

CERNO CAPITAL

Investment Letter: 29th April 2015

Last week, the investment group at Cerno Capital made its customary annual trip to the GMO London conference. This is the only such investment conference that the whole team attends, such is the esteem in which GMO is held here on Sackville Street.

For those readers not familiar with the firm, GMO is an acronym for three of its four founders: Grantham, Mayo and Otterloo. It retains Jeremy Grantham, as its spiritual and philosophical head, present in London. Founded in 1977 and headquartered in Boston, its roots are as an equity value house; to this core product set, it has added fixed income, multi-asset, quantitative and farmland over the years. GMO manage US\$116bn.

The reason for our assiduous attendance is that GMO is a firm that uses long-term value as a discipline and is packed full of interesting thinkers and ‘honest Johns’. They undertake primary research on markets, and in doing so develop new frontiers in understanding. In this, GMO have acted as a motivator and the inspiration for our own primary work.

At the conference, a great deal of ground is covered in a day, to the benefit primarily of endowment and pension fund administrators. GMO operates institutional minimum investment levels to set aside its traditionally reasonable fees and is therefore not available in the retail investment market place.

A semi-sombre atmosphere prevailed during the 2015 conference, compelling us to go deep into the morning session to understand why. The asset allocation team, represented by Sam Wilderman and James Montier, coined an aphorism to explain the central conundrum facing investors. They described the likely outcomes as being either ‘Hell’ or ‘Purgatory’. Being intrinsic disbelievers in the notion that Central Banks can forever square the circle in their prosecution of zero interest rate policies and abnormal bond market interference, the asset allocators predict worrisome outcomes (=purgatory).

Even if these do not prevail in the next few years, current valuations across all asset classes indicate very modest inflation adjusted returns: adequate only if investing in Emerging Markets or Timber. Elsewhere, according to their metrics, expected returns look desultory (=hell).

Later that week, over lunch with the vigorous and articulate Steve McMahon of Asset Risk Consultants (ARC), Steve asked us whether we thought end investor expectations were adequately couched suggesting that, after a good set of 1Q returns, they might well not be.

We would tend to agree. On the other hand, whilst trailing returns have been undeniably positive, there is no noticeable excitement at hand. In the past couple of years, a grim

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compulsion rather than a blithe spirit has been driving investors. And Chuck Prince's words - spoken when he helmed Citibank - were quoted once more at the conference.

“As long as the music is playing, you've got to get up and dance”.

The “you've got to” bit speaks of the compulsion element at work.

Reporting subjectively, our investor return for the first quarter was generally in the 4% to 5% range, and that is a multi asset return with an underlying average net equity weight of 60%. Single asset class returns, in places, have been higher than this.

Turning to immediate domestic events, by the time this letter appears next month, we will have a new government in the UK (or perhaps we will not). Irrespective, we have the sense that markets are beginning to peer through May 7th into the painters box of different political hues in combination. If the pound had been riding high on the wave of excellent employment and wages numbers, then we might commend a more judicious hedge. But it has not and there is some reason to think that, at 1.50ish versus the dollar, the short term outperformance of the UK versus the US economy has not been reflected, being somewhat impeded by the politics.

The market is now quite short the pound, yet there is something strangely confirmatory to Miliband's rebuttal of the Sturgeon embrace to “git Cameron oot o' number 10”. Geopolitical analysts and The Bank Credit Analyst argue that Lab/SNP is pound positive as they will not offer a vote on Europe.

Across the channel, Greece's romantic interlude with the far left is approaching its reckoning. Ultimately, the hard numbers will have their say and these point decisively to default. Some say this is a problem, some say not, but how can these things be spoken of with any certainty?

Where is value? In the places you'd rather not go: Russian energy, Chinese banks, Greek bonds, post default, probably. The key skills are increasingly behavioural. As a consequence, we are paying more attention to market balance, participant commitment and sentiment than ever before. The low volatility of markets is akin to the slow creep of morphia through the system. It feels good for a while but it's the devil's own doing.



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