CERNO CAPITAL

Investment Letter: 14th May 2012

In the equity domain, April entailed some hand back, particularly in Japan where the greatest gains had been made year to date.

By contrast, within bonds, Emerging Market credits have continued their rip. It seems that the world is replete with gentlemen whose preference for bonds will take them far from home, in search of the right coupon, but very seldom into the arms of an equity security.

A very large mass of investment assets are still aboard the bond market, being whipped with some fury, into the very last furlong. European political elections have provided further paper profits in core bonds: the yield on 10Y Bunds falling 33bps to 1.46% since the end of March. Markets are familiarising themselves with the notion that Greece will leave the euro, even if this is a ticket to selfimpoverishment. However, as most core bonds (Australian governments excluded) offer less than the prevalent rate of inflation, they are a duff long term investment at their current prices.

At some point we may look to question whether asset allocation within Europe can become any more core, any more crowded into Germany. Notwithstanding this trend, there are reasons to think that German equities offer decent value, even if its bond market does not. The earnings yield gap on the German equity market has touched 8% at the point at which the bond yield reached 1.5%. *Dieser ist breit und gut aussehend.* (This is wide and handsome). The reason for this *breit* and *gut aussehend*-ness is that non- European domiciled assets are largely absent from Europe. The view from the US is that Europe is a car wreck, too difficult to analyse, too toxic to invest. Europe is a pass. We have limited positioning with an equity long-short manager in the euro region but are otherwise not committed and have carried zero exposure to the euro for some time now.

Part of our daily routines are spent meeting managers and eliciting their views. In these conversations, a gloomy view of the world invariably emanates from Europe and radiates thence. In the obverse, a more upbeat assessment takes as its origin in the US. The most optimistic asset manager on the planet possesses a set of spectacles that gives a render of the deepest rose. That is not in any way to suggest he is wrong – in fact the script has been very much with him in the past few quarters, so our ears remain open. To his thinking, we are ‘only a couple of (US) jobs prints away from a meaningful upward turn in bond yields’ and that, if the current trajectory in US employment numbers are maintained, the Fed might be looking to make the first upward adjustment in interest rates in mid-2013.

Any upward nudge in rates would be very challenging for gold. We sold all remaining gold from portfolios in the past two weeks, at levels above US$1600/oz. The interest rate view did not lead this decision, although we recognise that probabilities here have shifted. Gold lacks an income stream on which a fundamental view can be anchored, therefore, it requires buying impetus from a combination of sources: diversification, fear, speculation, Indian weddings. Speculation has more of a role than we should be comfortable with.

CERNO CAPITAL

Volatility is here to stay but we should ignore it. Most attempts to trade ahead, around, or in the wash of volatility are value destroying, especially in the current environment where the switchbacks are sharp. Volatility, and the shifting sands of solvency, are the two ingredients that lend equity securities their Equity Risk Premium, otherwise known as the return you get above bonds. High income, low beta, high earnings defensibility are good attributes to have.

To a bond manager, high ROE with earnings defensibility and a dividend would be understood as a relatively low duration real asset. An asset for the times, in other words.

Quality equities, preferably with income, are the assets of choice from here.

James Spence

James Spence
Managing Partner

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