Peter Elston: Investment Letter

Issue 30: November 2017

This document is intended for professional investors only

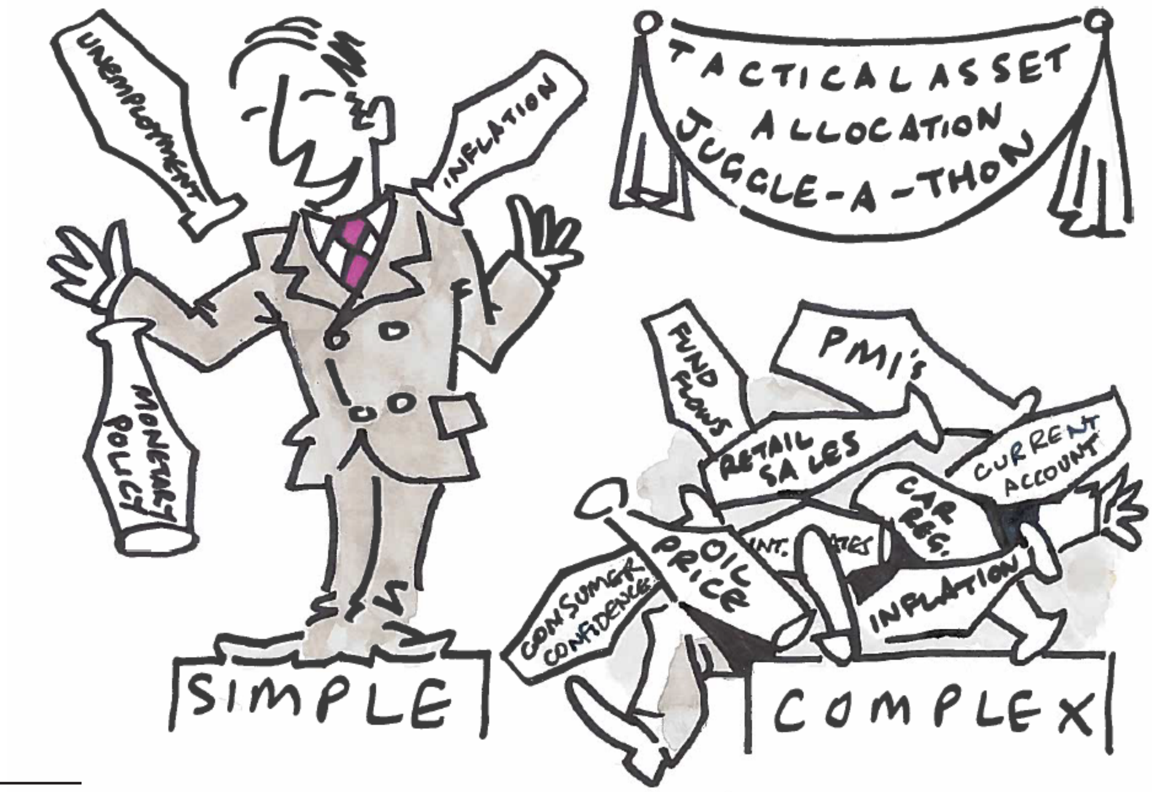
- **Keeping asset allocation simple**
- **Monthly review and outlook**
- **Current fund targets**

Keeping it simple – how to add value effectively through tactical asset allocation

Take a look at the equity weight over time of some multi-asset funds[1] and you'd have thought that the manager was at best flipping coins and at worst drunk. Up one month, down the next, up again, down again. It is well documented that markets are unpredictable over short time frames, so can this be the right approach?

I think not.

I have espoused the merits of keeping it simple on numerous occasions, but nowhere is this mantra better demonstrated than with respect to tactical asset allocation.



1 Source: Investment Association 40-85% shares sector October 2002 to October 2017

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Multi-Asset Value Investing

Over the years, I have become increasingly cognisant of the parallels between tactical asset allocation and the operation of monetary policy (stay with me). As I gradually learned the hard way that predicting short-term market movements is for the foolhardy (one can never learn fast enough!), and began to focus all the more on the longer term, I realised that my monthly market reports didn't change much month to month. What did change was the odd word here and there, with 'strong' replacing 'modest' or 'am confident that' instead of 'believe that'. In other words, it was all about gradual change in nuance, as is the case with minutes of Fed or Bank of England meetings[1] (that said, I very much doubt anyone will ever hang on my every word as they do with Yellen and Carney, other than my dog of course!)

I also found that as I matured as an asset allocation specialist, my proposed changes in equity weight or the weights of other asset classes became much smoother (yeah man!) in the same way that over the course of a business cycle central bank policy rates tend to move up gradually, stop, move down less gradually, then stop again. None of the constant chopping and changing you get with fund managers (unless your name is Jean-Claude Trichet that is![2]).

Most importantly, monetary policy tells you everything you need to know to be able to predict medium-term market movements with a reasonable degree of accuracy and thus to add value to portfolios through tactical asset allocation. And as far as monetary policy is concerned, all you really need to keep an eye on is the unemployment rate and inflation.

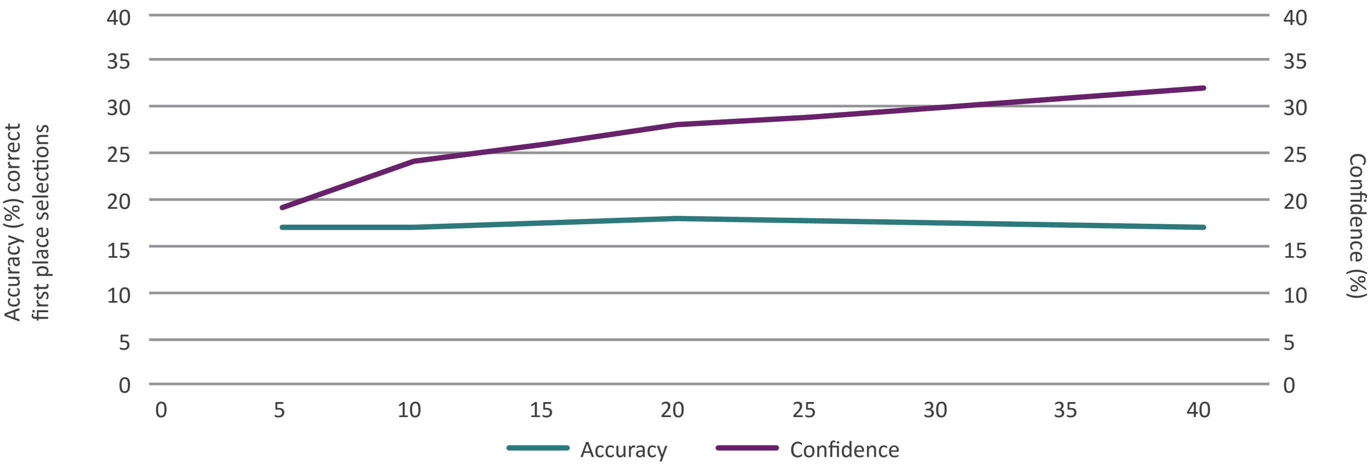
In other words, keep it simple - you really don't need more information.

The CIA was particularly interested in this idea, and indeed wrote a paper in 2005 called, you guessed it, do you really need more information?[3] In it, author Richard J Heuer Jr, referred to an unpublished 1973 manuscript by Paul Slovic entitled, "Behavioural Problems of Adhering to a Decision Policy", which described an experiment to measure the utility of information. In the experiment, eight experienced horse handicappers were asked to choose their fifth, tenth, twentieth and fortieth most important variables found in typical past performance tables e.g. the jockey's record, weight to be carried etc.

The handicappers were then given data for 40 actual races (sterilised to hide the race identities) and asked to predict the top five horses, in finishing order, as they were progressively given the 5, 10, 20 and 40 variables of their choosing. They were also asked at each stage to assign a degree of confidence to their predictions.

The results are shown in the chart below.

Chart 1: Accuracy of horse bettors' predictions versus their confidence in their predictions



As the handicappers are given more data, the accuracy of their predictions does not increase, but in fact decreases slightly. Just as interesting, their confidence in their predictions increases materially. In other words, the more information the bettors had, the greater their overconfidence.

The problem is that while overconfidence was useful for early humans in facing down a sabre toothed tiger or a woolly mammoth, it causes all sorts of problems when it comes to making good investment decisions. And while our intelligence and knowledge might have increased immeasurably over the last 100,000 years, we still have the same brains and thus the same instincts. Financial markets are there to make you look stupid and understanding this would make most people better investors.

1 https://www.federalreserve.gov/econresdata/notes/feds-notes/2015/semantic-analysis-of-the-FOMCs-postmeeting-statement-20150930.html

2 As President of the ECB Jean-Claude Trichet raised interest rates in both 2008 and 2011 but quickly had to change course (see https://www.bloomberg.com/news/articles/2017-10-23/boe-rate-hike-risks-carney-repeating-policy-errors-of-ecb-japan)

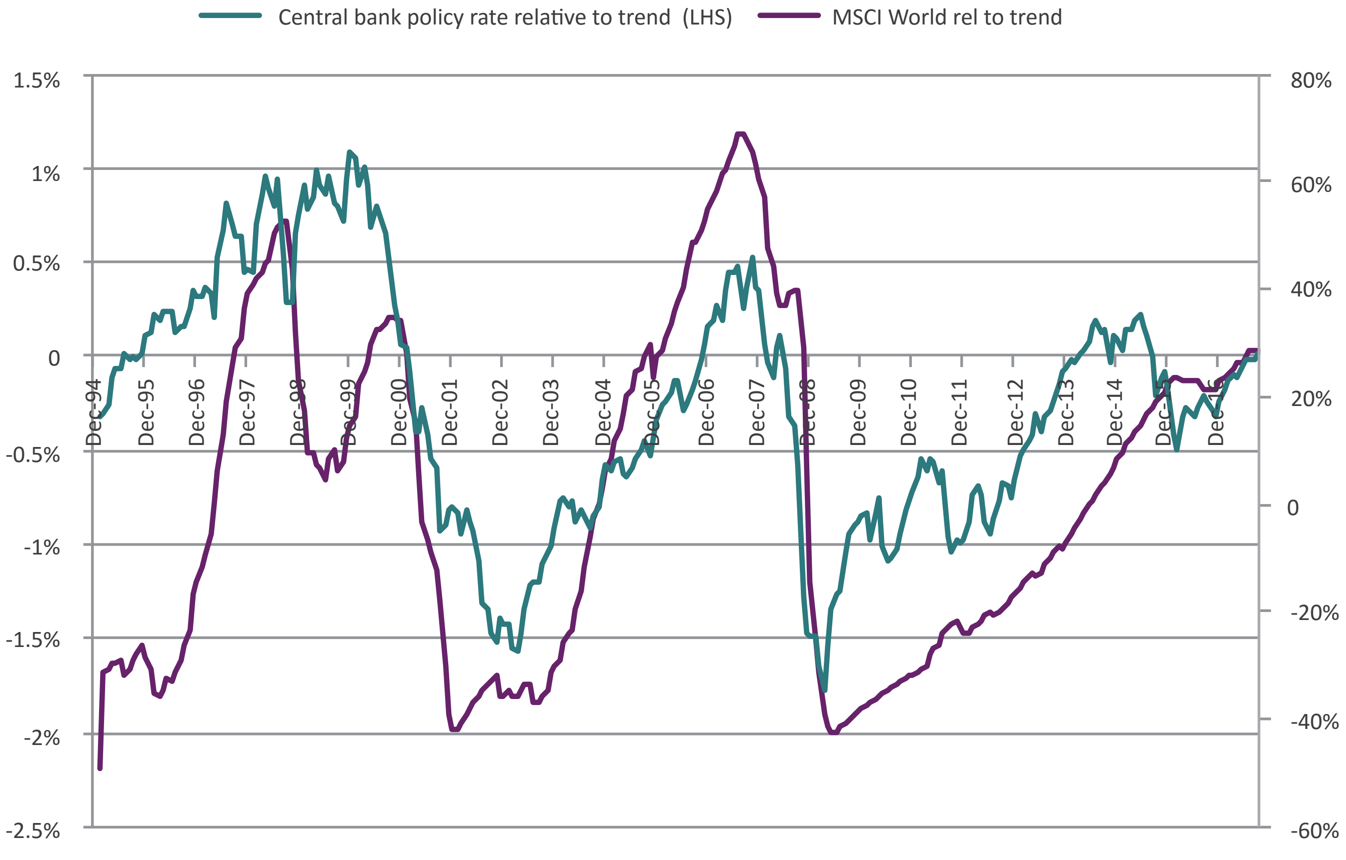
3 https://www.cia.gov/library/center-for-the-study-of-intelligence/csi-publications/books-and-monographs/psychology-of-intelligence-analysis/art8.html

Back to simple asset allocation.

The next two charts illustrate the simple link between monetary policy, future returns from equities, and tactical asset allocation. Over an hour or two recently, I played around with data comprising only monthly central bank policy rates and monthly MSCI World data.

Chart 2 shows the clear link between the central bank policy rate (average of US, UK, Eurozone and Japan) and the performance of the MSCI World index, going back 20 years (both relative to trend).

Chart 2: High correlation between central bank policy rates and performance of equity markets

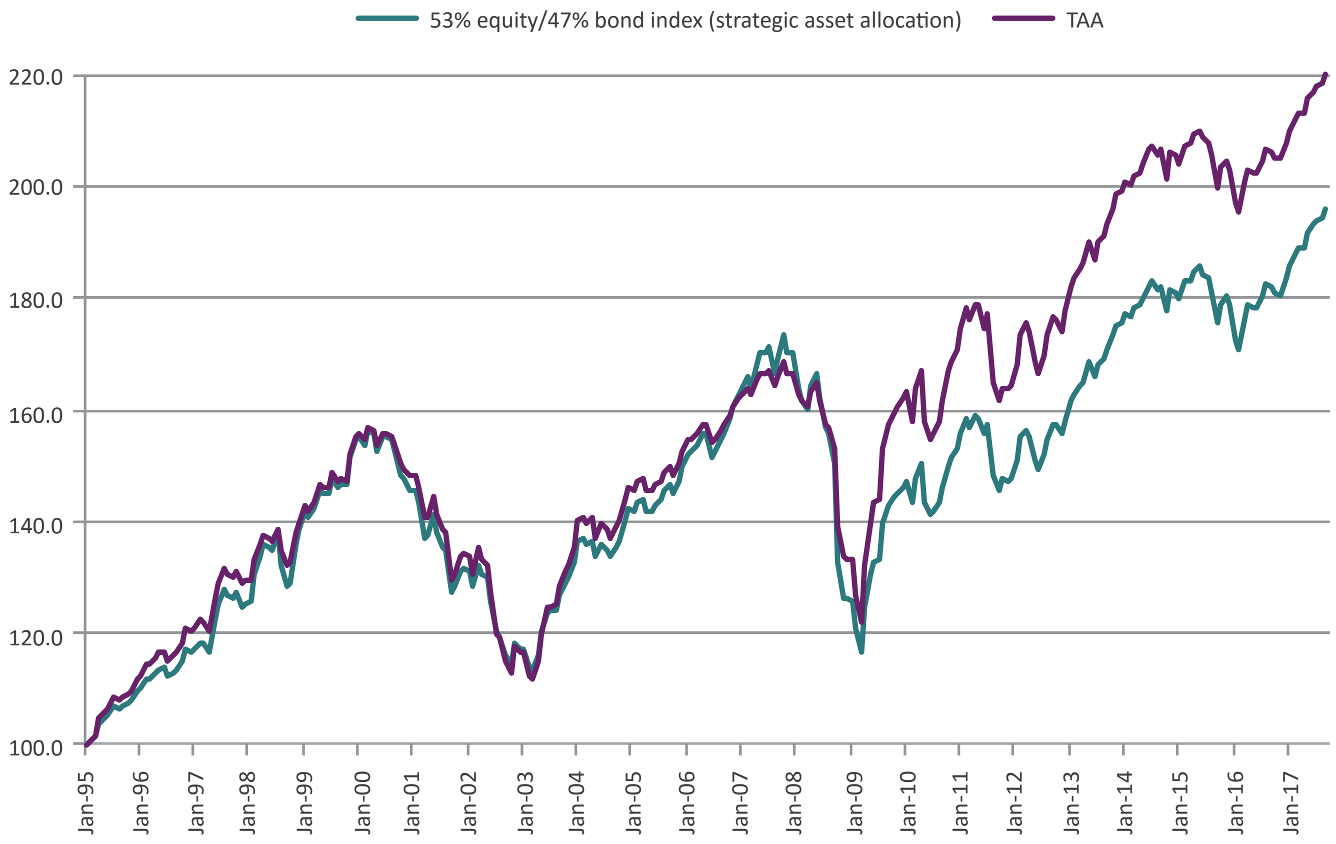


Source: Bloomberg

Using this, one can derive an equity target weight[1] for a hypothetical balanced fund that is based only on the central bank policy rate, then measure the performance of the tactical asset allocation (TAA) portfolio against a fixed weight strategic asset allocation. The results are shown in Chart 3 below.

1 The equity target weight is calibrated directly from the central bank policy rate, such that it stays within a range from 30 to 70%. The equity target weight is at its lowest when central bank policy rates are at their highest in relation to trend (tightest), and highest when rates are at their lowest (loosest).

Chart 3: A very simple tactical asset allocation framework adds significant value



Source: Bloomberg

Why have I chosen 53%/47% for the strategic asset allocation? Because I wanted to make sure that the volatilities of the strategic asset allocation index and the tactical asset allocation portfolio were exactly the same, and thus ensure that none of the outperformance came from higher beta (market risk).

If it isn't obvious, 23%pts of outperformance over 20 years is nothing to be sniffed at. This could be the difference between portholes or balcony on that retirement cruise you are dreaming about. Furthermore, with one or two refinements that might take another hour or two, I suspect the model could deliver even better results.

Simple refinements of course, not complicated ones.

Macro and Markets Monthly

Review

There were few signs during the month of October that the global economic improvement of late was starting to stutter. Labour markets in the developed world continued to strengthen, while inflation trends also remained positive. In other words, there was no reason to think that monetary policy roadmaps set out by developed world central banks would need to be adjusted any time soon.

In the US, the ADP Employment Change[1] came in at 135,000. This was bang in line with expectations but lower than the previous month's increase of 228,000, revised down slightly for the original 237,000. Nonfarm payrolls two days later were on the weak side, showing a decline of 33,000 jobs over the month. This however should be viewed in the context of a revision upwards in the September increase from 156,000 to 208,000. As for the unemployment rate, it fell from 4.4% in September to 4.2% in October. Furthermore, the underemployment rate showed a decent improvement from 8.6% to 8.3%. The labour force participation rate also ticked up slightly, from 62.9% to 63.1%, indicating that more people were being drawn back to the workforce. We now consider the US to be very much in expansion phase, during which we would expect to see employment growth start to decline slightly. In other words, the aforementioned employment data is what we would have expected to see at this point on the cycle.

Continuing in the US, on the inflation front, there are signs of stability appearing following a few months in which core inflation has fallen below the central bank target of 2%. Although core inflation fell short of the expected 1.8% year on year, it was in line with the previous month's 1.7%. Real average hourly earnings growth rose from 0.6% in August to 0.7% in September, another sign that price growth is at a comfortable level.

Elsewhere in the developed world, employment numbers continued on the whole to improve. In the UK, the three-month unemployment rate held steady at 4.3%, while the 3 month/3 month employment change was a reasonable 94,000. In the Eurozone, the unemployment rate for September came in at 8.9%, compared with 9.0% the previous month, while in Japan it held steady at 2.8%. Inflation numbers too in the UK, the Eurozone and Japan remained comfortable.

The reason for focusing on employment and inflation is that these are the key indicators that central banks target when deciding on monetary policy. In other words, there was nothing to suggest central banks needed to reconsider the monetary policy roadmaps that they had previously laid out.

Economic improvement was also seen in the emerging world, where inflation rates in China, India, Brazil, Russia and Indonesia are now at a much more comfortable level than was the case a year or two ago.

As for financial markets, equity markets generally rose in October. Asian and emerging market equities performed particularly well, as the global economic backdrop continued to improve. The improvement in inflation may also have helped to boost sentiment towards these regions.

Outlook

We think the global economy as a whole is moving from recovery phase to expansion phase (some like the US are firmly in the latter while others such as the Eurozone are still in the former). Thus we expect equity market returns to continue to fall slightly, but remain positive for the two or so years up to the point at which monetary policy becomes much tighter and when economies are likely to start peaking.

Inflation we think will continue to rise and we thus remain negative on safe haven bonds which anyway are very expensive in light of low or negative real yields.

1 A report that measures levels of non-farm private employment based on payroll data from over half of ADP's U.S. business clients. The data represents about 24 million employees from all 19 of the major North American Industrial Classification (NAICS) private industrial sectors.

Source for all data: Bloomberg

Table 1: Current fund tactical asset allocation (TAA) target weights as of 31st October 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	**22.5 (23.5)**	**20.0 (21.0)**	33.0 (33.0)
	North America	0.0 (0.0)	**2.0 (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)	**3.0 (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	**38.0 (39.0)**	**56.0 (58.0)**	**58.0 (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	**27.2 (26.7)**	**10.0 (9.0)**	**7.3 (6.8)**
	Fixed income Subtotal	**32.2 (31.7)**	**12.0 (11.0)**	**9.2 (8.7)**
Specialist assets*	Property	6.7 (6.7)	6.7 (6.7)	7.0 (7.0)
	Private equity	4.4 (4.4)	**4.8 (4.7)**	**5.6 (5.5)**
	Specialist financial	**9.4 (9.1)**	**8.5 (8.2)**	**10.0 (9.7)**
	Infrastructure	**6.0 (5.8)**	**6.2 (6.1)**	**6.5 (6.4)**
	Specialist Subtotal	**26.5 (26.0)**	**26.2 (25.7)**	**29.1 (28.6)**
Cash		3.3 (3.3)	**5.8 (5.3)**	3.7 (3.7)
Total		**100.0**	**100.0**	**100.0**

Source: Seneca Investment Managers, 31 October 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 weights lowered again as further evidence of continued progression of the business cycle emerged in the form of stronger purchasing manager indices
- European markets were boosted by the European Central Bank's announcement that its asset purchase program would be extended for nine months
- Intermediate Capital was exited on valuation grounds and in order to instigate the asset allocation reduction to UK equities. The dividend yield had close to halved since 2014, to stand at just 3%
- Corporate activity within the specialist lending sector highlighted the value that exists in the sector. First Rand approached Aldermore, providing some read across to OneSavings Bank
- Fund holdings in the Royal London Short Duration High Yield Bond Fund were increased following an lift in the tactical asset allocation to corporate bonds
- We supported the further equity raising by Greencoat UK Wind having previously taken profits at higher price levels. The management team have built a solid portfolio of wind assets
- After a solid first 10 months building a conservatively balanced portfolio of asset backed loans, we participated in the further equity issuance by RM Secured Direct Lending

SDGF

- The equity reduction came in the UK and North America, with proceeds spread between short duration high yield and specialist assets where yields still look decent
- Following a reduction to the tactical asset allocation weight to North America, the Yacktman US Equity Fund was reduced

SDIF

- The equity reduction came in the UK, with proceeds spread between short duration high yield and specialist assets where yields still look decent

SIGT

- The equity reduction came in the Japan, with proceeds spread between short duration high yield and specialist assets where yields still look decent
- Small additions were made to the Invesco Perpetual European Equity Income Fund and European Assets Trust in order to bring positions to target weight
- Following the reduction to the tactical asset allocation weight to Japan, the Goodhart Michinori Japan Equity Fund and CC Japan Income & Growth Trust were both reduced

Important Information