

# CERNO CAPITAL

## Investment Letter: 19<sup>th</sup> November 2014

In geopolitical terms, 2014 will probably be looked back upon as the year in which Mr Putin and the full range of his senses became strangers. He remains our closest and best-armed rogue threat.

Indeed, it is hard to digest the nightly news and retain the innate human optimism that keeps us going.

And there is no succour to be gained when the roster gets down to the financial and economic sections.

We are, apparently, on the edge of deflation. Or, possibly, hyperinflation. Wages are going nowhere. Bankers are innately evil and incurable of their sins. Active asset management is a waste of time.

Rather than try, we might as well give our money to Vanguard and remain supine, waiting for the daily drone from Amazon.com to bring us whatever consolations are to our tastes.

As somebody who eschewed Amazon a few years ago, joined a library and continues to lead a full life, this writer has developed a stubborn resistance to many of these trends. He'd rather travel down the Amazon than have the Amazon come to him.

In a similar vein, we are stout defenders of active management. Sometimes trends which appear to be endemic and irreversible have their origins rooted in more parochial causes. A multi-year bull market (5 years in equities, 32 (!) years in bonds) tends to flatter the passively constructed portfolio and its proponents.

The clamour that backs the passive movement is a powerful rainbow alliance, led by academics and journalists. However, their conclusions are based on the statistical phenomenon of *data mining* which is a misapplication of science.

Why would you ever wish to invest in an average manager for average performance when you know in advance that average is a losing proposition? Our business is about locating the top 5%, even the top 1%. We have a process to do this. Cerno means select.

Our cry is therefore that we will enter a phase in markets where a judiciously screened active universe will do better than a passively constructed balanced portfolio. We will neither experience a Rufferian hyper-inflation nor a Napierian deflation. Wages, for all but the bottom tier, will grow. Even Europe will grow.

Mad Putin might still blow us up but, short of that, we must look on the bright side of life.

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Last month, we posted a table in this letter which described key asset market performance from the year's beginning to 29<sup>th</sup> August and a more recent period in the second column.

We update that table below because it so effectively describes the performance characteristics of the year about to end.

Asset Class	Index	1 Jan – 29 Aug	1 Sept – 17 Nov
Equities			
- US	S&P 500 Index	+8.4%	+1.9%
- Europe incl. UK	Stoxx Europe 600 Index	+4.2%	-1.4%
- Japan	Nikkei 225 Index	-5.3%	+10.0%
- GEM	MSCI EM Index	+8.5%	-9.4%
Oil	WTI Crude	-2.5%	-21.2%
Gold	Gold Spot	+6.8%	-7.9%
Commodities	Reuters/DJ Commodity Index	+4.5%	-8.7%
Nominal bonds			
- Global	Barclays Global Govt Agg	+4.5%	-4.8%
- US	Barclays US Government	+3.5%	-1.9%
Index linked bonds			
- Global	Barclays Global Infl-Linked	+7.2%	-3.7%
- US	Barclays US Treasury TIPS	+6.3%	-1.9%
GBP	GBP/USD X-rate	+0.2%	-5.8%
High yield debt	Barclays Global HY	+5.3%	-2.7%
Emerging market debt	JPM EMBI Global	+9.9%	-2.3%
Emerging market currencies	MSCI EM Currencies Index	+2.9%	-4.4%

Source: Morningstar/Bloomberg

Almost every one of the above classes have experienced a reversal, those that have not, with the exception of US equities, are showing a deepening of a trend.

Turning to our own performance, having been flat in the first half of the year, better advances are being made in the second half. Our exposure settings are more in tune with the environment that has prevailed since late August. We will continue with these settings as we bridge to 2015.

In the below captioned pieces, Fergus Shaw provides cynical commentary on the phenomenon of Smart Beta, which will be at an investment provider near you very shortly....

<http://cernocapital.com/curious-tale-factor-based-investment-cynical-take-smart-beta/>

...and Russell Napier meditates on what the Cyclically Adjusted Price Earnings ratio is indicating about future returns from the US equity market.

<http://cernocapital.com/elephant-stands-head-cape-ratio-can-tell-us-future-us-equity-returns/>

# CERNO CAPITAL

A handwritten signature in black ink that reads "James Spence". The signature is written in a cursive style with a period at the end.

**James Spence**  
Managing Partner

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