CERNO CAPITAL

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The investment oceans were once splendidly full of fish of all sorts. No more.

In depleted waters one must trawl for the available krill, hook the odd bass and avoid things that swim but don't taste that good: the dogfishes of the sea.

For multi-asset class investors, only a few rods worked in the first half of 2013. The asset of class of preference was equity and within it, developed equity. The MSCI World Index (USD) rose by +8.4% in the first half and its main Emerging Market Index (USD) fell by -9.6%. Japan was the stand out market within the developed market group, although the US and UK were also good places to have money at work. Bonds of all types began to struggle. Gold, index linked bonds and emerging market income strategies were dogfishes: no amount of soy or cilantro could pep these up.

Our recent investment strategy has been the product of a philosophical and practical acceptance that there is little point seeking diversity where diversity is no longer present. Four considerations are serving us presently. Our clients' portfolios are narrowed in on a small, and simply explainable, set of investment ideas. Secondly, we are able to allocate to a number of excellent managers whose approach passes muster and abilities are evident. Thirdly, bonds have been eliminated on long term valuation considerations. Finally, we have been skeptical to the imminent threat of inflation, the link between QE and inflation and most of the investment options that are badged as offering inflation protection.

There are no end of temporal concerns to ruminate on: both geopolitical and economic. June's sharp correction in almost all asset classes presages what could be a long, hot summer in Emerging Markets. It is easy to imagine how EM dislocation could broil with resurgent problems in Europe's Mediterranean countries and for these two regions to dominate the news wires. The Greeks have not been following their plan. The rhetoric emerging from Turkey's leader is eerily familiar to that from Malaysia and Mahathir during the Asian Crisis of the 1990s. With foreign conspiracies being mooted, the country may make the full trip from poster-boy to goof in a couple of quarters. Egypt has entered a traumatic phase where the Jim O'Neills fly out and the Tony Blairs fly in.

In our last letter we suggested that the response mechanism between economic growth (simplified to the US unemployment ratio) and the yield on medium to long term government bonds should continue to function and that it would be dangerous to think that the central bank agencies can disintermediate between the two indefinitely.

Given that, we suggested that the taper debate is somewhat redundant.

From June's evidence of rapid changes in bond prices, we can infer markets are not yet thinking for themselves. Given the same data is available to all, central bankers might have expected a smoother recalibration of pricing at the long end. Events have forced them to increase the flow of dovish rhetoric and, as a consequence, we may have entered a somewhat dangerous phase where central bankers seem to be promising money forever and a day when they know this not to be the case.

With an eye to his legacy, Bernanke wants the recovery to stand on its own two feet and avoid the reputational blowback that has mired Greenspan's retirement years. Everybody is watching the snake charmers: Bernanke, Draghi, Carney and Kuroda and the snakes are also watching one another. The experience of June suggested that, if the snakes are startled, they can go back into their baskets lock-step. The truth of the matter is that central bankers do not fully know how best to negotiate nomalisation. Their worries are not a matter of public record. They are only spoken of at night, to their domestic pets.

Looking forward, given that our portfolios are constructed around a number of equity themes and geographical expressions, the issues at hand are particular to the equity class. On an aggregated basis, we care deeply about the relationship between the company earnings integer and the index. The degree to which the integer lags the index determines the quantum of upward revaluation in market multiples. A rising multiple in the face of normalising interest rates is fine, but fine only for a while. The asset allocation decision of greatest consequence in the next five years will be the correct judgment of absolute danger as this phenomenon progresses.

At the level below this, a very consequential debate is underway about how to gain an optimal balance between the evergreen attributes of earnings quality and equity income on the one hand and economic cyclicality on the other. As ever with labels, as soon as labels are attached to something, some meaning is lost. For earnings quality is not the strict opposite of cyclicality. In no sense is it the opposite either of value, although it is sometimes talked of as though it were.

Value is a useful way into the sorting process. Value has been on the side of various aspects of cyclicality for some time, although it has been no help to materials sector which is under pressure from declines in output prices.

We have our suspicions about a themed approach to investment. Paine Webber once employed a strategist who spoke long and lovingly about "thematics": so important he coined a new word for it. Acceptance trumps efficacy when it comes to thematics as the user is incentivised to promulgate themes that his audience can empathise, and readily agree, with.

The theme of the age has been selling into Asia and Emerging Markets – absolutely nobody thinks that is a poor idea. However, when recent performance is de-aggregated, and we have only done this so far for the UK equity market, we find that the Asian and Emerging Market themed beneficiaries have been underperforming the broad index for three years. In the UK at least, domestic cyclicality has been outperforming EM exposure for that period.

Most of these decisions are properly made at the stock level: own Lloyds Bank over Diageo, for example. Some of the available effect can be obtained from investing in specialist smaller capitalisation strategies, which we are doing.

Finally, we attach a report, composed by Natalia Soldatova, which addresses the specialist field of trade finance. Although there are only a small number of portfolios of trade finance lending which are available on a unitised basis, we have interviewed the leading practitioners and identified BAF Navigator as a target investment.

In depleted seas, there are few plausible income strategies outwith equity income.

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