CERNO CAPITAL

Investment Letter: 7th February 2013

In an investment world heavily populated with oversized economic threats, there lurks in the bones of the dedicated security investor, a strong pull to ignore the macro noise.

This may be just the moment to do so.

Whereas the trading pattern of equity markets in recent years has conditioned investors to expect solid gains, heavily eroded by sharp pull-backs, 2013 may prove different to previous years. If that does prove to be the case, we can either infer that stock markets have begun to behave in their traditional role as sentinels of improving economic fundamentals or that front line equity markets are being whipcracked by excess liquidity. Plausibly both.

As markets gradually recall the lines that come with the sentinel role, investors will begin to recognise patterns – patterns that have been largely absent for the past five years. The marker of this is stock dispersion: increased ranges of returns between different types of stocks. Other signals include the outperformance of the value style versus the growth style and the outperformance of small caps versus large caps : all phenomena that appear to be emerging. We should expect the relative returns of active, stock-picking strategies to recover versus passive, index hugging strategies.

This has considerable bearing on the private investor. A well built portfolio of equity managers is likely to contain some of both types: ETF trackers and active managers. We would urge investors to take a hard look at the performance attributes of their equity managers in 2013. Assuming they are adequately invested in markets, poor performance can signal overreliance on macro themes or inappropriate style bias.

When we think about how financial returns relate to the environment, pragmatism rules.

We would be best to accept the economic cycle with all its perceived limitations: disfigured by debt, misshapen certainly and deficient in many regards.

Eliminating consideration of exogenous threats which we can do nothing about, the more profitable debate is about the internal workings of economies and markets. The kind of questions that should be addressed include assessment whether repair is taking place in areas that need repair ? Are the backstops working ? How might animal spirits develop ?

For those, like us, who have looked to the US for leadership, we can proffer positive answers to these questions. Sadly, the tenor of British officials remains inimical to the development of animal spirits. The UK economy is recovering despite the officials, not because of them. Europe has shown that things can get done in extremis, so benign periods, such as exist presently, are counter productive to the necessary development of the euro superstate. Japan is being frog-marched toward reflation: weakening the yen and boosting equities as a consequence.

CERNO CAPITAL

It is our view that we are now bobbing through a period where returns from equity markets will be enhanced. January alone was a considerable enhancement.

What lies beyond ?

It is in our minds not to be premature in anticipating the end of this period. The next impediment might form in the shape of building concerns towards the end of QE as US employment recovers. Certainly, if there is one macro data series to keep a watchful eye on, it is US employment. The Fed has anchored its policy to either 2.5% inflation or 6.5% unemployment, whichever is breached first.

Before 6.5% unemployment comes about (and some economists say it never will, due to the fact that the world’s requirements have moved well beyond the available skills of the semi-skilled element of the US workforce), there will be an inevitable period of fretting as to the consequences. Equity markets tend not to react well to epochal changes to interest rate policies, although premature fears toward can, we think, be adequately discounted.

Within our generational view lies the more grave threat presented by unmanageable debt balances. The way of all flesh for sovereign nations has been to re-stoke the pile of debt – government stepping in to make up for private sector retrenchment. The US has claim to leadership in this profligacy. US lawmakers are smashing up the crockery to do deals that leave the essential issues unresolved. At some stage in our investment lives, we may face the consequences of a loss of confidence in reserve currency status and fiat money in general.

The practical dilemma for the investor is one of timing. This year, next, the next ten years. Fine, for now, is our temporal conclusion. But, like trained ornithologists, we keep our eyes on the bushes and the reeds for changes that would necessitate abandoning our current pragmatism.

James Spence.

James Spence
Managing Partner

be full or complete. Nor does this document constitute investment advice. No representation, warranty, or undertaking, express or limited, is given as to the accuracy or completeness of the information or opinions contained in this document by any CERNO CAPITAL, its partners or employees and no liability is accepted by such persons for the accuracy or completeness of any such information or opinions. As such, no reliance may be placed for any purpose on the information and opinions contained in this document.

Cerno Capital Partners LLP 34 Sackville Street, London, W1S 3ED
Telephone +44 (0) 20 7382 4110   Facsimile +44 (0) 20 7382 4122   Website www.cernocapital.com