Peter Elston: Investment Letter

Issue 29: October 2017

This document is intended for professional investors only

Data as at 30.09.2017

- **Five points about active management**
- **Current fund targets**

Five points about active management in the multi-asset space

I was presenting a slide deck entitled 'The Art and Science of Multi-Asset Investing' at five venues across the country recently, as part of Professional Adviser's Multi-Asset Roadshow[1]. Back at my desk, I thought it would be interesting to distil the numerous conversations we had with interested parties on the subject of 'good active management' - a key theme throughout my presentation - into five distinct topics. So, here they are.

Size of AUM - Small is beautiful (but not too small)

This is a point that I make frequently, so I'm happy to make it again. As I said in my August letter, "the big firms…continue to peddle the notion that bigger is better – witness a certain recent merger – when in fact my – and Warren Buffett's! – opinion is that the opposite is the case."

It is completely understandable that the big firms take this line - they're hardly likely to say that big is bad! And because it is the big firms who spend the most on advertising, and thus get the bulk of the column inches, the myth tends to get perpetuated.

1 *http://events.professionaladviser.com/mars*

Seneca Investment Managers Limited
Tenth Floor, Horton House, Exchange Flags, Liverpool, L2 3YL.
T 0151 906 2450 **E** info@senecaim.co.uk **W** senecaim.co.uk

So, why do Buffett and we think that small is beautiful?

Simple.

With less AUM, there are more investment opportunities available - think about a fishing net with smaller holes. And often, the smaller investments are the more interesting – in the case of equities, smaller companies have more potential to grow than larger ones. Why? There is more blue sky. It's that simple.

With football clubs, for example, bigger is better. Not so with fund management companies.

High tracking error is bad but low tracking error is worse

Good active management is firstly about structuring funds such that they have the scope (potential) to produce alpha well in excess of fund costs, and secondly about having a strong investment style that will enable them to achieve this potential.

If a fund doesn't have the potential to outperform, it doesn't matter what investment style it adopts. So, in many ways, the first step is more important than the second.

What this first step says is that a fund must be sufficiently different from its benchmark index. If a fund is similar to the benchmark index, gross performance will be similar to the benchmark index, and net performance will be below the benchmark index.

To have the chance of producing gross alpha well in excess of fund costs, funds need to be different. Such difference can be measured by looking at tracking error. As a rule of thumb, my experience is that a fund's tracking error should, over time, be around three times its OCF.

Anything less, beware.

Passive multi-asset funds do not capture the opportunity in 'specialist assets'

Our three multi-asset funds are simple creatures, but they are more than just balanced funds. What makes them different to balanced funds are what we call 'specialist assets'. These on the whole are listed specialist investment trusts that own illiquid tangible assets such as property, infrastructure, aircraft, and loans. Because these tangible assets are easy to understand – what can be less complicated than bricks and mortar or an airplane? – the trusts themselves are easy to understand.

As a result, our funds are also easy to understand[1].

Although in recent years they have been very popular, and indeed continue to be, passive multi asset funds such as those offered by Vanguard, Blackrock, L&G and HSBC[2] are not able to capture the opportunity offered by specialist assets. In fact, they are either balanced funds or close to being balanced funds - HSBC and L&G have small allocations to property, without which they would be just comprised of equities and bonds.

Our 'specialist assets' offer useful features in relation to both bonds and equities, which is what makes them interesting.

In relation to equities, they have more stable income streams - they don't have the operational gearing that companies have. While in relation to bonds, they tend to have higher yields and income streams that are either explicitly or implicitly linked to inflation.

As for price behaviour, their volatility is generally lower than that of equities, and they are lowly correlated with broad equity markets. So you can imagine what having a quarter of portfolios in these things, as we do, does to their Sharpe Ratios!

Shame to miss out on such a great opportunity.

1 *Many active multi-asset funds invest in complex investments such as derivative strategies, hedge funds, structured products or the like. We avoid these. Can't understand, don't invest.*

2 *Vanguard LifeStrategy, Blackrock Consensus, L&G Mixed Investment, Architas MA Passive, HSBC World Index*

Passive beats active in the 'single-asset' space, but in multi-asset the opposite is the case

We've all seen the headlines:

"99% of actively managed US equity funds underperform"

"86% of active equity funds underperform"

"Nine out of 10 active funds underperform benchmark"

"87% of active UK equity funds underperformed in 2016"

Source: FT.com

All of the above headlines relate to pure equity funds, whether in the US, Europe, the UK or emerging markets. You never see such headlines in relation to active *multi-asset* funds.

Why?

What distinguishes a multi-asset fund from an equity fund (or a bond fund) is one key feature: asset allocation.

In my September letter, I wrote, in relation to funds in the IA Mixed Investment 20-60% Shares sector, the following:

> "It is encouraging that although only 23 of the 102 funds generate active alpha equivalent to three times the active fees (i.e. at least two thirds of gross active alpha go to the customer), the vast majority (71 funds) produce positive alpha net of fees. The implication of this is that 'multi-asset' may be an area where active management works pretty well (as opposed to 'single-asset' where evidence clearly indicates the opposite)."

I surmise that the reason for this is that it is easier to add value from tactical asset allocation than it is from stock selection, so actively-managed multi asset funds have an advantage over actively managed equity funds.

There is plenty of academic research that has found close relationships between the starting valuation of equity and bond markets on the one hand and subsequent performance on the other. This can be understood most easily with respect to bonds. As I noted in September:

> "If the real yield of the five-year linker is -2%, you know that the real five-year return will be -2% annualised. You also know that the real return of the five-year "nominal" will on average be pretty close to -2% annualised (breakeven inflation rates are generally a reasonably good predictor of actual future inflation). Furthermore, if the real yield of the ten-year linker is -2%, the subsequent five-year real return is likely to be pretty close to -2% annualised. And so forth."

There is a similar logic with respect to equity markets, but the link between yields and subsequent performance is not quite so stark.

In summary, you really don't need to do anything complicated to add value through active (tactical) asset allocation.

Are there 'suitability' issues in relation to putting clients into passive multi-asset funds that have massive bond risk?

Back in 2008, the real 10-year Gilt yield was around 1%. Although this was low – 10 years earlier real yields were 4% - one could still justify buying Gilts on the basis that the real yield was positive.

Fast forward to today and real 10-year interest rates in the UK are close to -2%. This means that if you buy them and hold them to maturity, your real return will be -2% per annum (-1.79% to be precise)[1].

To make money in real terms, real yields would have to fall further and you'd have to sell the bonds before maturity. But yields are already at -2%! Expecting them to fall to, say, -3% is, in my humble opinion, not investing but speculation.

In the previous section, I mentioned four providers of the more popular passive multi-asset funds. If you consider their offerings that sit in the IA Mixed Investment 20-60% Shares sector, they generally have around 40% in equities.

Where is the other 60%? All or mostly in bonds, where one has to be lucky to win.

In other words, are these funds really suitable for your clients?

1 *Source: Bloomberg*

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 30th September 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	23.5 (23.5)	21.0 (21.0)	33.0 (33.0)
	North America	0.0 (0.0)	3.0 (3.0)	0.0 (0.0)
	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 (4.0)
	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	**39.0 (39.0)**	**58.0 (58.0)**	**59.0 (59.0)**
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	26.7 (26.7)	9.0 (9.0)	6.8 (6.8)
	Fixed income Subtotal	**31.7 (31.7)**	**11.0 (11.0)**	**8.7 (8.7)**
Specialist assets*	Property	6.7 (6.7)	6.7 (6.7)	7.0 (7.0)
	Private equity	4.4 (4.4)	4.7 (4.5)	5.5 (5.5)
	Specialist financial	9.1 (9.1)	8.2 (8.2)	9.7 (9.7)
	Infrastructure	5.8 (5.8)	6.1 (6.1)	6.4 (6.4)
	Specialist Subtotal	**26.0 (26.0)**	**25.7 (25.7)**	**28.6 (28.6)**
Cash		3.3 (3.3)	5.3 (5.3)	3.7 (3.7)
Total		**100.0**	**100.0**	**100.0**

Source: Seneca Investment Managers, 30 September 2017

Increased *Decreased*

* 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.

General

- Sterling rose sharply in September on signs of rising inflation, an improving economy, and progress in Brexit talks
- Inflation also rose in other parts of the developed world which helped quell concerns over weakness in recent months
- Equity markets were generally firm, reflecting the improved inflation, and by implication growth, picture
- There were no asset allocation changes during the month
- New holding in Babcock International, which has unjustifiably been tarnished with the same brush as other support service companies, such as Capita, Interserve and Mitie. Dividend yield at 10 year high at time of investment [1].
- Good results from Kier Group, in which the dividend was increased 5%. Shares yield close to 6% [2].
- There were no changes to Fixed Income holdings during the month.
- International Public Partnerships announced a solid set of results for the 6 months to June 2017 [3]. The primary risk surrounding this space is the scope for political interference.
- We are seeing trusts that have delivered on their stated objectives announce further capital raisings to enlarge their portfolios. We are reviewing these opportunities to assess whether we participate.

SDGF

- Goodhart Michinori Japan Equity Fund was reduced back to target weight following strong performance this year.

SIGT

- Aberdeen Asian Income Fund was added to in order to bring to target weight. The Trust trades at a 4% discount to net asset value.

1 *Source: Bloomberg*
2 *Source: Bloomberg*
3 *Source: International PPL half year results, posted 7 September 2017*