CERNO CAPITAL

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Short term financial asset performance will continue to be explained almost solely in terms of the Federal Reserve's decision not to announce the commencement of tapering in September.

Ultimately we do not think the consequences of this to have much bearing on the long term investment outlook. If we are wrong it will be because economic growth proves to be disappointing or, more darkly, that the decision to demur is the first in a series of unexpected events that point to the sapping of Central Bank powers. Like Prufrock, Bernanke asked himself:

> Do I dare
> Disturb the universe?
> In a minute there is time
> For decisions and revisions which a minute will reverse[1].

The answer that came back was no. Apparently the universe could not be disturbed.

The consequences of this have been to stimulate a tandem rally in both core bond and equity markets and prompt a bout of US dollar weakness generating some respite for emerging currencies, which had been under considerable pressure. The quality of this rally can be called into question but that too is barely relevant to a long term investor. If markets work towards price discovery, then the trove lies a little further off than it did before.

As we are being guided along the path to normalisation it appears that this path is to remain free from any overt or quasi-tightening of rates, for the time being. This is of greater consequence in the US as a consequence of longer term fixes on mortgage rates.

Here in the UK the BoE has had communications problems with its communications strategy. Guidance has required further guidance. From a podium in Manchester, we are told that austerity will require further austerity. Mantras abound.

Our contention that none of this matters much is based on our belief that the underlying cyclical forces of economies and of human spirits are throbbing away below the water line, like the engine of a giant liner. As official policy has been transmuted by the biggest crisis of our generation, the minds of officials are conditioned to crisis response. They are not so much steeped in recent history as pickled in it. This would tend to preserve the crisis reflex. It remains a matter of conjecture as to what degree economic activity is underpinned by QE.

Normalisation will be accompanied by other multi-syllable phenomena. Cross-asset correlation is likely to fall from extra-ordinarily high levels and, within asset classes, differentiation is likely to increase.

The measured correlation between equities, bonds, commodities and REITs reached 0.56 in May 2012 and has been falling since. The correlation between US and EAFE equity markets (Europe, Africa and the Far East) reached 0.91 in August 2011 and has been falling since. Developed versus emerging equities peaked at 0.93 in November 2009. Correlations within developed markets peaked at 0.71 in November 2011. Global equity sector correlations peaked at 0.87 in June 2012.

The ground is thick with other examples and a forthcoming study will discuss a number of these in more depth.

This is good news for investors in general but in particular for those who specialise in security selection. In the equity sphere this favours stock pickers, small-cap investors and value investors. Sometimes these attributes can be found in single funds and these strategies are being weighted progressively more within our clients' portfolios. For now, micro trumps macro and we favour backing regional or global teams with good security selection over top-down geographic allocation.

There is some logic to inverting the normal logic that a portfolio should be built around core weights in index heavy-weights.

One of the lessons learnt from the hop over the wall from the "sell-side" to the "buy-side", from being a provider of information and opinion to being a consumer of it, is to become more accustomed to admitting to ignorance. "I do not know" should be an oft-sought thought in the mind of a dedicated asset manager (even if it is a rare response from a broker). More often than not it means "I cannot know". Part of this is the recognition of the boundaries of what can be known; the rest is an admission that the possible detrimental outcomes sum to a moderately high probability. After all, most investors who lose their clients' money - a loss as in permanent loss - do not set out to lose money. Their error, more often than not, is to attach too high a probability to one desired outcome.

Not only is the universe expanding, but the rate of that expansion is increasing. Our ignorance will expand with it but not prevent us doing a good job.

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[1] The Love Song of J Alfred Prufrock – T.S. Eliot

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