CERNO CAPITAL

TM CERNO *Pacific*

UCITS Regional Equity Portfolio (Class B)

Q4-2022

Fund Data

NAV/Share (Class B Acc)	£14.31
Fund Size (£mn)	68
Currency Share Class	GBP (Base)
Investment Management Charge	0.75%
Ongoing Charges Figure	0.99%
Dealing Frequency	Daily
Legal Structure	OEIC (UCITS)
Co-Managers	Michael Flitton & Fay Ren
Inception Date Fund	2017
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.

Q4 Investment Report

Fund Activity

Fay Ren provides performance commentary and details position changes during the quarter.

Hamamatsu

A global leader in light technology for metrology.

Fund Activity

Fay Ren

The fund delivered a return of +3.5% for the quarter, in line with broad Asia Pacific equity index, in GBP terms. This takes the return for 2022 to -30.2% versus -7.2% for the comparator index. The large gap in relative underperformance in 2022 was due to the Fund's style bias towards growth, which suffered under the global interest rate hiking environment compressing valuations, lack of exposure to sectors such as Energy, and geopolitics driven volatility within our China and semiconductor allocations.

The final quarter was characterised by a V-shaped equity market in Asia. October marked the bearish extreme of investor sentiment as geopolitics took a turn for the worse on outcomes of the China 20th Party Congress and the semiconductor embargo expansion by the US that alarmed investors. The MSCI China index corrected -17% in USD terms, troughing on 31st October.

Subsequent reversal of this downtrend came as the Chinese leadership was forced into a somewhat abrupt dismantling of its controversial zero covid policy. The original intent for a gradual loosening (with no clear timeline) quickly shifted gear into full policy U-turn, catalysed on the back of widespread public protests broke out across the nation in late November as citizens vented their pent-up frustrations. By year end, the vast majority of the draconian measures had been rolled back including mass PCR testing, health QR code checks, home lockdowns, centralised quarantines, and re-opening of international borders for business and travel after three long years of self-imposed isolation on 8th January 2023. The market welcomed this much needed visibility and Chinese equities rebounded strongly, posting a +30% USD gain on the MSCI China Index from the October trough.

The focus now shifts to monitoring the exit wave of infections, particularly heading into the upcoming mass seasonal migration during Chinese New Year in late January. Surging cases will test China's healthcare capacity and cause further labour shortage induced supply chain disruptions, which will expect to be challenged over the next few months, mirroring economic re-opening trends observed in other countries previously. However, given the highly transmissible Omicron strand and spread during the holiday season, this disruption may sweep over faster than expected. Indeed, larger cities have already reached over 80% infection rates in December.

Consumption is beginning to return, with travel at the forefront. Travel bookings is already bouncing back to 65% of pre-pandemic levels versus 22% in just a month before. Lunar New Year travel is expected to double to 2.1 billion trips, cited by the Ministry of Transport, which indicates a recovery to 80% of holiday traffic versus pre-pandemic 2019. This benefits travel booking companies like Trip.com, which we own in the portfolio.

At the individual company level, the top three performance contributors were Kingdee (+156bps), Glodon (+141bps), and Hengli Hydraulic (+77bps). Kingdee and Glodon, both domestic focused enterprise software names, rebounded on expectations of economic activity resumption associated with Covid re-opening. In particular, despite exposure to the construction industry, Glodon delivered revenue growth at +20%, with little direct impact from property sector slowdown. Hengli's excavator end-market is starting to see a bottoming out shown where excavator sales volumes turned positive for the first time in since Q3 2021 in October. The company's efforts in end-market and geographic diversification are also bearing fruit with non-excavator revenues exceeding 50% for the first time in Q3, and overseas revenues resilience helping to offset at least partially offset some of the domestic weakness.

Top detractors included Wuxi Biologics (-59bps), ResMed (-58bps), and Harmonic Drive (-57bps). Wuxi Biologics was one of the worst affected during the October sell-off, additionally impacted by the concerns over impact of Biden administration's executive order to advocate onshore biotech manufacturing, where Wuxi has over 50% revenues from US customers. While the company is making progress in removing itself from the Unverified List (meaning less likelihood of being placed onto the Entity List), it remains our view that the geopolitical sentiment will be the main driver of stock performance rather than fundamentals, hence the decision to take the loss and redeem the position in full. ResMed continues to take share in CPAP devices at the expense of peer Philips' recall, although component supply constraint and rising costs pressuring margins. Harmonic Drive (HSD)'s largest shareholder, Nabtesco, announced it has sold the remaining 10% holding in HDS as part of its long-term divesture plan, which will work through a digestion period as the shares trickle back into the market via brokers, pressuring valuations on negative share supply/demand.

During the quarter we took the decision to consolidate our China holdings to account for heightened geopolitical risk, internal governance concerns, and worsening zero covid dynamics. As we wrote in our previous report, China exposure was trimmed back to 19% around the Party Congress. This turned out to be a suboptimal strategy and subjected to revision when it became clear that policy change was underway.

In our prior missive we stressed flexibility in our response to events. It is one thing to misstep, but the priority is then to correct any error speedily. Given a decisive pull-back in zero Covid policy, emerging signs of policy pragmatism, and Xi's flurry of diplomacy the outlook for China's equities has materially improved. As a result, we started to rebuild our allocation in China on release of the initial zero Covid policy tweaks into November to reach 20% by end Q4, primarily through additions to domestically oriented names that will benefit from a recovery in economic activity and consumption after building up three years of savings. This is still much below pre-Congress levels, as medium-term headwinds still prevail in the geopolitical sphere, particularly with the US, and the new government's competencies yet to be demonstrated. The residual cash was recycled into Japan and Australian names, including one new addition in Japanese photonic specialist Hamamatsu. Michael Flitton details investment case for the new holding overleaf.

2022 has been a challenging year with a myriad of macro and micro factors culminating in a turbulent market. With the Chinese economy re-opening and the interest rate cycle decelerating, Asia looks to be in a much more favourable setup heading into the New Year. We thank you for your continued support and look towards a more prosperous 2023.

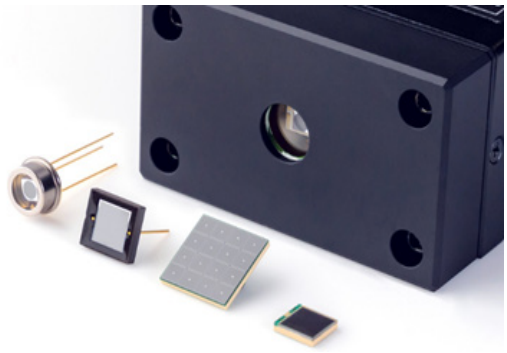
TM CERNO *Pacific*
IN DEPTH

Hamamatsu Photonics – guided by the light

Michael Flitton

In the past 20 years, China became a powerhouse of IP generation. The supply of skilled labour, targeted government support, and an entrepreneurial culture have combined to produce a swathe of companies creating new markets or challenging existing multinational incumbents. The opportunity set led to Chinese companies accounting for the largest set of allocations, aggregated by country of domicile.

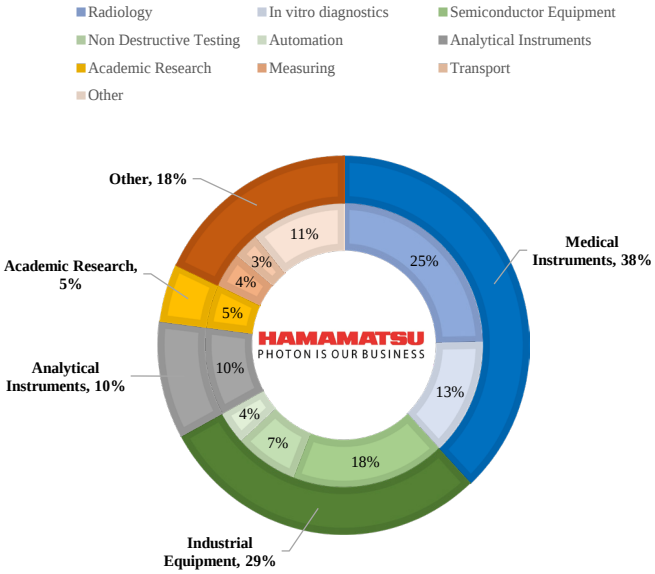
Founded in 1953, the business focused on developing optical technology products for Japan's nascent post-war electronics industry. From its initial commercial success with phototubes, which convert light into electrical signals, the company's pursuit of light-related technology led to its development of photomultiplier tubes in 1959 and silicon opto-semiconductors in 1972. Over time, this evolution has led to a broad portfolio of over 15,000 products all linked by the technology of light.



Sample Product Set, Source: Hamamatsu

Fundamentally, Hamamatsu is in the business of helping measure things accurately with light. The applications for light-enabled metrology are varied. Hamamatsu's expertise gives the group a building block utility function into a wide range of industries. From a bird's eye view, medical and industrial applications represent two thirds of revenues. However, a more detailed sector view illustrates the diversity of the group's end markets and a healthy range of mature and emerging industries.

Within Medical Instruments the group's radiation tools allow the visualisation of bone and tissue structure while in vitro testing technology enables sample analysis, including haematology, antibody, and PCR. Industrial Equipment solutions range from light source for EUV blank inspection to quality control testing of EV batteries. The remainder of the business is equally varied and among others includes environmental testing instruments, LiDAR components, and civil engineering equipment.



The breadth of Hamamatsu's portfolio makes estimating detailed market shares challenging. We can surmise the group holds an advantageous position by virtue of stable gross margins of over 50%. We do have certain details, which help in the mosaic of the whole. Hamamatsu has a 90% share in high sensitivity photomultiplier tubes. These are high specification for demanding applications. Opto-semiconductors are smaller and lower voltage. Their range of uses is broader and so the market supports more players. Here the company has 80% share in high end and 40-50% in the remainder. In emission microscopes for memory semiconductor prototypes the group commands 100%. Together these pieces suggest a company with a dominant position in high end light technology products and a leading position overall.

This position has been achieved through technology leadership. There is an academic kernel to the group, which is formalised in its dual strategy. Hamamatsu looks not only to commercialise products but 'explore the nature of light'. This desire to advance fundamental research has propagated a deep relationship with academia, which represents 5% of sales. Hamamatsu's products were used to detect neutrinos at the Kamiokande in Japan and the Higgs bosun at CERN. The outcome of this dual ambition is a company with one eye on long term breakthroughs alongside iterative, customer-led innovation of its current portfolio. Such an approach likely creates some excess and inefficiencies but we judge these to be acceptable against the expanded opportunity set for growth.

Technology alone is not enough to sustain a competitive advantage. Customisation is a core part of the business and has led to deep relationships with customers. This results in a high mix, low volume portfolio of enormous breadth. This breadth confers a wide moat as each market may not be enough to sustain a new entrant on its own. Competitors must therefore compete across many sub sectors to gain scale, which is a challenge.

Given the diversity of use cases, demand for Hamamatsu's products ranges from GDP plus for established radiology markets to high growth emerging drivers like new energy vehicles. In the near term we expect some cross winds, as semiconductor capex and demand for PCR testing cools. Over the longer term however, the broad demand exposure and critical value of their service creates a robust growth outlook.

The investment approach at Cerno draws us towards companies that are businesses enablers. These companies are more insulated from the increasingly short cycle demand trends of the end consumer. They can supply multiple winners over the course of an industry life cycle. Business to business relationships are founded less on price and more on quality, reliability, and service. As we move into an environment of structurally higher inflationary pressures these companies are well placed to weather the challenges ahead. Hamamatsu is a case in point albeit a further step back supplying other enablers, including several invested companies across the Global Leaders and Pacific strategies. This is a company with option value built in through its dual focus on breakthrough and commercial technologies. The CEO's motto 'status quo is not an option' points to a desire for consistent reinvention and is the commitment to adaption we look for in the companies with invest in.

- Michael Flitton

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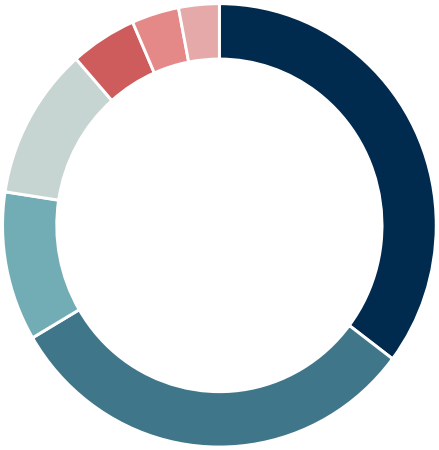
FUND FACTS



Geographic Exposure

- Japan - 35%
- China/Hong Kong- 31%
- Australia - 11%
- Taiwan - 11%
- Korea - 5%
- Singapore - 4%
- LATAM - 3%

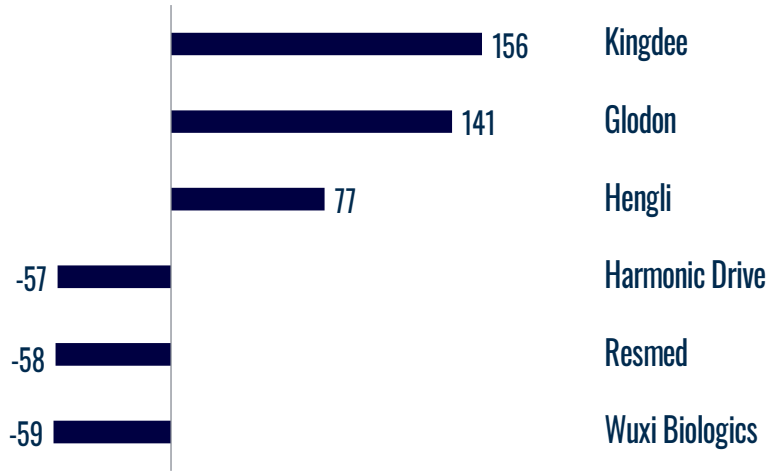
Top 10 Holdings

CSL	6.1%
TSMC	5.2%
Hamamatsu	4.9%
Samsung Electronics	4.7%
Kingdee	4.3%
Resmed	4.3%
Advantech	3.8%
Midea	3.7%
Denso	3.6%
Nabtesco	3.4%

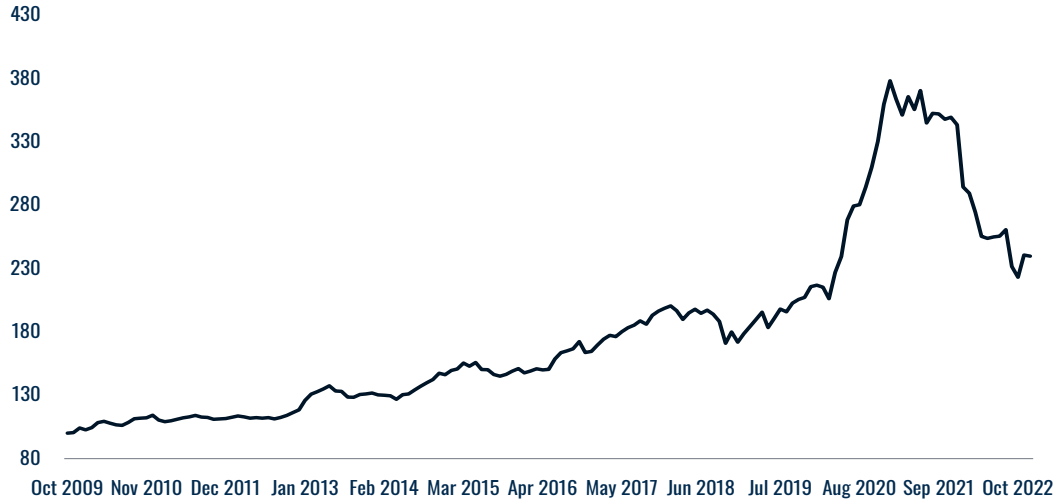
Allocation by Sector

Information Technology	33%
Industrials	29%
Health Care	21%
Consumer Discretionary	10%
Communication Services	3%
Materials	1%
Cash	3%

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	Dec 2022	Dec 2021	Dec 2020	Dec 2019	Dec 2018
Net Performance	-30.2%	-4.5%	+66.7%	+25.9%	+13.3%

*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)	£14.31
Fund Size (£mn)	68
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	January 2017
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) 0.24% OCF 1.24%
Ongoing Charges - Class B (incl. Management Fee)	Management Fee 0.75% Other Fees (incl. running costs) 0.24% OCF 0.99%
Transaction Costs	Explicit Costs 0.06% Implicit Costs 0.10%*
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