Investment Letter dated 31st January 2017

The election of Donald Trump has caused perturbation from Baltimore to Beijing: a rude *volte face* to the graceful Obama years, a reversal of international liberal orthodoxy, a rebuttal of globalisation, an aggressive restatement of weaponised American hegemony, and on.

Those that voted for him love it, much of the rest of the world is aghast. While many are offended, some are amused. In politics, the next few years will be a wild thrash. This may not last long and hopefully no warheads are loosened off.

Part of the emerging mash of policy – on energy most notably – look like bizarre refutations of global trends that will not brook reversal. Others - resisting China's claims over the Western Pacific - maybe overdue.

There is more to come. Trump did not find time in the first week of his Presidency to fall out with Janet Yellen and the Federal Reserve. As sure as apples is apples, that will happen.

It is not a great time to be an agency wonk in America. Under the last administration, even the hunting down of Osama Bin Laden was a meditative affair, a point captured in the line from *Zero Dark Thirty* where a National Security Advisor tells a CIA chief: "The President is a thoughtful, analytical guy. He needs proof". That was then, now is now. Proof took a four year vacation the day after the inauguration with the risible arguments about attendance numbers.

Most overtly populist leaders ultimately fail because they fail to deliver the promised goods to their core constituency. This view is very much current in thinking circles. But what if some of these policies do work, at least for a while? This question was put by Niall Ferguson and his counterpoint should not be dismissed in haste.

Practically speaking, therefore, it is necessary to separate the moral judgements (and questions of taste) from other judgements. This is never more true than in financial investment which is predicated on a search - never a grope - for truth.

Financial prices make best of what information is given them. Striving for, but never attaining what is called "efficiency" where all available information is accurately reflected, each price change a subtle iteration by way of adjustment to that information.

For that reason, markets can be said to be intelligent as they contain more information than any one of its participants. There *is* wisdom in crowds. It is necessary to divine this wisdom, irrespective of who resides in the White House.

The book on 2016 has closed and as its commentaries were composed, we observed that the decisive date in markets last year was not the June UK referendum, nor the November US Presidential election, but rather 11th February when equity markets turned tail after a brutal start to the year and began to go up. At that time, value stocks (defined as relatively lowly valued) reversed several years of relative decline versus growth stocks (defined as relatively highly valued). That trend continued all year and derived an extra fillip from Trump's election which was seen as catnip to several value sectors: specifically materials (the stuff infrastructure is made from) and banks whose multi-year derating has seen them converge in the value bucket.

Cyclicals versus Defensives is another way of thinking about Value versus Growth and the overlap between the universes is strong. Global cyclicals and US domestics were the two bright spots of 2016 and this relative performance has returned cyclicals to their long term price averages versus defensives in all places bar the Emerging Markets. Interestingly they have also, on a global basis, seen the relative valuation of cyclicals move to above longer term averages. This suggests that the larger part of the move has been completed.

The part of Trumpenomics that we have traction with is infrastructure. The case for infrastructure is a good one. It is not difficult to invest in, it is easy to understand, it normally has a yield attached to it, it often has some ratchet link to inflation. The US has been notably deficient in keeping its infrastructure ship-shape in recent decades. Clintonomics espoused increased investment here as well, perhaps the only thing Donald and Hillary agreed upon. The impetus to boost infrastructure goes well beyond the US. It is an uncontroversial way to support growth and plenty of it lies behind China's 6.7% growth rate and Japan's 1.3%.

In the latter part of 2016, within the core portfolio, we added 11 companies who are engaged in the provision of infrastructure or elements of. We assessed broad players without too much reliance on a single sector or country and with well funded balanced sheets. As a consequence of this initiative, as examples of the 11 names, we have invested in Skanska: a big engineer for big projects, Martin Marietta which supplies materials and consultants such as WS Atkins.

To augment these we have also invested in two UK listed investment trusts: John Laing Infrastructure Fund (JLIF) and HSBC Infrastructure Fund (HICL). These companies manage pools of completed infrastructure projects and are adept at blending assets as diverse as street lighting systems, local authority buildings, schools and motorways. From an investment point of view, there is much to like about the transparency, income and inflation protecting elements of their portfolios as well as the professional manner in which they are run.

The infrastructure stocks and the trusts account for around one fifth of the portfolio. Some more thoughts behind this initiative is contained here

http://cernocapital.com/builders-now/

One quarter of the portfolio is allocated to Global Leaders where we look to invest, for the very long term, in great businesses in growing global industries. Luxottica is the 19th of these stocks and the programme limit is capped at 20 names so it is very close to being fully filled.

Industry structure is a key component of our analytical process within this programme.

The spectacle frame maker Luxottica has been on our approved list of companies since 2015. We held back from activating this investment as the founder, Leonardo Del Vecchio, had yet to settle on a succession plan. Through the announced merger with French lens maker Essilor, his business makes a great vertical combination that brings with it a CEO in the form of Hubert Sagnieres who will ultimately run the combined group. Ham and eggs indeed.

http://cernocapital.com/ham-eggs-view-proposed-merger-luxottica-essilor/

The rest of the portfolio is allocated to US inflation linked government bonds, a small amount of gold and specific equity allocations to India and Japan. The final allocation is with a strategy run by Douglas Brodie and his team in Edinburgh at Baillie Gifford. They invest in innovative enterprises that are developing differing, sometimes revolutionary, technologies. We recognise this form of growth investing as a specialist skill best done by a dedicated team who are trained to think and act in certain ways. They need to be highly flexible individuals who can cope with the inevitable disappointments that ensue in the search for those few companies who succeed spectacularly and account for the bulk of returns.

Our overall thought on markets is that it is a good time to own financial assets that have some claim against inflation. Trumpenomics is a orange-faced, blond-topped dash for growth. If it succeeds, we get growth plus inflation. If it fails, we get just the inflation.

James Spence
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