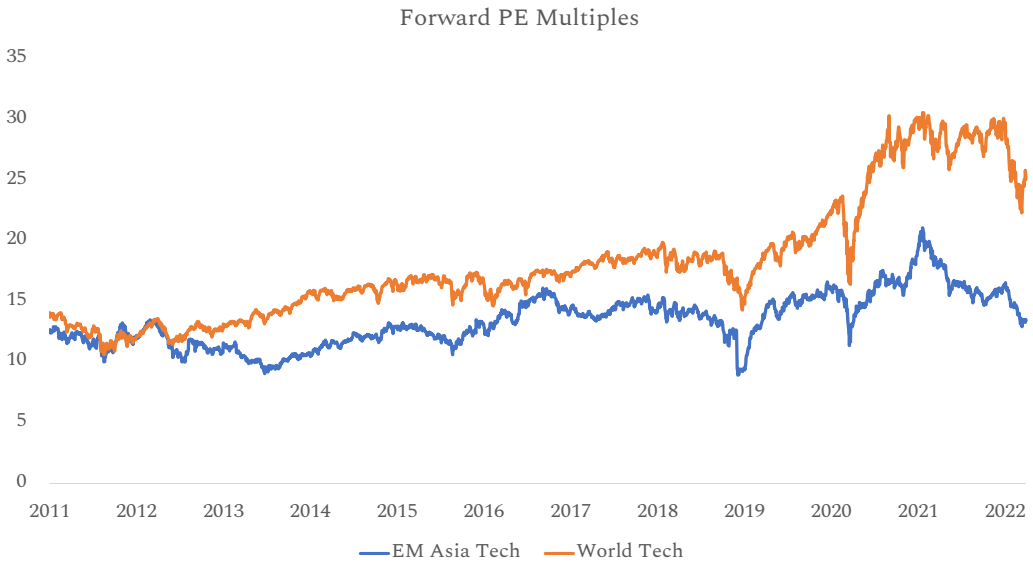
A economic regime change has occurred. We now face a different inflationary environment than the Goldilocks period that has prevailed since 2009. For equities the return premium demanded by investors to expose themselves to this uncertainty will increase. Market valuations are therefore likely to decline. In this respect Asia is ahead of the curve. Technology stock valuations in Asia ex-Japan are back at 2011 levels. The Pacific strategy represents a portfolio of quality companies with good growth prospects underpinned by innovation. Financials are robust. Part of our criteria for investment is adaption. While this regime change brings uncertainty it is this resiliency and ability to adapt, which will drive long term outperformance for the portfolio. In the following section we provide some handholds to help look through the noise.

Taking Stock

Fay Ren

Over the past year, the portfolio has suffered on several fronts. Beginning with China's regulatory crackdown to interest rate-driven rotation, geopolitical reverberations arising from the Russian-Ukraine war, and more recently the renewed Covid outbreak in China.

Portfolio valuations have gone through a period of significant de-rating since the market peak in February 2021. On average the market cap of portfolio companies has declined 43%, while analyst forecasts have risen 3%. Market analyst expectations should always be taken with a generous helping of salt, however this represents a significant dislocation. The equivalent numbers for the broader Asia Pacific region are -16% and +13%. This divergence is reflected in the valuations of technology shares globally.



This price move has reset valuations. Currently, the portfolio trades on a 12m forward PE of 24x. Given forecast earnings growth of 21% this represents a price-to-growth (PEG) ratio of 1.1x against the comparator index on 3.4x. Not only is this growth cheaper, in our view it is more durable than that derived from the rotation beneficiaries over the past year.

During periods of extreme turbulence, the financial robustness of portfolio businesses is critical. This is a key margin of safety, which ensures the portfolio can weather unforeseen events. Companies with strong financials should find themselves relatively strengthened by economic stress and more able to take advantage of market opportunities than peers.

The portfolio businesses have weighted aggregate operating margins of 20%, outpacing the broader Asia index by 1.8x. Cash returns on capital, as measured by CFROI at 17%, is also comfortably above their cost of capital. This points to a group of companies delivering value add, where returns are sustained by good economic moats. Cash conversion rate of over 100% and free cash flow margins of over 10%, against the index at 6%, both suggest superior cash generation potential. Capex as a percentage of operating cash flows is 53%, which points to high investments into the business and generally an indicator of ability to drive future sales growth. In addition, these companies have unlevered balance sheets, where three-quarters of the names are net cash.

We have witnessed wild market swings in Q1, given the high level of investor sensitivity towards bad news. It is important to distinguish the noise from the facts: what may be a short-term sentiment driven sell-off versus real weakening of the underlying business model. We have topped up on the former, while keeping a watchful distance on the latter. We elaborate on the two examples below:

Sentiment driven price action: An update on the CROs

In early February, two subsidiaries of Wuxi Biologics were placed onto the US Department of Commerce's 'Unverified List' (UVL), causing a major single day drop of 24%. Other healthcare companies fell in sympathy including Wuxi Apptec and Tigermed. Collectively the three companies represented approximately 10% of the portfolio.

The proximate concern was that these companies could not service customers due to component sourcing issues. Concerns also arose with respect to possible break clauses from contractual violations and potential loss of new sales should being on the UVL prevent their large market of overseas clients from using them in the future. Sentiment was already fragile as this sector was the target of a rumour in relation to US sanctions on Chinese biotech companies in December last year (which, in the end, did not materialise). Valuations for the CRO subsector have declined 40% year to date.

The Unverified List (maintained by the US Commerce Department), however, is different in nature compared to the more widely recognised Entity List or the Black List, which bars any US companies from doing business or investing in the company. Companies that import certain sensitive components from the US are subject to periodic onsite inspections from the Commerce Department to ensure that the products are being used as originally intended (and not sold on to unapproved third parties, for example). This inspection was unable to take place over the last two years due to China's strict Covid quarantine policies. After clarifications from the companies, it was important to note three things: i) the companies did not know in advance or warned they were going to be placed on the Unverified List, it does not appear to be an act of deceit (albeit the seemingly lack of awareness is also unwelcome); ii) The companies have taken immediate actions to rectify the situation working with relevant Chinese and US entities to schedule a visit from the US Commerce Department, this process will take place over the few months; iii) business impact in the meantime is immaterial (8 early stage projects out of 400), and alternative suppliers are available to ensure stock at least over the next 6-12 months;

Wuxi Biologics has continued to sign up 11 new clients across US, EU and Japan since February, including two pending large pharma orders valued at over US$100mn. Wuxi Apptec and Tigermed have also issued statements clarifying that they are not under threat of the UVL. Wuxi Apptec has since announced Q1 numbers showing continued strength, with top-line sales growing at 70% and underlying earnings at 86%. Forward earnings guidance for all three companies remains strong.

We have topped up into the share price weakness. All three companies are at full weight in the portfolio.

Visibility impaired

We have reduced exposures to profitless businesses. Within the portfolio this was limited to three companies: Bilibili, Sea, and Kingdee. Bilibili curates a unique online community with differentiated content. Profitability depends on more effective monetisation of its highly engaged user base. It is not yet clear if they will be successful but there is enough potential to warrant remaining investors, albeit at a lower weight.

As the saying goes Sea 'moved fast and broke things' to take leading market share across southeast Asian ecommerce and build one of the world's most successful gaming franchises. The challenge is now execution. Management has pledged to be profitable in their core markets in 2022. There are risks to their foray into Brazil. For now, we believe management deserve the benefit of the doubt but keep the position under review.

Kingdee, the ERP software business in China, has historically been very profitable. Over the past few years, it has been aggressively transitioning to a Software as a Service (SaaS) based delivery model, which mechanically depresses near term earnings. High levels of investment in R&D and capex to drive expansion have also weighed on cash generation. We are comfortable with the long-term outlook. The Cloud business, growing healthily, should be accretive to profits as incremental scaling will require less resources as the underlying infrastructure has been built in, following similar patterns to other established SaaS businesses.

Last year we wrote on the outlook for the strategy's invested companies in periods of inflationary pressure (*Pacific Stocks in Periods of Inflation*). While historical data is limited, it is our observation that the Pacific Strategy exhibits sufficient quality characteristics plus the key measure of growth to have a high probability of outperforming in such an environment.

While we cannot pledge that all of our companies will be unscathed from supply chain pressures, rising inflation and geopolitical impacts in the short-term, we take some comfort in knowing that as long-term investors, the companies will exit this period of turmoil in relatively good shape. They will participate as value-adding players in the accelerating megatrends of digitalisation, industrial automation, supply chain redesigning through substitution, and green sectors in clean energy and auto electrification. All of which requires continued innovation and continued technological upgrades. The Pacific strategy seeks to invest in businesses participating in these structural trends.

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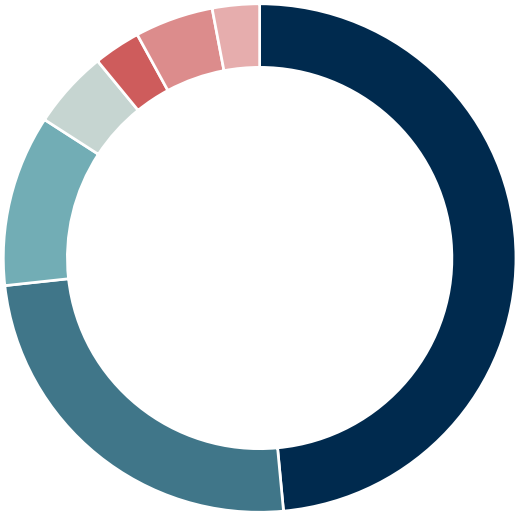
FUND FACTS



Domicile by Geography

- China/Hong Kong - 41%
- Japan - 29%
- Taiwan - 13%
- Korea - 6%
- Australia - 4%
- Singapore - 4%
- LATAM - 3%

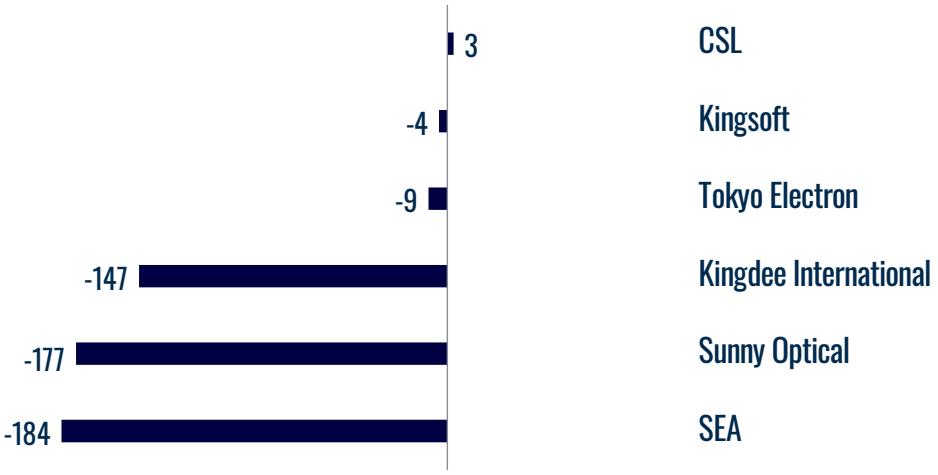
Top 10 Holdings

Tokyo Electron	6.1%
Samsung Electronics	5.6%
TSMC	5.5%
Shenzhen Mindray	4.2%
Hangzhou Tigermed	4.1%
Denso	4.1%
Wuxi Apptec	4.0%
Disco	3.5%
Delta Electronic	3.5%
Advantech	3.4%

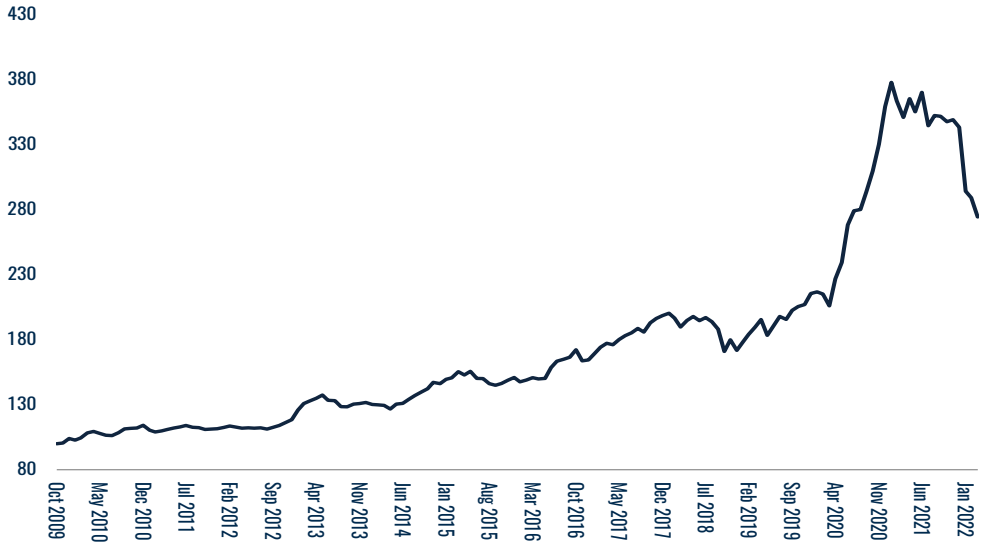
Allocation by Sector

Information Technology	39%
Industrials	24%
Health Care	19%
Consumer Discretionary	7%
Communication Services	5%
Materials	1%
Cash	4%

Top/Bottom Quarterly Contributors (bps)



Performance Since Inception



Performance is based on a Net Asset Value (NAV) price basis with income reinvested, net of fees. Past performance is not a guid to future performance.

Performance

Year Ended	Mar 2022	Mar 2021	Mar 2020	Mar 2019	Since Inception
Net Performance	-21.9%	+70.4%	+8.9%	+0.1%	+63.8%

***Inception as a UCITS: 27 January 2017**

Fund Codes

	ISIN:	SEDOL:	Bloomberg:
A Acc	GB00BDCJ9Z32	BDCJ9Z3	TMCPEAA LN
B Acc	GB00BDCJB138	BDCJB13	TMCPEBA LN

Key Fund Information

NAV/Share Class (Acc)	£16.38
Fund Size (£mn)	83
Currency	GBP (Base)
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	September 2013
Fund Saving Structures	SIPPs, ISAs & JISAs
Key Fund Documents	cernocapital.com/cerno-pacific
Ongoing Charges - Class A (incl. Management Fee)	Management Fee 1.00% Other Fees (incl. running costs) 0.% OCF 1.21%
Ongoing Charges - Class B (incl. Management Fee)	Management Fee 0.75% Other Fees (incl. running costs) 0.17% OCF 0.96%
Transaction Costs	Explicit Costs 0.03% Implicit Costs 0.52%*
Initial Charge	5% - waived as standard
Contact	Tom Milnes 020 7036 4126 tom@cernocapital.com

*We have only started calculating this data from 1st July 2021, and as such this is an estimate based on the available data so far