CERNO CAPITAL

Investment Letter: 13th May 2013

In each one of the past three years, markets have exhibited a strong seasonal pattern: the first and last quarters providing all the positive return for the year, whilst softness occurs in the middle two. This phenomenon may occur once more in 2013, but it is a habit of financial markets to alter their behaviour when their observed patterns become widely recognised. That things change by being observed is a matter of physics.

Tim Bond of Odey is a constructive thinker on this subject, even suggesting a reason for the increased seasonality. He suggests, in an Amazonian world (the dot com that is), that consumption patterns are becoming more and more seasonal. Whereas there were just three gifts at the Nativity, we now send billions of brown parcels around the world at the end of each year. Casual employment is driven by our compulsive clicking, and the consequent stacking and delivering. The economic boost fades once our wallets are consumed.

The combination of the fact that the equity asset class has been *the* show in town, with some unreliable performance characteristics emerging elsewhere, is presenting a challenge to multi-asset class managers who adhere to the “Yale model”.

The Yale model of asset management probably reached its apotheosis of recognition at the point when it lost some of its sheen. David Swensen, who runs the Yale University endowment, published a book called *Pioneering Portfolio Management* in 2000. The book’s subtitle reads “an unconventional approach to institutional investment”. The problem of late has been that the unconventional bit became somewhat more conventional. So well embraced was the notion that you could obtain uncorrelated returns by investing in different asset classes, that it became the dominant management model in the endowment world. Thanks to Vanguard and iShares, other investors were able to join in. The River Swensen met the River Bogle in a happy confluence, where private and professional multi-asset class investors were able, through ETFs, to emulate endowments. This very significant additional liquidity did for the uncorrelated bit of returns. Consequently, multi-asset managers who continued to try to fill all their asset allocation boxes are beginning to struggle with some of their ancillary allocations.

For example, within the putative “real” space, commodities have lost ground, as has gold more recently, despite Central Banks continuing to add to their stock of government bonds.

Neither is all entirely well in the world of Private Equity. Despite the name of the asset class, not for nothing did private equity’s glory years entirely supercede a ramp of leverage when debt was easy to come by.

There are genuine “Alternatives” on offer, though not all of them sit well within a fund structure. What they tend to have in common is very high fee loads and sometimes the term is read as a proxy for hedge-funds.

For our part, as we hold no bonds, no gold and no commodities in our clients' portfolios, we have braced ourselves to go along with the narrowing of the opportunity set, recognising that we are, to some extent, being corralled into the equity class for lack of viable alternatives. This is fine whilst we can locate equity sectors, equity markets or individual securities that offer a positive real yield.

With perhaps the exception of some parts of the Japanese equity market, since the beginning of the year, equity prices have been rising quicker than earnings. We know now that we are experiencing an atypical recovery. Atypically slow, that is. If the price over the earnings ratio inflates too precipitously, the case for caution would increase. It would be an uncomfortable world in which all the haven assets and risk assets became overvalued. Haven assets are already expensive.

Finally, we get to the good news. The World Equity Index is trading at an earnings yield of 6% and inflation is slowing. Despite the rally, there remains some positive margin between the earnings yield and inflation. Moreover, we are investing in some managers who are able to improve on this earnings yield through investing in cyclicality. Cyclicals have been depressed by the outperformance of quality and earnings stability.

We expect to be held to account for the allocation between cash and risk. Beyond this however, the better portfolios will be the ones that strike the right balance between quality and cyclicality.

We reproduce a table (below) of statistics that is, in a way, our calling card: it is a quarterly run of the overall outperformance (statistically defined as alpha) of our approved list of asset managers. To our minds, this tally needs to be consistently positive to justify active investment management and our own role as mediators of private and charitable capital.

QUARTERLY PERFORMANCE OF CERNO CAPITAL APPROVED MANAGER LIST										
By asset class										
OVERALL Equity Fixed Income Alternative Commodities										
	Absolute	***Alpha***	***Absolute***	***Alpha***	***Absolute***	***Alpha***	***Absolute***	***Alpha***	***Absolute***	***Alpha***
4Q_2009	+3.6%	+1.2%	+4.9%	+1.1%	+2.8%	2.1%	+2.4%	+2.2%	+9.9%	+0.9%
1Q_2010	+4.6%	+0.3%	+5.7%	0.0%	+6.5%	2.2%	+2.9%	-0.1%	-3.6%	+1.5%
2Q_2010	-3.3%	+1.3%	-5.3%	+4.0%	-0.1%	-3.7%	-0.5%	+0.0%	-4.2%	+0.7%
3Q_2010	+7.3%	+0.7%	+10.6%	-1.1%	+4.8%	2.4%	+4.0%	+3.6%	+13.0%	+1.3%
4Q_2010	+5.8%	-0.1%	+9.1%	-0.2%	+1.2%	1.0%	+3.4%	+0.3%	+15.9%	+0.1%
1Q_2011	+0.7%	+0.5%	+0.6%	-0.6%	+1.6%	2.2%	+0.4%	+1.8%	+5.8%	+1.3%
2Q_2011	+0.9%	+2.1%	+1.6%	+1.5%	+1.8%	-0.2%	+0.5%	+4.1%	-7.3%	-0.6%
3Q_2011	-8.2%	+1.0%	-13.0%	+2.1%	-5.8%	-6.1%	-0.4%	+1.9%	-12.5%	-1.1%
4Q_2011	+1.5%	-1.2%	+2.7%	-2.1%	+2.0%	0.2%	-0.4%	+0.1%	+0.9%	+0.7%
1Q_2012	+7.3%	+1.3%	+10.6%	+0.3%	+4.8%	+3.0%	+3.2%	+3.3%	+2.5%	+1.6%
2Q_2012	-3.6%	-1.2%	-4.7%	-0.3%	-0.1%	-2.3%	-2.3%	-2.4%	-3.6%	+0.9%
3Q_2012	+4.4%	+0.5%	+5.9%	+0.1%	+2.6%	+0.3%	2.2%	+1.8%	+11.0%	+1.2%
4Q_2012	+3.1%	+1.4%	+3.5%	+0.1%	+2.5%	+3.1%	3.1%	+3.5%	-5.7%	+0.6%
1Q_2013	+6.6%	+1.5%	+9.3%	+2.0%	+2.0%	+0.9%	4.0%	+0.8%	-1.0%	+0.2%
Annualised	***+9.8%***	***+2.7%***	***+13.1%***	***+2.1%***	***+8.2%***	***+1.7%***	***+7.1%***	***+6.0%***	***+5.6%***	***+2.9%***

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From this approved list we have selected those who will form the core of the TM Cerno Select Fund, an onshore UCITS fund that will be launched this summer.

Run as a multi-asset class portfolio, with equity as its home asset class, the fund is suitable for core wealth management portfolios. Highly liquid and transparent, it will offer daily dealing at NAV. Cerno Select becomes our principal investment offering and is suitable for ISAs and SIPPs. For investors who may wish to join the seed class, we are making available a 1.00% fee class, discounted to 0.75% for six months for commitments received before 28th June. Further details are appended to this email and we can be reached at select@cernocapital.com.

James Spence
Managing Partner

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