CERNO CAPITAL

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The year just elapsed has left many asset managers confounded. Of the mainstream investment strategies US and UK government bond investors trumped all before them: the US 10 Year Treasury rose +12.8%. World Equities fell by –5.5% in local currency terms.

According to the consultants that track these things, the hedge fund community, on average, (although we question whether average is a meaningful measure) lost money in 2011. Withinhedge strategies, equity long-short was an area of particularly poor returns. Managers struggled to gain traction in markets that shed direction in the second quarter and thence followed a jagged trace. And whilst Global Macro managers fared best - with the more successful managers producing positive returns and some in double digits - these returns were predicated largely on rates trading. The core strategy of rates traders is being ‘long’ (that is, receiving interest coupons) of one part of a government bond curve and being ‘short’ (paying interest coupons) on another part. As the key central banks signalled all year that they were working on depressing long rates, this provided the rates community with a clear hymn sheet - the Fed even attaching a brand name to their strategy which they termed Operation Twist.

2011, therefore, was a boon for US government bond investors and global rates traders and a bane for pretty much everybody else.

The critical currency overlay trade of the year was to recognise the decisive change in value of US dollar, against its major pairs, that took place in August and re-position accordingly. For our clients’ portfolios this entailed excising the remnants of any Asian and Emerging Market currencies and remaining out of the euro. The euro had remained relatively robust during the Trichet era at the ECB, partly held up by the positive rates differential against USD and partly by diversification flows from reserve bank investors.

Updating to the new Draghi regime, the new governor lost no time in cutting European rates, removing a good part of that positive differential. He also instigated liquidity support that is a form of QE by another name. As a consequence, reserve bankers are not quite so avid buyers of euro paper these days, the doughty German woman and the peripatetic Frenchman looking short of the perfect sales force to the cashiers of Abu Dhabi, Riyadh, Beijing and San Paulo.

We saw a number of retirements and fund closures during the year, retiring managers complaining of the fogginess of the view. This fogginess has been described very ably by Bill Gross (who has decisively not retired) in a recent letter which begins:

Now we appear to be morphing into a world with much fatter tails, bordering on bimodal. It’s as if the Earth now has two moons instead of one and both are growing in size like a cancerous tumour that may threaten the financial tides, oceans and economic life as we have known it for the past half century. Welcome to 2012.

Far from delevering, global economies and their credit markets continue to (mildly) expand. We enter 2012 facing a bimodal fat-tailed risk and whilst the fat right tail of potentially higher inflation has existed for over three years now…

…at the other tail is the potential for "implosion" and actual deleveraging. To the extent that most sovereign debt is now viewed as "credit" in addition to "interest rate" risk, then its integration into private markets cannot be assured…

…private bond markets and non-peripheral banks in particular may refuse to play ball the way ball has been played since 1971 – purchasing government debt, repoing the paper at their respective central banks and using the proceeds to aid and assist private economic expansion.

He defines the undesirable consequences of sustained zero interest rate policies reducing the normal functionality of credit and deposit markets, citing Will Rogers, a Depression era figure who memorably commented that he was more concerned about the return of his money than the return on his money. Locked into today's "paranormal" reality where curves are pancake flat, we might all become Will Rogers.

Conceptually, when the financial system can no longer find outlets for the credit it creates, then it de-levers.

If Bill Gross is right in concluding that it cannot be said at this point in early 2012 with a sufficient degree of certainty as to which moon the global financial tide will lean toward, then we suggest that investors should audited their wealth to uncover the biases that lie within.

Within this framework, cash is not a neutral pick, but an asset attached to the deleveraging outcome.

The collective portfolios that we manage enter 2012 without any pronounced tilt to one set of outcomes. They remain constructed around a core group of macro managers, none of whom are expressly directional in their positioning in equity markets and whose competencies lie in rates trading, currency pairs trading and market neutral merger arbitrage.

Our equity allocation is split between a US mega-cap manager whose style is very much tilted towards earnings quality, a long-only Japanese manager and a long-short European manager.

Gold remains a feature in portfolios – principally through a bullion backed ETF, but also supplemented by a tracker of global large cap gold equities. Gold has struggled of late – largely as a consequence of the rising dollar and some weakness in base metals in the latter part of 2011. However gold remains the prime beneficiary of any further money printing and devaluation of fiat currencies.

We have added a position in long dated Australian sovereign bonds; this is somewhat anomalous given our general view that there is very little value in other government bond markets. Australia's outlook is intimately tied up with China, where we expect economic turbulence and some reduction in their avidity for Australian ore and metals. The Reserve Bank of Australia has commenced a rates cutting cycle at the short end as inflation abates and we expect the whole curve to shift downward.

Finally, the US dollar, through currency overlays, has been an important component of portfolios since the third quarter and accounts for approximately 40% of the underlying currency exposure.

The early part of each year is always distinguished by the need to explain past events and inter past thoughts. Looking forward, this is not a time for extravagant prognostications but rather to keep patient eyes skyward, trained on those twin moons. Ultimately, one will gain sway and that will open up the path to more reliable returns.

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