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Investment Letter: 7th December 2012

The direction of travel within our clients' portfolios has become progressively more clear as 2012 ran its course. The equity asset class is now favoured by a greater margin over cash, bonds and alternatives than at any time in the past five years.

Within the equity allocation – centered around a minimum 60% allocation for medium risk portfolios – style and regional expressions have evened out since the spring and summer. Whereas the US and quality were the cornerstones, Europe, Japan and selective cyclicality have gained more of a foothold since the year's mid-point.

We observe that equity markets have run this year somewhat ahead of PMIs and leading indicators – partly supporting our notion that nothing is a better lead indicator of the equity market than the market itself, but also as perhaps a consequence of what we think is a generational top in bond valuations. Frankly, where else is there to go?

Whilst the exact return from a heavy equity component cannot be known in advance, over any decent period of measurement it will hinge principally on the sum of valuation change, earnings growth, (with earnings growth as a very smoothed correlate of economic growth) and income via dividends.

In terms of understanding the blend of valuation change, income and earnings growth that will determine US equity returns, we can do no better than direct investors to the excellent work of Saumil Parikh of PIMCO who has, in a 14 page paper¹, woven the three factors into a well fitted model, using mean reversion as his guide. His work suggests a 10 year compound return from US equities in the range of +4.0% to +5.1%. Whilst this is well short of the +10% compound return that investors could have theoretically enjoyed from the US market over the past 100 years, it is well ahead of the paltry +2% compound of the past 10. Parikh's analysis takes full account of the currently extended PE valuations of the US market and his return forecast assumes a fade to mean, using Robert Shiller's Cyclically Adjusted PE ratios to do so.

Parikh's approach and conclusions fit well with our own thoughts and methodologies; it suggests that investors will enjoy positive returns over the next 10 years from the US stock market. By interpolation, we can surmise higher available returns from Emerging Markets, Developed Europe and Japan.

And yet, we encounter within ourselves considerable reluctance to exclude US assets from a global multi-asset portfolio. We retain the belief that being first in, first out of the economic crisis is worth something, we observe that cyclical sections of the US market are still in the early to mid sections of recovery - banks in particular -, we are intrigued by the transformative impact of shale gas on energy costs and we rather rely on the US to sustain and pick-up momentum to help underwrite growth elsewhere.

¹ *Forecasting Equity Returns in the New Normal – November 2012*
(<http://europe.pimco.com/EN/Insights/Pages/Forecasting-Equity-Returns-in-the-New-Normal-.aspx>)

CERNO CAPITAL

Put another way, if growth investing fails in the US, we all become value investors, *per force*.

From a European perspective America does not have a political left at all, although the battle on the ground is being drawn as left versus right on fiscal matters. Perhaps they will foul it up, probably not. If only because the right is likely to do more harm to itself in doing so.

Everybody is looking for better outcomes for Europe and Japan. Our previously expressed wishes for Japan – of which we had no better hope than a note up the chimney to Santa – suddenly found voice in LDP opposition leader Shinzo Abe. But he has an election to win first.

There is a limit to Japan's recovery, a limit not captured by mean reversion, in the form of atrocious demographics. The imbalance of old versus young and a well ingrained aversion to immigration has hurt Japan's economy hard and will continue to do so.

History tells us that the mean is not always recovered. Great Britain has a fraction of its former economic influence, as does Argentina. The Philippines was once the largest economy in Asia.

It is our view (a view indebted to the work of Arjun Divecha and his colleagues at GMO) that demographics are the second most important factor in determining a country's economic growth potential. The first is economic freedom. Japan has been on the wrong side of the demographic bubble for a few years now, and China is also reaching an irresistible downturn in its economic potential as a result of its one-child policy.

Japan has shown that it is well capable of taking a poor hand and playing it poorly. Europe has its own particular dysfunctions – notably a predilection for fudge and a lack of candor. Who can admire an economic governance system that relies, more or less entirely, on everybody lying to each other all the time?

Since the summer, we have seen a litmus like response of European equity markets to the fall in Mediterranean bond yields. Burden sharing via debt write-downs is helping diversify from the awful rigor of policy where austerity begets austerity. The greatest challenge lies ahead. It never mattered whether Greece could last its package. It will matter that Spain can, and without unilateral default and a descent into communism or fascism.

Whilst our estimation of the expected return from equities has not changed by any meaningful degree in the past six months, we see reason to expect less from the amorphous group of managers variously termed “alternative”, “non-directional”, “macro”, “skill based”.

In a beta driven world, available alpha is proving elusive. Ditching the Greek for a second, low-activity long only strategies have beaten high activity hedge strategies by a wide margin, not just in the past year, but the past three years. The lurgy affecting highly paid humans has also removed the edge of highly paid machines: the efficacy of quant-driven strategies has shrunk to zero. Excluding specialist credit managers, many of whom charge hedgetype fees for essentially long exposure, the relative bright spot in the asset class has been in global macro. Within the multi-strategy desks of global macro, the lion's share of capital has been directed to rates traders who have been (very effectively) piggy-backing policy makers, especially the Federal Reserve.

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We believe that return from rates trading has fallen as a consequence of bond curves being so flat, now that opportunity for great movement from here has been exhausted. Anomalies in the curve remain – in particular the plateau that exists between 10s and 30s, pointing to an odd probability set in regards to future inflation. However these anomalies can persist for a long time when governments are in markets.

Despite the trailing off in global macro returns, we note that capital commitment to rates traders remains as high as ever, suggesting that capital allocators within macro firms cannot see better returns in other strategies.

As a consequence, the expected return from macro managers is depressed in relation to their histories, as long as volatility remains low. How low? We expect the best managers in the sector to return better than twice the cash rate, after fees. A range of 2%-5% per annum whilst low volatility persists is more the expectation.

Our position is, therefore, to run portfolios in which equity strategies have the dominant share. The main issues at hand are therefore equity related: what measure of commitment to emerging versus developed, cyclicals versus defensive, what type of cyclical, growth versus value and how much to hold within the US market which accounts for half the world's market capitalisation? Future letters will address these questions.



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