CERNO CAPITAL

Investment Letter: 8th March 2013

Performance aggregates for the first two months of the year have been swayed by two broad developments – the underperformance of bonds and the outperformance of equities. This is a better mix for our clients' portfolios than prevailed in the past three years. By vacating bonds more than two years ago, we obtained none of the final flush in their performance. During the same period, equity performance was chimerical, even if it tallied positive overall. Our admittedly early, and therefore incorrect, asset allocation meant that we were tacking into the wind throughout the 2010-12 period. Our returns to clients have been positive but not as good as a 50% bond, 50% equity portfolio for that period. This has now changed to our investors' favour.

Recent country equity performance seems to support the notion that there is a strict relationship between active, supportive and unorthodox monetary policy and rising equity markets. The UK, US and Japan have been at the vanguard - three markets in which our portfolios are well represented.

As pragmatic investors, we concede the validity of this relationship whilst doubting its longevity or ultimate reliability.

The financial press has cottoned on to the term 'The Great Rotation' as a shorthand means of referencing this outperformance of equities versus bonds. However, Great Rotators are prone to be unreliable bed mates. Western demographics are strongly suggestive of plan asset managers stocking up on bonds, not selling them, as their unit holders approach retirement age, or indeed age beyond retirement age.

The recently published 2013 Barclay's Equity Gilt Study refers to the implied negative risk premia on core government bonds. In non-jargon terms, this means bonds yielding persistently less than inflation.

Put another way, when nominal yields are compressed to almost zero, capital values can no longer rise as yields can barely fall further. Repression through compression leads to distortion.

Cross the axis of ultra-low yielding nominal bonds and we enter the weird and wonderful world of index linked bonds. The volatility that has hemorrhaged out of conventional bonds, as a result of QE, has been transferred to their index linked analogues.

This writer's understanding of the index linked asset class got off the ground when he realised that index linked bonds are, in fact, nominal bonds with a kink (the indexation of cash flows). They are not, after all, real assets. As in Strawberry Fields, nothing is real.

You don't have to invest in index linked bonds – we do not at present, as real yields are measurably better on high quality equities – but every macro allocator and multi-asset class investor certainly needs to know what their pricing and behaviour are saying. Our conjecture would be that the BoE and Fed spend more time peering at their index linked markets than their conventional markets for price signals and inflation expectations. Further deepening of negative real interest rates is helpful to reducing the real claims of creditors and (theoretically) stimulative to consumption. As nominal rates cannot easily move below zero, it is the inflation number which needs to extend for real rates to budge at all.

A few questions pop up immediately.

Imagine buying an asset that is advertised as inflation protection yet delivers a negative real yield? The curve is priced at negative real yields all the way out to the distant future. The 2062 index linked gilt offers a real yield of 0.023%. Not what it says on the tin.

What if economic improvement fans out from the US and real yields actually rise? Good for equities (up to a certain level of inflation), but immediately bad for nominal and index linked bonds. What if we have a major inflation explosion, caused by some macro trauma? Equities lose, nominal bonds lose, inflation linked bonds rise initially but then could collapse. Why? Because they are fiendish instruments that contain very high tail risk and the tail risk increases as inflation increases. This is because the bulk of the cash flows are contained at the terminal repayment. As that number rises due to the indexation of inflation, sovereign risk rises with increased risk of default. These factors already play across the Italian inflation linked market but who is to say they would not in the UK, at some stage?

On a less imaginative level, it is entirely possible for inflation to rise and investors to lose money on inflation linked bonds. This point is not well understood and is the result of the direct interplay between nominal and inflation linked bonds. The latter are priced off the former.

When they win - and win decisively against other financial assets - is when inflation expectations explode *and all other things remain the same*. That is that real yields do not rise and repayment risk does not rise.

Fixing these somewhat interconnected factors is made more difficult by the fact that it is hard to imagine inflationary expectations rising without there being higher inflation prints. Inflation is (most often) the precondition for inflation. Even if it goes all hockey stick on us, near term measured inflation (what a bond investor would call realised inflation) should be rising beyond norms before hyper-inflation or high inflation takes hold. In a reflexive world, this rather precludes all other things being the same.

The final question is the biggest one of all and that is whether Central Banks can actually generate any more inflation than they currently are doing? An investor in index linked bonds needs to think they can. Many arrive at the asset class because they do not trust Central Banks and governments. The irony of their position is that they need to trust them even more: the first to create inflation and the second to pay them back.

It should be emphasised that both bulls and bears of the asset class are operating in a realm of 100% theory as the UK sector has only existed since 1981 and the US since 1997. The asset class has only existed in an age of disinflation. Its track record during disinflation is good but it has never been tested against a backdrop of inflation.

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For interested investors, index linked bonds are the subject of a new report by Mustafa Abbas who joined Cerno Capital in December.

The recent weakening of GBP has channeled memories of 1992 and the 1970s and rather underlines the lack of policy options in the UK. A bearish consensus hangs over our islands.

We are being told that the mix of fiscal rigour and monetary wizardry is here to stay (until 2015, that is). But it is one thing to talk restraint (and receive all the cream pies on the noggin for doing so), but where is it in the figures? Debt is not falling, the deficit is not falling.

Not all the forces of nature are against us though. Total employment (numbers of people working) is at an all-time high and rising. The personal savings ratio has reached 8%. If the government inadvertently scares people further, it can go higher but today's level would normally be seen as being toppish. A falling savings rate is associated with increased consumer activity.

When we look at the UK bottom-up, we find plenty to be getting on with. There is a well-grounded bull market in mid-cap stocks, into which we are invested. We find that the earnings yields and dividend yields, on the types of companies our UK managers invest in, remain attractive. Buying British is not jingo, it makes good financial sense.

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