CERNO CAPITAL

Investment Letter: 19th December 2013

2013 has proven to be a good year for both the equity investor and the multi-asset class investor with a constructive view of the world. Being both constructive on growth and generously allocated to the equity class, our clients' portfolios have advanced by a good margin. As the year ends, we might ask how should forward expectations be shaped?

The immediate past has been a boon for reflationists and a bane for inflationists. At face, this is an odd distinction as we might expect them to be cut of the same cloth. Although the higher reaches of the investment debate have dwelt on the polar opposites of inflation and deflation for some time, measured inflation has been quiescent throughout. As a consequence, asset class choices made in the name of either inflation or deflation have recorded patchy results or been outright deleterious.

Looking back for a moment, we cannot deny how very close we got to a massive deflation in 2008. The escape from its jaws was a last hour affair.

Inflation is another matter. The prediction of an inflation - long and noisily made by great sections of the investment community - is founded on bad economics: money creation may be a necessary condition for a great inflation but it is not a sufficient condition. Beyond this fundamental issue, the practical challenge for the inflationist is what to do in the name of inflation. All the frontline asset classes, bar perhaps land, have documented flaws in terms of their ability to deliver a return, after inflation, or even keep pace. Even inflation linked bonds, which read like the real thing, are not failsafe by virtue of their price link to nominal bonds. If inflation rises and real interest rates rise (a fairly normal equivalence) an investor may lose money, for a period, in ILBs. The probabilities improve for hold to maturity investors. This suggests that long dated ILBs are suitable only for private or endowment capital.

Whilst we are engaged in the debate, we remain sceptical of the merits of making allocations in sympathy with what we still regard as fairly remote probabilities. For it is not the rightness or wrongness of the arguments that matter, it is the probabilities assigned to the various outcomes. Indeed, we would be very surprised if the magic mix of very low inflation, zero interest rates and highly stimulatory policy were to persist for many quarters more. The evolving issue is how well key asset classes will fare as generally improving economic conditions are reflected in reduced stimulus and changing interest rate structures.

The last part of the last sentence reads "changing interest rate structures" rather than "rising rates" as we have been signalled or "guided" not to think that rates rises are imminent. Let us take that as read for now and give the central bankers most of next year to be steadfast on these promises. The entertainment then transfers to further out the interest rate curve and into what can be inferred from the prices of inflation linked bonds. Arcane stuff. The upward flick of the interest rate tail in the middle of the year suggested that bond markets may have a life of their own, after all.

Pushing the investment case for nominal bonds in this environment is work akin to that endured by Mr Mandela on Robben Island. And the rocks do not get softer as you move up the risk curve into corporate bonds or high yield or emerging credit.

We are effectively zero duration in the **fixed income** asset class. Although there may be isolated, profitable opportunities in certain government bond markets (Greece in the early part of this year, Indonesia mid-summer spring to mind) the general weather is made by key reference bond markets, in particular the US, whose yield curve is steepening and will, we think, continue to steepen in 2014. As commented above, we should anticipate a change in the confluence of exceptional central bank stimulus married to the absence of inflation.

There is no guarantee that the reset of rates will be smooth. As Stewart Cowley of Old Mutual puts it: “Don’t bet against the Fed, but don’t trust them either”. BoE Governor Carney referred to “great risks” on the 17th of December in the House of Lords and he will receive a bowl of Christmas duff from Cerno Capital for his honesty in doing so.

While core government bond markets are deep and liquid, very few other registers are. Specific dangers lurk in the event of a sudden absence of liquidity in emerging market and developed corporate credit bond markets prompted by redemptions from open ended bond funds and unexpected losses in the UK and US index linked market places as losses on nominal bonds extend into their index linked counterparts.

One of the eternal questions of investment is: are we being paid to take the risks we are being asked to take?

Historically and theoretically speaking, the higher expected return in equities comes from accepting short term set-backs. Attempts to avoid the set-backs (by hedging, for instance) are self-defeating as they inevitably lead to some shaving of the return objective.

The best arbitrage of all is to think and act longer term than your fellow investors. However, whilst this is a secure stance in the endowment world, it is not necessarily an anchored certainty when looking after the capital of others.

Our **equity** allocations are distinctly tilted toward developed markets. We observe that the US, Europe, UK and Japan are at different stops along the reflation path. Of these, the UK most closely resembles the US, but at a lag. We have long held a FIFO view of US economic prospects: “first in” to the economic crisis and therefore “first out”. This is now better recognised and non-financial US valuations are beginning to be challenging. Sentiment in the UK has been held back by untoward pessimism on the part of key public officials (Osborne of the Treasury/King of the BoE, now retired).

Europe offers a long term arbitrage as the European equity index and earnings index now lags that of the US by two standard deviations. While US potential has been amped, European has been repressed. The risk with a European allocation is that the arbitrage plays out over a much longer time frame (say ten years rather than five). That risk is real as the general tenor of policy remains deflationary.

Japan was the only large equity market to offer deep value in 2012: the stock market bottomed at a price to book ratio of around one. At the time we allocated to that market, there was no guarantee that Abe would win the election and enact transformation. This has now happened and the market has begun the path to reflation. As the process continues, the earnings growth that has been obtained from the yen weakening will be less and therefore internal led reform becomes more important. Japan's economy and stock market has less to fear from any tightening in global inflation conditions as it desires inflation at home. We also recognise that it is sometimes better to travel than arrive and the easier money has been made. The relative (against other equity markets) attractiveness of Japan is rising as its absolute attraction wanes.

We continue to allocate to **global macro** specialists. At one level, macro management is a non-directional (or more precisely, not specifically long duration) allocation to fixed income strategies. Skilled practitioner managers can execute flexible strategies within key bond markets. We also regard currency pairs trading as a continuing source of return due to global and regional differentials on two counts: 1) the fault line that has developed between developed and emerging markets which threatens emerging markets when global liquidity conditions tighten and 2) inter regional differentials on count of monetary stimulus or absence of. Finally, we note that the macro managers selected can often prosper during periods of elevated volatility and therefore offer useful offsets against other allocations, notably an equity allocation.

Our portfolios are distinct by virtue of their simplicity and zero allocations to many asset class. What follows are very brief views behind these zero allocations.

Although currently a zero allocation to **event driven**, we look forward to greater merger and acquisition activity in 2014. Merger spreads remain tight in a super low interest rate environment but will rise as interest rates rise and as hostile activity picks up. The return prospects are therefore improving.

We do not believe that **commodities** are in any way a homogenous asset class. Industrial commodities do bear some relation to one another. The rise of China has led to a most uneven demand pattern and China's rate of fixed asset investment in relation to its GDP has been elevated to very high levels for a number of years, suggestive of a greater risk from moderation than opportunity from further incremental demand. The relevance as an inflation sensitive asset class is only proven in cases where commodities themselves are the source of inflation.

Somewhat allied to this view is our view on **gold**. Of the numerous factors which play across the gold price, one of the most meaningful is the real rate of interest. Rising real rates of interest exact a toll on the fundamentals of gold as gold does not generate an income, therefore the relative attractiveness of other assets increase as real interest rates rise. It remains an over owned asset, often believed to offer inflation protection attributes – a claim that is not well proven.

We believe that **UK commercial property** will earn a positive rate of return in the next three years, perhaps even comparable to that obtainable from equities. However, we note that the recovery part of the cycle is well established. It can no longer be described as a buyers' market.

Finally, **cash**. Cash is both an overvalued and underappreciated asset class at this juncture.

The world has turned. We now enter the extraction phase of the experiment. It would be unwise to expect the next two years to be smooth. The only comfortable way to be invested is to be core, liquid and pragmatic. We are all three of these things.

James Spence
Managing Partner