CERNO CAPITAL

Investment Letter: 21st August 2014

Our general sense of things is that the levels of investor commitment to financial assets is at a relatively high mark. The corresponding opportunity set is, only moderate and outright poor in some assets. The combination of high levels of commitment and lowish levels of opportunity is unwelcome and normally stipulates the adoption of defensive tactics. Now is no obvious exception and consistency is the key.

We have raised some cash across portfolios and are prepared to be patient. The best thing about valuation lead investment is that it (generally) keeps one away from the crocs, the less good thing about it is that it tells you very little about timing. Many good careers have ended prematurely when the valuation-sensitive manager had steered his canoe into the reeds and the crocs continued to doze.

The amount of cash raised places us at a staging post where our portfolios are still positioned to accrue value as markets rise, yet offer some buffer should they fall. The portfolios could not yet be termed defensive as they retain constructive settings, just of lower magnitude.

Over the summer months, we have seen reason to amend expectations and remodel our base case on a few counts. First and foremost we must concede that the road plan to normalisation which we laid out in a document published in the Autumn of 2013, cernocapital.com/normalisation report is experiencing delays. To date, the Fed has not moved toward a tightening bias nor prepared the way to do so (we learn recently of greater diversity in views within the rate setting committee of the BoE). This has led some to speculate that Governor Yellen is possessed of her own private data set - a somewhat fanciful notion. Conversely, in the detail of US employment data, we find evidence that greater balance, even tightness, is appearing in skilled segments. This suggests to us that we should be closer to normalisation (of inflation expectations and interest rates) than we have been. For the time being, the official tone is dovish to a turn. Perhaps our understanding of the sequencing of policy is sub-optimal and QE will be run-down first before the price of money changes. If we are *not* wrong, and the Fed is indeed behind the curve, we bear the unwelcome risk of market disruption as the consequence of a later, more precipitous adjustment. The adverse consequences of such a readjustment will be felt most in the corporate credit asset class where investor participation is very substantial but the underlying liquidity fundamentals very poor. We might also expect a doubling of intensity in Emerging Market corporate credit, a class that has ballooned in size and would be further squeezed by a rising US dollar.

On the second count, we have taken a less positive view toward European equity markets where we had previously maintained meaningful exposures. This has been the subject of the preceding two letters, so will not be dwelt on here bar to mention that the set of probability outcomes that we were working from when we were invested owed more to the interplay between valuations, growth and investor participation than any prediction as to what the ECB might do or not do. It seems to us to be an essentially unknowable thing and we have much sympathy with the sceptics who contest that the ECB is not a proper central bank at all and therefore there are substantial limitations as to what it might do, even as disinflation approaches deflation. The ECB has not kept the line on sustaining a positive inflation rate and its credibility is lessened as a consequence.

The tail of the tape, this year so far, has been that core bonds have edged all the other frontline asset classes. Already expensive, fixed income assets have become more so and their remaining allure is blind to all bar the ardent deflationist.

The challenges have not changed much as the year has developed. True diversity remains a struggle, true value is extinguished. The majority of our investors' money is invested in an array of equity strategies, independent of one another, though dependent through the correlation relationship of all equities: *vis* income strategies, disruptive technologies, global leadership companies, US banks, mergers and acquisition strategies and, finallly, Japan as a unique concoction all by itself. A small portion of capital is allocated in a basket of expressions sympathetic to our negative view of China's residential property market. This is an allocation that may be tuned up as events determine. A meaningful portion is invested in skill based macro strategies that illicit no obvious beta or market direction. The balance is held in cash: worthless in income terms but valuable as a store for later purchases when opportunities arise.

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