CERNO CAPITAL

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A few years ago a formulaic American horror film was released. It was titled *I Know What You Did Last Summer*. In this film, four youths are hunted down by a killer after they cover up their involvement in a fatal accident. It was successful enough to spawn a sequel: *I Still Know What You Did Last Summer*. Both title and plot pedantically tap into the original.

The early 2014 Emerging Market (EM) wobble is also a re-run of something that happened last summer. It contains the potential to scare and has therefore transmitted a shiver of fear through mainstream asset classes: developed equities have underperformed core bonds in the first six weeks of the year. Gold is up too.

The economic back-drop for emerging economies is not catatonically bad. For sure, in many places, credit cycles look as if they have been running at full spate and are now in abeyance. The problem, rather, is the valuation of their investment markets. Good shares remain expensive, vis the average price to earnings ratio of the Arisaig Asia Consumer portfolio at a lofty 29.6x, local bond markets are highly priced by historical averages and many of the EM and Pacific property markets look overheated.

If western world capital, which has been very fully committed to EMs in the past 10 years, is repatriated in bigger chunks, the ability for the EM end of foreign exchange markets to accommodate these flows comes into question. The immediate consequence of the imbalance of short term capital flows is a weakening of local currencies and some countries (India, Turkey, South Africa, Brazil, Indonesia) have already responded by increasing local interest rates as an incentive.

Meanwhile, back at the ranch, the Fed is practicing with its new tin ear. Having baulked last year, the taper has begun and whilst officials swear to flexibility in this, they would surely rather run the programme through, than risk the unfortunate signalling that would be the consequence of a taper-*interruptus*.

“You can’t do that” cry the Indian central bank. But with the dollar behind them, of course they can. The dollar is both a mystical being and a dark force. It does its masters’ bidding. Weak when they need it to be weak, strong when it doesn’t hurt. As Eswar Prasad has written, the conundrum is that by pushing more of them around the world, the world is ever more dollar invested when it swore it would be less so.

We know that financial markets can take their toll on real economies and beyond this EM shiver lies a possible greater fright. The purveyors of EM debt funds have not adequately conveyed the risks of their asset class. They have been unwise, they have been greedy and their hope must be that the bear market in EM credit cranks slowly. For, if the adjustment is more precipitous, EM debt in managers will not be able to honour all their investors' redemptions at the indicated dealing date.

As we cannot predict these possible outcomes with certainty, step 1 is to excise all direct EM currency and asset exposure. Step 2 is to foretell a larger event, encompassing steeper falls in core asset prices. We remain of the view that this second scenario is not the probability outcome and therefore retain the constructive positioning that we sustained throughout last year.

Early year events have also excited the inflation/deflation buffs, referred to as the *flationistas* by a well diversified client. There is something for everybody here. Inflationists can point to the better year to date performance of gold and inflation linked bonds, even if gold is enjoying a counter-trend rally and ILBs have been spurred by lower yields in their nominal cousins (actually <u>dis</u>inflationary). Deflationists mutter about the possibilities of capital controls being erected in Turkey, forced selling of EM debt positions causing a financial panic and the subsequent currency devaluations spreading a deflationary wave across the globe.

Some of the bigger falls have been recorded in the Japanese equity index, not an Emerging Market, even if it is perched on the Pacific rim. Japan under Abe has attracted all manner of capital being managed in all manner of styles. We know from interviews with Global Macro managers, whose normal bailiwick is fixed income markets, that they have been moving money into the Japanese stock market whilst simultaneously shorting the currency. For many of them this became "a trade" of consequence and therefore prone to short term adjustment as their risk models struggle to accommodate meaningful short term drawbacks. For that reason, Japanese equities have been the most volatile asset class and many hedge funds will be trading against themselves in the short term. This, though, is volatility we can ignore as we are investing on a longer footing. Our interest is retained, our positions unchanged.

Last month we committed capital to specialist merger arbitrage and event driven managers. Our thesis is that, after a period of considerable conservatism, we can expect more expansionary activity on the part of corporate managements worldwide. Greater corporate ambition will result in more announced bids and, critically, more contested bids. That, in turn, will increase spreads, increasing the opportunity set for specialist managers who invest around bid situations in a fundamental manner.

Julia Scheufler's note explains the investment rationale in some more depth:

http://cernocapital.com/event-driven-merger-arbitrage-strategies/

As a consequence, we expand the asset class to the range in which we are currently invested. Alongside core equity exposure, represented by both active management positions, ETFs and individual securities, we are invested in macro managers, absolute return bond managers and merger and arbitrage specialists.

The watchword of the approach remains to invest only where expectations of a positive future return profile can be plausibly sustained.

Finally, the below article by quantitative manager Cliff Asness had us thumping our dispatch papers on our benches. He lists 10 investment peeves and we have no quarry with any of his observations. Well worth a read as not every quant is born with such well tuned common sense.

http://www.cfapubs.org/doi/pdf/10.2469/faj.v70.n1.2

James Spence
Managing Partner