CERNO CAPITAL

**Investment Letter dated 1st July 2016**

In the historical context, the landscape of modern investment has been defined by the relatively free movement of ideas, capital and increasingly, people. Through the eyes of most urban folk and the majority of the political elite, these are generally taken to be unalloyed gains, uncontroversial goods. That a larger number have voted for a distinctly different set of arrangements has delivered a shock.

Far from being a “Lehman moment”, as some have termed it, last week’s vote has longer drawn out and more pernicious effects. With respect to the UK, we should expect a recession as investment decisions are reversed, cancelled or delayed.

The principal manner in which these events connect into our clients’ portfolios is through currency. With pounds Sterling as a reporting currency, a natural level of protection can be achieved by buffering the falling pound with assets in other currencies. As a global investor, with no natural UK bias, this is more of a default than an option.

It has not required, therefore, conscious risk taking outside of our normal range of operations to achieve a high measure of short term protection. We were able to make plausible assumptions about the impact of either possible result of the referendum by doing line-by-line assessments on portfolios. That analysis indicated a clear skew on the result with the sudden re-pricing of GBP being the principal driver of this. We expected the pound to fall to US$1.30 on a Leave vote, but rise only to US$1.50 on Remain.

If we reduce last week’s events to their rudimentary parts, we have had the shock and that will likely be followed by a long period of considerable uncertainty. As such, this has the classic profile of a crisis with markets moving fast to price uncertainty. In the UK context, the bulk of the pressure so far has been taken through the currency, somewhat shielding listed equities and bonds. However, this crisis has yet to generate demonstrable good value in financial assets.

In terms of economic responses, we note that twenty or thirty years ago, the Chancellor of the day might well have responded by hiking interest rates to defend the currency. Modern central bankers have a different reflex and ARE more liable to cut rates in face of such events, as Carney has just averred. The BoE has only a little wiggle room on this and will be hoping that further sharp falls in sterling do not generate an unmanageable spike in imported inflation. Being priced in dollars, stronger oil prices, in this context, acts as a double whammy.

If the modern way is to be loosey goosey with currencies, the same cannot be applied to the government gilt bond yield. So far, these have complied: yields snapping lower in tandem with other developed market bonds. The truly difficult moment comes when they are repriced upwards should the UK's deteriorating credit rating begin to tell. In this respect, additional QE offers (again) a protective blanket of bespoke size. *In extremis*, the Bank of England can simply buy all and every new issuance from the Debt Management Office, starting with the next auction on July 5th.

With respect to Europe, it is not clear whether the centrifugal forces that had been pushing countries out of union now spin more violently or actually desist for a period. It may have just been the proximate removal of awkwardness but the recent breakfast of the 27, minus Cameron, looked like a moderately jolly affair.

Whilst Britain's domestic politics are indeed gripping, the lack of dedicated investment in the UK in Cerno Capital clients' renders us less of an interested party in the immediate economic outcomes than many asset managers.

While all eyes are here, there may be some reward from spending substantially more time directing investment attention elsewhere. The international dimensions of our portfolios, as they stand today, are connected to, for example, the fundamentals of Indian domestic growth, the Japanese profit cycle, US inflationary expectations, technological disruption, chronic health care.

Asset class, thematic and geographic diversity are obvious features to have and to hold.

The recent meeting of our Investment Committee spent a respectable amount of time pondering the near term effects of this vote and a healthy amount of time contemplating longer term themes.

The longer the time frame under consideration the more relevant valuation becomes. Valuations have a large bearing on investment outcomes but their mean reverting effects only work with reliability in the long term.

Various ideas were advanced and discussed: the continued outperformance of the equity value style, more room for Emerging Markets, China's reliance on coordinated Western world stimulus and Japan's call for just that. In addition we talked about the role of gold in portfolios, why the Rest of the World will outperform the US equity market in the next 10 years and the return of inflation and what that means for bonds. Your investment managers remain fully engaged with plenty of bones to be chewing on.

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