Peter Elston: Investment Letter

Issue 26: July 2017

This document is intended for professional investors only

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- **Preparing for the next downturn**
- **Our tactical asset allocation framework**
- **Current fund targets**

Preparing for the next downturn

The whole point of a fund is to pool investments and thus diversify risks. Multi-asset funds particularly embody the concept of diversification, because, unlike single-asset class funds, they diversify risks across asset classes as well as holdings. Seneca only manages multi-asset funds, so, with respect to tactical asset allocation, correctly anticipating downturns is critical, enabling us to strengthen our funds' defences. Bear markets, after all, are when asset allocators earn their spurs.

I am anticipating a global economic downturn in or around 2020. This, I think, would precipitate a global equity bear market, beginning some time in 2019. I might be early, but that's better than late.

Downturns and bear markets are as inevitable as death and taxes, so I doubt that this time is any different. Over the last year or so we have already been reducing our funds' equity weights as markets have risen. We will continue to reduce them over the next two years such that by the onset of the next bear market our funds are defensively positioned (like driving, slowing down when you get to a bend rather than well before it is, frankly, nuts.)

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Multi-Asset Value Investing

The current growth phase that began in 2009 is now eight years old. This by most standards should be considered ancient – according to the NBER (National Bureau of Economic Research), the average length of the 11 growth phases in the US since 1945 was 59 months, a little under five years [1](note: does not include the current cycle).

So, why do I expect the current expansion to reach the grand old age of 11, more than double its life expectancy?

The growth phase of any business cycle is itself made up of three sub-phases: 'recovery', 'expansion' and 'peak'. The recovery phase is when economic indicators are rising but remaining below trend; expansion phase when rising and above; and peak phase when falling and above (the other sub-phase of the cycle is 'recession', when indicators are both falling and below trend). It is during the expansion phase that monetary policy gets tightened, as central banks seek to restrain growth and inflation, and the peak phase begins when monetary policy has become tight and is starting to impact growth.

So, since in much of the developed world monetary policy tightening has yet to begin, we are arguably still in the recovery phase (the US is probably in expansion phase but only just). If that's the case, a global downturn is far from being imminent.

The current cycle has been characterised by weak inflation. This is despite unemployment across the developed world falling to levels which in the past would have been inflationary (to put this into more technical language, the Phillips Curve has shifted to the left). It is my belief that there are two key reasons for this, one structural and one cyclical. The structural reason is that automation has reached a tipping point such that labour no longer has the pricing power of days gone by. As for the cyclical reason, there may be more slack in labour markets than the headline unemployment rates suggest.

In the US, for example, the participation rate has hardly risen, as might be expected during a growth phase. Some of this is no doubt due to demographics, but then the increasing need for retirees to continue working should render this moot. The large number of disaffected workers who left the workforce following the Great Recession and retirees who need to work should keep a lid on wage pressures for a while longer.

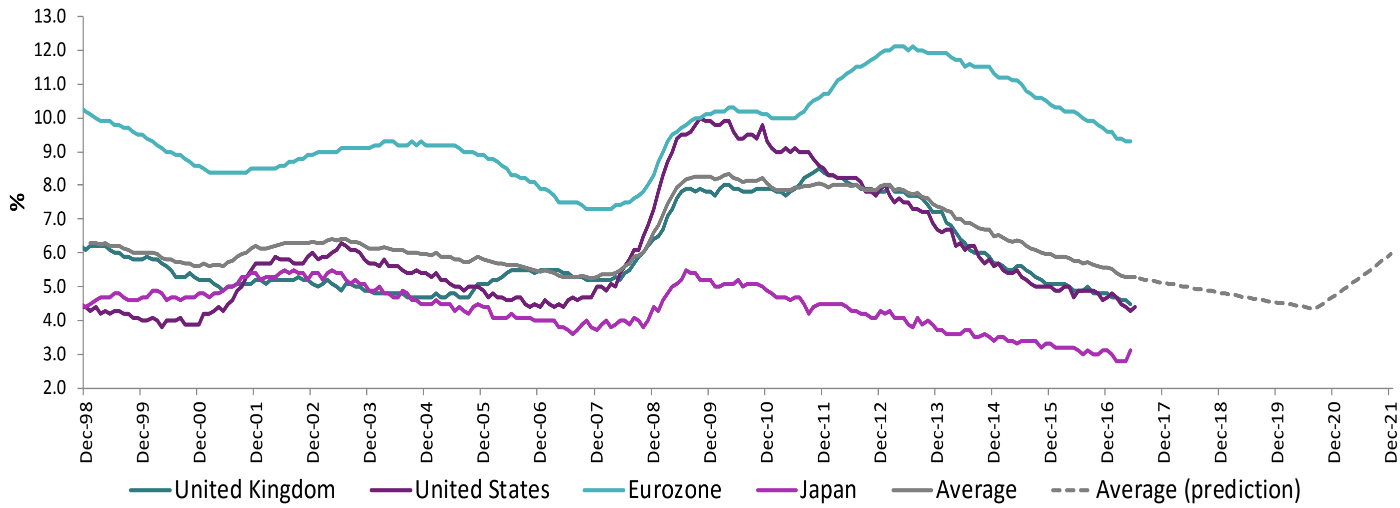
In the UK, the rise in employment this cycle has to a greater extent been in lower paid jobs than might have been the case in previous cycles. Plus, we have the same issue with retirees increasingly needing to continue working. Let's face it, the gap between retirement age and life expectancy has reached unsustainable levels. Not just in the UK but, in much of the developed world.

These cyclical issues have shown up in terms of weak productivity growth. In the UK, productivity growth has at no point risen above 2% during this cycle, while in previous cycles it has hit 4%. A similar pattern can be seen in the US. Thus there is scope for a cyclically-driven rise in productivity to hold back inflation pressures for a little while longer.

Another simple point to note is that because unemployment rates rose to high levels in 2009, they subsequently had a long way to fall. Naturally, this was always going to take more time than normal. The worse the accident, the worse the injuries, and the longer the recovery time. 2009 was, in no uncertain terms, a car wreck.

So, extrapolating current trends in unemployment rates, and taking account of the aforementioned shift in the Phillips curve which should have the effect of extending the current cycle, I get to a downturn in 2020 (see chart). There is not a great deal of science behind this prediction. It is based on what is essentially simple analysis. But to paraphrase Warren Buffett, simple behaviour is more effective than complex behaviour. And let's face it, the dismal anticipation by most economists of the Great Recession should have proved once and for all that their trade is not a science.

Chart: Unemployment rates in the developed world (%)



Source: Bloomberg, Seneca IM

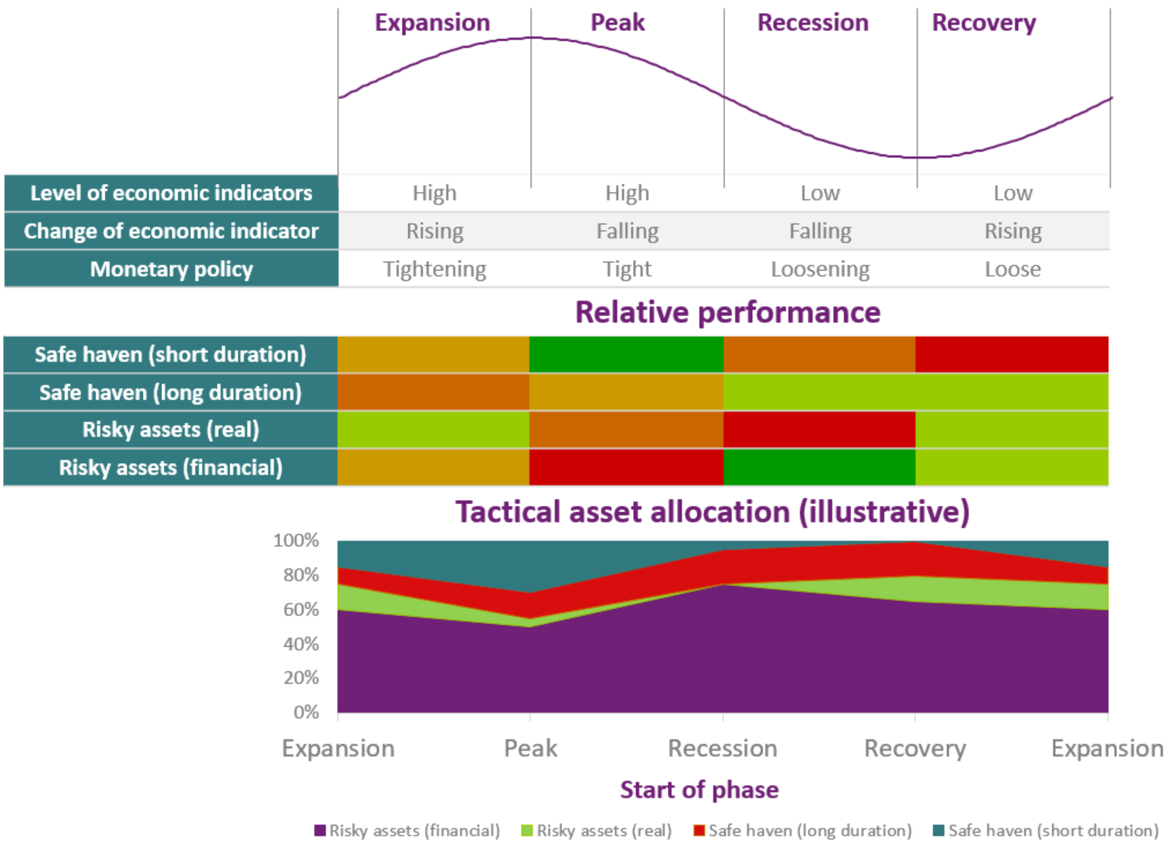
1 https://en.wikipedia.org/wiki/List_of_economic_expansions_in_the_United_States#cite_note-NBER-1

Our tactical asset allocation framework

In light of my views on the next global downturn as set out in the above section, I thought it would also be worth touching on the framework I use for tactical asset allocation. Although valuations of asset classes are important, I believe these need to be considered in relative rather than absolute terms. What I mean by this is that valuations need to be considered in the context of monetary policy, namely real short term interest rates. Business cycle analysis can do this effectively and so is at the core of my tactical asset allocation framework.

The main research that I have drawn on is titled Dynamic Strategic Asset Allocation: Risk and Return across Economic Regimes[1] written by Robeco's Pim van Vliet and David Blitz in October 2008. In it, the authors map real returns of various asset classes to each of the four phases of the business cycle, drawing on data going back to 1948. They found that risky financial assets (equities and credit) perform worst in the peak phase, risky real assets (commodities) perform worst in the recession phase, and, in view of what other asset classes are doing, cash performs worst in the recovery phase. One can therefore vary one's asset allocation to align it with these findings, as per the graphic below.

Graphic: The business cycle, asset class returns, and tactical asset allocation



As I mentioned in the first section, I think in aggregate the developed world is close to the end of the recovery phase. The analysis above suggests that, given this, we should have been lowering our equity weight from overweight to neutral which is exactly what we have been doing over the last 12 months. From here, the analysis suggests we should be lowering our equity weight further which, again, is what we intend to do.

How severe will the next downturn be? Frankly, I don't know. Some suggest it will not be nearly as severe as the last one as central banks will prevent it from infecting banking systems. Others suggest that because central banks' balance sheets are still bloated, and the next downturn will start from lower interest rates, they have less scope to step in.

The good news is that I think I have a decent amount of time to develop my views further in relation to this question.

1 https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=1343063

Current fund targets

The target weights in the table below are where funds should be positioned currently. Actual positions may deviate slightly from these target weights as a result of market movements or ongoing trades for example.

Table 1: Current fund tactical asset allocation (TAA) target weights as of 30 June 2017 (prior month's targets in brackets)

TAA target Weights (%) (prior month's targets in brackets)		OEICs		Investment Trust
		CF Seneca Diversified Income Fund	CF Seneca Diversified Growth Fund	Seneca Global Income & Growth Trust plc
Equities	UK	**24.5** (25.5)	**22.0** (23.0)	33.0 (33.0)
	North America	0.0 (0.0)	4.0 (4.0)	**1.0** (1.5)
	Europe ex UK	6.0 (6.0)	9.0 (9.0)	8.0 (8.0)
	Japan	1.0 (1.0)	8.0 (8.0)	**4.0** (4.5)
	Asia Pacific ex Japan	5.5 (5.5)	10.5 (10.5)	9.5 (9.5)
	Emerging Markets	1.0 (1.0)	4.5 (4.5)	3.0 (3.0)
	Global Funds	2.0 (2.0)	2.0 (2.0)	1.5 (1.5)
	Equities Subtotal	**40.0 (41.0)**	**60.0 (61.0)**	**60.0 (61.0)**
Fixed income	DM Government	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
	EM Debt	5.0 (5.0)	2.0 (2.0)	1.9 (1.9)
	Corporate	26.2 (26.2)	8.0 (8.0)	6.3 (6.3)
	Fixed income Subtotal	**31.2 (31.2)**	**10.0 (10.0)**	**8.2 (8.2)**
Specialist assets*	Property	6.7 (6.7)	6.7 (6.7)	7.0 (7.0)
	Private equity	4.0 (4.0)	4.5 (4.5)	5.4 (5.4)
	Specialist financial	10.2(10.2)	9.0 (9.0)	11.1(11.1)
	Infrastructure	5.3 (5.3)	5.0 (5.0)	5.7 (5.7)
	Specialist Subtotal	**26.2 (26.2)**	**25.2 (25.2)**	**29.2 (29.2)**
Cash		**2.6** (1.6)	**4.8** (3.8)	**2.6** (1.6)
Total		100.0	100.0	100.0

Source: Seneca Investment Managers, 30 June 2017

* Target weights for the specialist assets subsectors are the aggregate of holding level targets as top down driven asset allocation targets are not applied to this sector.

Increased ***Decreased***

General

- Equity exposure reduced by 1% bringing weighting to neutral position against strategic asset allocation.
- Equity market valuations look less compelling following further strength this year.
- Reduction in equity weighting taken from UK equities.
- Rise in interest rates in the United States with commentators beginning to focus on higher rates in the UK and Europe following Draghi and Carney comments.
- Good trading update from Kier Group, whilst the new CEO of Bovis Homes further increased his shareholding in the company.
- In Europe, we trimmed the holdings in Invesco Perpetual European Equity Income Fund and European Assets Trust.
- Gilt yields rose to highest level for 3 months towards the end of the period following more hawkish comments by Mark Carney.

SDGF

- A strong share price performance from Aberdeen Private Equity Fund, aided by some heavy buying by large shareholders, moved us to take some profit from the overweight holding.

SDIF

- New investment in RPC, following share price weakness. Company has grown its dividend for 24 consecutive years and we believe it will continue to grow at a healthy rate.
- Somerset Emerging Markets Dividend Growth Fund was reduced to bring in line with target weight.
- Holding in TwentyFour Select Monthly Income Fund was reduced following strong performance over the past 12 months.
- A recovery from previously “”oversold”” levels in LondonMetric allowed us to move the position back down to its target weight.
- Following our participation in the recent equity raising in Sequoia Economic Infrastructure the shares returned to their previous strength, consequently we took some of the profit.

SIGT

- Following reductions in the tactical asset allocation weights to North America and Japan, we reduced the positions in the Cullen North American High Dividend Value Equity Fund and Goodhart Michinori Japan Equity Fund.