SENECA
INVESTMENT MANAGERS

Peter Elston: Investment Letter

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This document is intended for professional investors only

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Looking back...

All three of our funds have been blowing passive multi-asset funds out of the water based on volatility adjusted returns for five years now and even more so over three years (see Table 1). Importantly, the bond bear market that could crucify these passives and their high fixed allocations to investment grade bonds may only just be getting started.

I'm certainly now pleased with our past performance as well as very much excited about the future. And I implore those with exposure to a bond bear market that could last for the next 20 years to reconsider.

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Multi-Asset Value Investing

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Table 1: Performance of Seneca funds versus passive multi-asset funds (sorted by three-year volatility adjusted returns)

	FE Risk	Total Return		3y/FE Risk	5y/FE Risk
		3y	5y		
Specific funds					
Seneca Global Inc & Growth (NAV)	**48**	**39.0**	**65.2**	**0.8**	**1.4**
LF Seneca Diversified Income	**44**	**28.6**	**46.6**	**0.7**	**1.1**
LF Seneca Diversified Growth	**55**	**35.4**	**58.1**	**0.6**	**1.1**
Vanguard LifeStrategy 60% Equity	62	31.0	58.8	0.5	0.9
Vanguard LifeStrategy 40% Equity	47	23.3	44.9	0.5	1.0
L&G Mixed Investment 0-35%	36	17.1	33.5	0.5	0.9
L&G Mixed Investment 40-85%	67	30.0	51.0	0.4	0.8
BlackRock NURS II Consensus 70	65	28.4	47.2	0.4	0.7
BlackRock NURS II Consensus 60	59	25.5	41.7	0.4	0.7
L&G Mixed Investment 20-60%	51	21.2	n/a	0.4	n/a
BlackRock NURS II Consensus 35	56	23.1	35.9	0.4	0.6
Fund range averages					
Seneca average	**49**	**34.3**	**56.6**	**0.7**	**1.2**
Vanguard average	55	27.2	51.9	0.5	1.0
L&G average	51	22.8	n/a	0.4	n/a
L&G average (excl 20-60%)	52	23.6	42.3	0.5	0.8
BlackRock average	60	25.7	41.6	0.4	0.7

Source: Seneca Investment Managers

2017 was very good to us and thus to our customers. Not only did equities and other risky assets generally perform well, but our investment performance in relation to markets was also good (see attribution tables).

Both our OEICs finished in the top ten in their respective sectors for the year (the income fund was 8th of 147 and the growth fund 7th of 143), while our investment trust, in a slightly more eclectic sector, finished 3rd of 13 (NAV based). As long-term investors, we do not target 12-month performance, but the long term is made up of short terms, so we expect shorter term performance to be good more often than not.

Table 1.1

Performance	31.12.2017	31.12.2016	31.12.2015	31.12.2014	31.12.2013
LF Seneca Diversified Income Fund ‘B’ Shares	11.0	10.0	5.5	2.6	11.7
LF Seneca Diversified Growth Fund ‘B’ Shares	15.3	9.9	7.1	1.2	16.5
Seneca Global Income & Growth Fund plc Share price	15.2	14.3	11.0	6.1	25.5

Source for all performance data: FE Analytics. Basis: Bid to bid, net income reinvested and net of fees in UK Sterling terms.

Past performance is not a guide to future returns.

Table 2.1: 2017 performance attribution for LF Seneca Diversified Income

Asset class	SAA (%)	TAA (%)*	Total return (%)		Attribution (%)		
			Fund	Market	Alloc	Selec	Total
UK equities	22.5	23.5	16.7	11.6	0.0	1.4	1.4
Overseas equities	17.5	16.5	20.4	19.0	0.1	0.0	0.1
Fixed Income	35.0	31.1	8.2	5.4	0.8	0.3	1.1
Specialist assets	25.0	25.7	7.1	10.2	0.0	-0.8	-0.8
Cash	0.0	2.4	0.1	-	-0.3	0.0	-0.3
Total	100.0	100.0	11.9	10.3	0.6	1.0	1.5

* average of beginning and end period weights
Source: StatPro, Seneca
Note: Totals may not sum due to rounding

Table 2.2: 2017 performance attribution for LF Seneca Diversified Growth

Asset class	SAA (%)	TAA (%)*	Total return (%)		Attribution (%)		
			Fund	Market	Alloc	Selec	Total
UK equities	20.0	21.0	16.4	11.6	-0.1	1.2	1.2
Overseas equities	40.0	38.0	21.5	17.9	0.2	1.0	1.2
Fixed Income	15.0	11.0	10.8	5.7	0.5	0.4	0.9
Specialist assets	25.0	26.4	10.3	10.2	0.0	0.0	0.1
Cash	0.0	3.6	0.1	-	-0.6	0.0	-0.6
Total	100.0	100.0	15.6	12.9	0.1	2.6	2.7

* average of beginning and end period weights
Source: StatPro, Seneca
Note: Totals may not sum due to rounding

Table 2.3: 2017 performance attribution for Seneca Global Income & Growth Trust

Asset class	SAA (%)	TAA (%)*	Total return (%)		Attribution (%)		
			Fund	Market	Alloc	Selec	Total
UK equities	35.0	31.8	16.5	11.6	0.0	1.7	1.7
Overseas equities	25.0	28.0	20.2	19.0	0.3	0.3	0.6
Fixed Income	15.0	8.1	9.0	5.7	0.6	0.1	0.7
Specialist assets	25.0	28.4	8.6	10.2	-0.1	-0.4	-0.5
Cash	0.0	2.9	0.8	-	-0.4	0.0	-0.4
Total	100.0	100.0	14.4	12.2	0.5	1.7	2.1

* average of beginning and end period weights
Source: StatPro, Seneca
Note: Totals may not sum due to rounding

This bull market has been called 'the most hated ever'. We have never considered it so. I suspect the principal reason many have hated it is because they anticipated its demise prematurely. Whether it was QE, the feeble economic recovery, the belief that the problems in the financial sector that caused the downturn in 2008 still lurked just beneath the surface, or the increasingly popular notion that secular stagnation had set in, there were plenty of reasons to be nervous and uncertain.

But central banks have been very aware of this nervousness and its impact on economic confidence, and have been operating very loose monetary policies. It is these loose monetary policies that have supported economies and thus equity markets in recent years and continue to support them; with negative real deposit rates, why would you want to hold cash? Those who have sold equities have been quick to realise their error, or indeed quick to blame it on the bull market being generally despised (it is human nature to pass the buck).

2017 has thus seen markets continue to be supported by ultra-loose monetary policy. Furthermore, this ultra-loose monetary policy seems to have finally resulted in the global economy reaching escape velocity. Unemployment has fallen to very low levels over the last several years, while inflation is now either out of the danger zone or causing monetary authorities to ease off on their largesse.

We've been decently positioned in equities and other growth assets such as high yield bonds, loans, REITs and infrastructure funds. And the economic recovery has hit safe haven bonds where we have no exposure. We also tend to have relatively low foreign currency exposure, believing over time that it adds lots of volatility but not much return. So the sterling strength this year has also helped, at least relative to peers.

At a holding level, our funds have benefitted from a general mid cap focus in the UK, as well as from the good performance of a number of our chosen mid-caps. And as you can see from the attribution tables, selection elsewhere has been good too.

All in all, therefore, 2017 was a good year, which probably means 2018 will be challenging. And this brings us nicely onto the outlook.

...and forward

My asset allocation framework is based on business cycle analysis. Asset classes tend to behave differently in each phase of the business cycle, so if you can determine where you are in the cycle, you can add value from asset allocation.

Key developed economies are either now in expansion phase (US and UK) or still in recovery phase (Europe and Japan). The expansion phase is evidenced by unemployment having fallen to low levels and inflation hitting levels that require central banks to start tightening monetary policy. The phase behind the expansion phase is called the recovery phase, where employment conditions and inflation are improving but are still weak, and thus where economies still require a great deal of central bank support.

My belief is that 2018 will see key developed economies progressing further along the business cycle and thus towards the point at which monetary policy becomes tight. This will be when a global downturn becomes a real possibility.

When do I think we will reach this point? Probably sometime in 2020, so we have a little way to go yet. In the meantime, though, I expect returns from equities and other risky assets to fall, albeit remain positive. We have already been reducing our equity weights and will continue to do so, with the expectation that we will be materially underweight by the time the next bear market starts in or around 2019, in anticipation of the aforementioned economic downturn that will begin in 2020.

There isn't a great deal of science behind these predictions. I could be wrong by a year or more. But with asset allocation it is not so much about the 'when' as the 'what'. And I'm not going to wait until the end of the cycle to reduce risk – this would be like braking when you get to the bend rather than gradually as you approach it.

I know that many see quantitative easing as the sickness rather than the cure. Not I. True, the global economic recovery has been slow and at times elusive, but this is as much about the severity of the 2008 downturn as it is about underlying structural problems. A nasty accident necessitates a longer recovery time and much care and attention. QE is simply what central banks must do when interest rates hit zero – they have no choice. In other words, negative real interest rates do not portend a bleak future, but are what is required to get growth going and thus secure a bright future.

The same goes for the other factors that have caused the concern. It was US economist Alvin Hansen who coined the term 'secular stagnation' in 1938 in response to two very nasty recessions. It wasn't that long after that the world embarked on a multi-decade period of high, silicon-induced growth. Consider all the amazing technologies hitting the headlines, and you may conclude as I have there may just possibly be a bright long-term future ahead.

Monthly review and outlook

Review

December saw a number of key economic data releases indicating continued strength across both the developed and emerging worlds. Latest inflation data in the US, the UK, Europe and Japan all showed increases, providing further evidence if any were needed that more interest rate increases are on the way. The US and the UK, which have both already seen interest rate hikes, saw inflation rising away from what should be considered target (US and UK CPI increased, respectively, from 2.0% to 2.2% and from 3.0% to 3.1%). The Eurozone and Japan have yet to hike rates for the first time this cycle, but both saw increases in inflation (respectively from 1.4% to 1.5% and from 0.2% to 0.6%).

As for the emerging world, Mexico, India, Indonesia and Brazil all saw inflation increase, while China's and Russia's were flat.

Such broad rises are indicative of a strong global economy and what one would expect at this stage of the cycle. In fact, if anything it is a surprise that inflation hadn't risen earlier.

The major source of inflation pressures at any time and in any place is wages, which themselves tend to be a function of levels of employment. In key developed economies, December saw jobless rates either fall or stay steady. Indeed, employment trends have been very consistent with the inflation data. The US and the UK are later cycle than the Eurozone and Japan, and so should be seeing lower employment growth. This is exactly what we saw in December with unemployment rates in the later cycle countries showing no change, while the Eurozone and Japan announced further declines (respectively from 8.9% to 8.8% and from 2.8% to 2.7%).

From a longer term perspective, unemployment rates in the US and the UK are now close to historical lows, while Europe and Japan appear to still have scope to fall further (Japan's 2.7% may seem low but it is still well above previous cycle lows).

Employment data in the emerging world is less reliable (China's has been close to 4% for years!), but even so, the trends are positive and indicative of broad economic strength. Unemployment rates in Russia, Indonesia and Mexico have been falling steadily over the last few years and have now reached historically low levels. Encouragingly, Brazil, which has been going through an economic rough patch for the last 3 years, is now seeing its unemployment rate fall (having peaked at 13.3% in the second quarter last year, it fell to 12.1% in the fourth quarter).

Given the economic backdrop described above, and where various countries are on the interest rate cycle, one should have expected equities and commodities to be strong and bonds to be weak. This is in fact exactly what we saw, with energy, industrial metals and precious metals all posting strong gains. Having paused somewhat in November, equity markets were also firm across the board. Bonds were a little more mixed, with the US, Europe and Japan seeing their 10 year yields rise, while the UK's fell slightly.

Outlook

There was nothing in December's economic data releases to cause us to question our outlook, namely that the world economy is now moving firmly into expansion phase and that we should continue to reduce our exposure to risky assets. We think that equities on the whole can continue to rise for another couple of years and that peak phase, the point at which interest rate hikes start to bite, will arrive around 2020.

Table 3: Current fund tactical asset allocation (TAA) target weights as of 29th December 2017 (prior month's targets in brackets)

TAA target Weights (%) (prior month's targets in brackets)		OEICs		Investment Trust
		LF Seneca Diversified Income Fund	LF Seneca Diversified Growth Fund	Seneca Global Income & Growth Trust plc
Equities	UK	21.5 (21.5)	19.0 (19.0)	32.0 (32.0)
	North America	0.0 (0.0)	2.0 (2.0)	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 (3.0)
	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	**37.0 (37.0)**	**55.0 (55.0)**	**57.0 (57.0)**
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 (27.2)	10.0 (10.0)	7.3 (7.3)
	Fixed income Subtotal	**32.2 (32.2)**	**12.0 (12.0)**	**9.2 (9.2)**
Specialist assets*	Property	8.1 (8.1)	8.1 (8.1)	8.4 (8.4)
	Private equity	4.4 (4.4)	4.8 (4.8)	5.6 (5.6)
	Specialist financial	10.3 (10.3)	9.5 (8.5)	10.8 (10.8)
	Infrastructure	6.3 (6.3)	6.4 (6.4)	6.7 (6.7)
	Specialist Subtotal	**29.1 (29.1)**	**28.8 (28.8)**	**31.5 (31.5)**
Cash		1.7 (1.7)	4.2 (4.2)	2.3 (2.3)
Total		**100.0**	**100.0**	**100.0**

Source: Seneca Investment Managers, 29 December 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

- There were no asset allocation target changes in December
- Equity markets were generally buoyant after a somewhat tepid November
- Inflation rose in the UK, the US, Europe and Japan, indicating continued economic strength
- The Federal Reserve increased its Fed Funds rate by a further 25 basis points as expected
- The target weight for Babcock International was increased, in order to take further advantage of the compelling dividend yield which is over 4% and close to 3x covered by earnings
- Strong results from Victrex; healthy cash generation enabled the company to announce a larger than expected special dividend.
- Following the announcement that Aberdeen Private Equity Fund is to be wound up at NAV we reduced the position following the 16% leap in the share price.
- We participated in the equity raise for Ediston Properties Income Fund which has bought a portfolio of retail parks with asset management opportunities.

SDGF

- In Japan, the Goodhart Michinori Japan Equity Fund and CC Japan Income & Growth Trust were reduced to bring back to target weight

SDIF

- Activity in overseas equities was limited over the month with the only transaction being an addition to European Assets Trust to bring in line with its target weight
- The sole transaction during the month was a small reduction in the Muzinich Short Duration High Yield Bond Fund following the final dividend for the current financial year going xd

SIGT

- Positive trading update from Legal & General. The shares offer an attractive dividend yield of 6%.
- A new position was initiated in the Samarang Asian Prosperity Fund. The manager Greg Fisher, focuses on small cap Asian equites that are undervalued and not on the radar of most investors
- To fund the purchase of Samarang, the Aberdeen Asian Income Fund was reduced to a smaller position size
- There were no fixed income transactions during the month

Important Information

Past performance is not a guide to future returns. The value of investments and any income may fluctuate and investors may not get back the full amount invested. This document is provided for the purpose of information only and if you are unsure of the suitability of these investments you should take independent advice.

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Seneca Global Income & Growth Trust plc

Before investing you should refer to the Key Information Document (KID) for details of the principle risks and information on the trust's fees and expenses. Net Asset Value (NAV) performance may not be linked to share price performance, and shareholders could realise returns that are lower or higher in performance. The annual investment management charge and other charges are deducted from income and capital. The KID and latest Annual Report are available at http://www.senecaim.com/

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