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Investment Letter: 5th April 2012

The first quarter of 2012 was a time of wine and roses for equity investors: a reward for patient, consistent allocation. The so-called "riskier" end of bond registers, high yield and Emerging Market bonds, also performed well. By contrast, the US bond market offered no return during the quarter and the upward flutter in rates that took place in March hardened suspicions that core government bonds have run their course. Finally, it was a period of abeyance for macro hedge funds and gold – other key asset classes.

Deconstructing the equity return into its base components, we certainly need to acknowledge the persistently improving data, especially that emanating from the US economy. This has even surprised Ben Bernanke who was forced to proffer alternative theories for the better than expected growth in jobs before resting on his conclusion by elimination that "jobs growth we indeed have". It has happened before: the phenomenon whereby small-business America agglomerates enough employee additions so as to make a difference to the national statistics, confounding macro observers. It denotes greater confidence where confidence has been deficient, it speaks of better order books and thirdly, for those businesses for whom it matters, it suggests a very competitive exchange rate.

The Chinese have noted this too – halting the appreciation of RMB in its tracks and issuing statements attesting to its fair value. The rapid re-alignment of the RMB's real effective exchange rate in the past few years has been achieved not through the numerical rate itself but through the inflation of base wages in China, causing significant pressures on the low margin manufacturing base. So yes, the data has improved, but perhaps not by the magnitude that would justify the 28% increase in the S&P500 since October last year. The rally owes more to its start point during a period of considerable pessimism and overly light allocations.

It may well be that US corporate results chime in to support the significant move in the market but we are still prone to think that the 2012 return from equities will hinge on their continued upward rerating, something that is hard to predict in advance and something, given the strength of the move to date, and the advancing spread between bulls and bears, we should place a lower weighting on now. Given the fact that a fully invested multi-asset class portfolio with a core weighting in equities will have returned between +3% to +4% in the first quarter of the year, we should have curtailed return expectations between now and the end of the year. This first quarter return, after all, represents something akin to 24x to 32x cash on a annualised basis. And if it don't feel as good as it sounds, we should be forgiven for having trouble adjusting to the "new normal", as Bill Gross has termed it.

Longer term bears are, for the most part, relying heavily on valuation work to suggest that US equities are expensive on *average*, rather than trailing or prospective earnings bases. Corporate margins are at an all time high and, whilst this is a mean reverting series but again, it is hard to predict these matters in advance or at least to locate accurately the year in which they come home to roost.

What would be the catalyst to cause a meaningful fall in margins ? The bearish line has it that debt-strapped governments, having squeezed first their own budgets and then filched from savers and pensioners, would ultimately turn to corporates – there being nowhere else to turn. Maybe, but the next five years of American life either entails middle-of-the-road-Mr-compromise-Obama who lacks the radical bent, or low-tax-private-equity-Jesus-lived-in- America-call-me-Mitt-Romney, neither of whom seem the type. Even our own compromise government set-up is trying to steer a pro-employer line in policy even if employment legislation and the taxation code appear to be insurmountable foes. In Italy, Mr. Monti is doing nothing more (Sunday trading apart) than what Italians know needs to happen in their *bel casino*. Perhaps France will be the test case for this: assuming Sarkozy loses and Hollande gets in.

Other events are also plausible instigators of corporate disruption: a nuclear Israel-Iran conflagration, a massive oil shock from this or another source, a jumbo fall in Chinese residential flat prices.

However, is there ever a time at which the potential negatives do not circle like velociraptors in a dinosaur nightmare ? There is a speech at the end of the film *Margin Call* made by the character played by Jeremy Irons, who plays the head of a brokerage that survives the financial crisis by dumping their toxic assets on unaware counterparties.

Having traded their way out of the crisis by burning their relationships, he is trying to comfort a morally queasy Head of Sales who is played by Kevin Spacey. In the speech, replicated in full at the end of this letter, Tuld, the Irons character, lists a number of dates of asset market crashes in history.

"…it's not wrong and it's certainly not any different today than it's ever been. Ever. 1637, 1797, 1819, '37, '57,'84, 1901, '07, 1929, '37, '73, and 1987..., 92, 97, 2000, and whatever this is gonna be called. They're just the same thing over and over. We can't help ourselves, and you and I can't control it, stop it, slow it, or even ever so slightly alter it..."

As pointed out by a member of GMO's quant group, recently in London for a series of presentations, it is these crashes that establish the Equity Risk Premium that make equities the best asset class in the long run. The drawdowns, the consequent angst and forced selling is the ultimate source of the superior residual return, accessible to those able to weather such events.

It just so happens that it ain't been so for the past 30 years. The ERP has been elusive, precisely zero, as the return from equities and government bonds are tied in real terms over the past generation. As we move forward, this anomaly is likely to be corrected by a destruction of capital in bonds. We remain of the view that the authorities have a logical bias to taking a risk on inflation rather than deflation, because they know it is difficult but not impossible to get out of an inflationary spiral but destructive and problematic to escape a deflationary spiral. Part of this view is founded on overconfidence on the part of the authorities. Sebastian Lyon of Troy Asset Management reminded us of an interview on CBS' network show *60 minutes* in 2010 with Ben Bernanke:

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CBS: “You have what degree of confidence in your ability to control [inflation]?” Bernanke: “One hundred per cent.”

Gotta love America. That’s what they call *chutzpah.*

We own next to no bonds, we own some gold, although much less than before, we are invested in some low volatility macro managers and we have a bias toward income producing equity franchises. That is likely to be the shape of our portfolios for the rest of the year.

James Spence
Managing Partner

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