

CERNO CAPITAL

Investment Letter: 7th June 2012

It is entirely logical to harbour substantial doubts about the near term prospect for financial assets. Happily, the near term need not matter that much.

As the outcomes of vital events can't be known in advance, all we can do is debate the probabilities of their occurring, or, more remotely still, the relative importance of causal factors. Mr. Ruffer speaks great sense in saying he has no idea on the direction of markets. Being agnostic on the short term is the only reliably counter-consensus viewpoint in an opinion-heavy world and represents a shrewd way to forestall persistent error making.

In the European theatre, our enquiring human minds compel us to strap on an imaginary flak jacket, metaphorically load up with Marlboro reds and camera film and wade out onto the streets to establish "what is going on" and "its likely solution". This is wasted labour and we should still our inner Kate Adie.

What is unusual about the euro crisis is that we already know what the outcomes are. The problem is that they are polar-opposite and each is as implausible as the other. As Professor Paul Krugman pointed out recently: one of two unimaginable events will take place, we just don't know which one. Either the German orthodoxy regarding austerity and the delineation of sovereign risk within the euro zone will be abandoned or we will face a very substantial deflationary bust, with great poverty ensuing.

Our softish, democratic, late 20th Century conditioned bones leads us to think that the former may be the ultimate outcome, but perhaps not reached until the tidal forces of a pan-national debt bust rise to Frankfurt and Berlin's doors. The compelling logic at the heart of Greek politician Alexis Tsipras' argument is that there is no point in speaking of Greeks and Germans – us and them, one versus another - the problem is indeed shared. The number of Mercedes Benzes rolling around the streets of Athens confirms this.

The commodity that we, as investors, should seek now is not safety. Safety is overpriced. Nor is it certainty. Certainty is not available. What we should seek is comfort.

Comfort is an achievable goal, in a portfolio sense. There should be no leverage. There should be no time-decay or premium erosion. Investment positions that of themselves become less valuable as time passes are undesirable, we should crave the opposite: positions that will increase in value over time, however slowly. Thirdly, it makes good sense to invest across more than one asset class. Diversity is a hard commodity to locate, but where it exists we should hoard. There needs to be some amount of offset in portfolios – particularly in an environment where we are sway to the gravitational influences of two opposing moons: reflation and deflation. Finally, income should be an objective: income engenders some clarity in a highly uncertain exercise.

CERNO CAPITAL

At best, equity markets have traced an arc in the first five months of this year. US Growth stocks, Chinese shares and the US bond market are still positives – Japan, Emerging Markets and Eurostoxx are now down on the year at the time of writing.

Over the past three years, we have backed the US recovery and have centered our equity exposure there: first through broad ETF index exposure and more recently through active allocations in managers invested in large cap shares. The attached note on US valuations, by Fay Ren, sets up the counter argument, the fat fly in the ointment.

In her piece, she takes the work of Professor Shiller on Cyclically Adjusted Price Earnings (CAPE) ratios which maps the evolution of the equity price divided by a ten year average of real earnings (to eliminate proximate economic cyclicality) to determine whether high or low CAPEs have any predictive power.



James Spence
Managing Partner

Disclaimer: This document is being issued by CERNO CAPITAL PARTNERS LLP (“CERNO CAPITAL”) and is for private circulation only. CERNO CAPITAL is authorised and regulated by the Financial Services Authority in the United Kingdom. This document is strictly confidential and does not constitute an offer to sell or the solicitation of any offer to buy any securities and or derivatives and may not be reproduced, distributed or published by any recipient for any purpose without the prior written consent of CERNO CAPITAL. The value of investments and any income generated may go down as well as up and is not guaranteed. You may not get back the amount originally invested. Past performance is not a guide to future performance. Changes in exchange rates may have an adverse effect on the value, price or income of investments. There are also additional risks associated with investments in emerging or developing markets. The information and opinions contained in this document are for background purposes only, and do not purport to 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.