Peter Elston: Investment Letter

Issue 15: July 2016

This document is intended for professional investors only

Data as at 30.06.2016

Recent fund performance

Since the referendum, our funds have slipped down the peer group rankings. This does not mean that their absolute performance has been particularly poor, just that the funds have underperformed their respective peer groups in recent weeks. While many will understand that poor short-term performance relative to peers – as well as in absolute terms – may happen from time to time, there may be others who are not so comfortable. The following will I hope provide reassurance.

Our funds are diversified in that they are spread across equities, bonds, and specialist assets. However, we are value investors and so are trying to capture the medium- to long-term price appreciation of financial assets that results from their value being under-appreciated. This is why we have a mid-cap focus in the UK – investors tend not to fully understand the scope for smaller companies to grow, so their share prices as a group tend to perform better.

As value investors we are also seeking to avoid financial assets whose value we think is being over-appreciated. This is why we do not hold developed world government bonds, which even before recent events were expensive – buy the 30-year inflation Gilt today and hold it to maturity and you are certain to lose a third of your real capital at today's rates.

While we continue to have absolute confidence in our positions with respect to mid-caps focus and government bonds, both have hurt our peer-relative performance over the last 2-3 weeks. It should also be noted that we have other positions that have performed well or held up over the same period.

Many of our competitor funds own expensive Gilts or US Treasuries and avoid under-appreciated smaller companies. Such positioning will naturally – and indeed did – aid short-term performance but it will also very likely lower their longer-term returns. We think it is longer-term performance that is more important. In fact, given increasing longevity, paucity of value in bond markets, as well as low growth generally, we think it is more important than ever to focus on longer-term performance. The harsh reality of this however means having to accept the odd period of poor short-term performance, whether in absolute terms or relative to peers.

Our mid cap focus in the UK has been the major cause of the recent poor short-term fund performance in relation to our respective peer groups. However, we are very careful about what we buy, placing great importance on balance sheet strength and profitability. This we believe will help to produce good performance over time in relation to both mid-cap and large-cap indices and thus counter the impact of periods such as the last few weeks when mid-caps fell off sharply. Furthermore, we don't own too many mid-caps, so we know them extremely well. Here are a couple of examples.

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Kier Group is a conservatively managed vertically integrated construction and services company. Despite the fact that 85% of revenues in its two largest divisions are already covered by existing orders out to June 2017, the shares have been weak and now yield 7%. The dividend is well covered by earnings and supported by a strong balance sheet. Recent acquisitions of May Gurney and Mouchel provide considerable scope for further expansion, as cross-group revenue synergies are explored. Meanwhile, the company should also benefit from rising infrastructure spend which has cross-political party support. Specifically, the Highways Agency's £17bn ring-fenced budget for its Road Investment Strategy and the National Infrastructure Commission's £100bn budget out to 2020 provide tailwinds.

Victrex manufactures polyether ether ketone (PEEK), a high performance polymer that possesses unique qualities, such as being ultra-lightweight, extremely strong, resistant to chemicals and extreme temperatures, and is also electrically conductive. The company has dominant market positions and is frequently finding new uses for PEEK, due to its constant drive for innovation and ongoing collaborative work with its customers. Over 90% of Victrex's revenues are from outside the UK, therefore it is a big beneficiary of sterling weakness. The shares yield over 3% and the dividend has grown by over 13% p.a. over the last 10 years. The company has net cash on the balance sheet and has stated that it intends to return surplus cash back to shareholders by means of special dividends.

Elsewhere in the funds, while we have some currency-hedged overseas equities funds, most are unhedged so have performed well as a result of the weakness in the pound. As for our fixed income funds, their prices have generally remained stable, though they have not of course performed nearly as well as safe haven bonds.

Of interest we think is the performance of some of our specialist assets. As a reminder, these on the whole are investment trusts that invest in income generating assets such as aircraft, property, medical equipment, loans, mortgages, and infrastructure. Again, we are very careful what we buy and, because we don't own too many of them, we monitor them closely. We are looking for income streams that are stable and index-linked. We are looking for decent yields. These attributes have served some of our specialist assets holdings particularly well in recent weeks. Here is one example.

Primary Health Properties is a REIT invested in predominantly UK based purpose built modern GP surgeries and medical centres. It has a very secure tenant (NHS plus ancillary services), a visible and growing income stream, and resides in a property sector that requires substantial increases in investment. The attractions of such low volatility tangible value are thus clear. The investment pays us a fully covered and growing dividend yield of 4.6%. At the time of writing (5th July) the shares are trading where they were prior to the referendum vote and have displayed none of the stresses experienced elsewhere in the property sector.

To conclude, we continue to have complete confidence in our process and in the capacity of our funds to generate value over the longer term. We place a great deal of importance on the quality of businesses we own and making sure that third party managers we engage have a similar mindset.

Brexit

There is much that can be written about the referendum result. Indeed, much already has been. I shall try to keep this simple and focus on what, I believe, are the two key questions for our investors and ourselves. One, what were the prospects for the UK and global economy before the referendum? Two, what has changed since?

For the last few years, growth in the UK and globally has been OK but not great. My view was that things were likely to continue in this vein rather than growth recovering to pre-crisis levels or on the other hand it slipping into negative territory.

I had a number of reasons for believing the global economy would continue to grow. First, that is its tendency. Despite the tiny minority who would like to return the human race to the Stone Age, most of us conduct our daily lives in a constructive way, both providing as well as consuming products and services. Aggregate that at a systemic level and you have what is called growth. And it's quite hard to stop that in its tracks because, well, it's what we like to do.

Since we quite like being constructive, we tend to do it more and more until economies overheat and central banks feel the need to step in and end the party. Looking at inflation prior to last Thursday, it seemed clear that economies on the whole were far from overheating. Agreed, some were closer than others, but at a global level it was obvious that there was a still a chronic shortage of demand rather than an excess of it.

Former US Treasury Secretary Larry Summers has written about this "chronic" demand shortage. He refers to it as secular stagnation – a term coined by Alvin Hansen in 1938 to describe what he feared the US economy was experiencing in the aftermath of the Great Depression. In fact, I was going to write about Summers' deliberations on the subject in detail in this investment letter. Alas, Brexit has rather overtaken events and that shall have to wait. Nevertheless, Summers' key conclusion is that secular stagnation is real but that it can be countered with public investment in areas such as infrastructure. Since fiscal austerity has not generally resulted in a strong recovery in private sector confidence, he argues, it should be stopped. Furthermore, econometric models suggest, he says, that although government borrowing as a percentage of GDP would at first rise, over time it would fall as the multiplier boosted the denominator, GDP.

I have had increasing sympathy with this argument and as a result felt more optimistic about the prospects for the world economy. That said, it will likely be a while before key policymakers listen to Summers - and the many others who share his views - and consider his proposed solution.

In the meantime, I believed that ultra-loose monetary policy would prevent demand from falling off a cliff while workforce slack would prevent inflation from rising to uncomfortable levels.

My somewhat hopeful view was supported by generally positive leading indicators, yield curves that were steep rather than inverted, as well as the aforementioned low inflation and labour force slack.

Then on 23 June Britons voted to leave the EU. What has changed as a result?

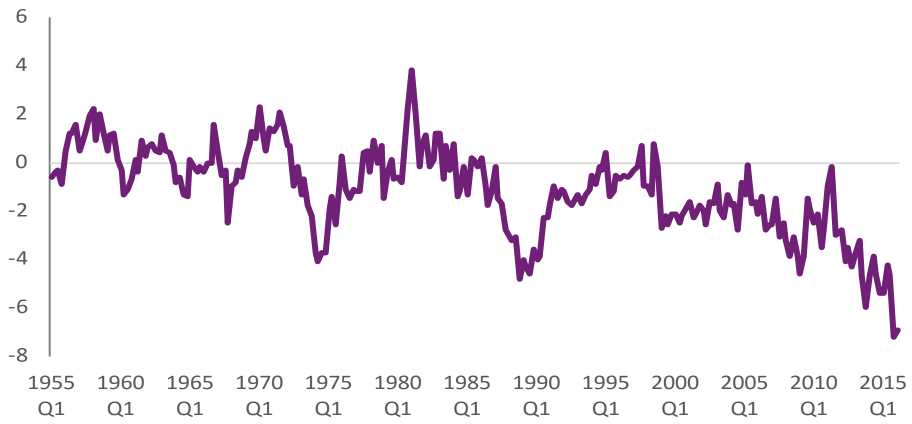
The most obvious and incontrovertible thing that has changed is that the referendum is now behind rather than ahead of us. This matters because the UK and European markets had been weak over the preceding year or so, arguably because the referendum lay ahead and represented uncertainty (in the 12 months to May 2016, outflows from all IA sectors totaled £38 billion). True, there are now other uncertainties that have taken its place but at least they are not binary in the way markets hate.

Another equally incontrovertible fact is that the 'leave' camp won the referendum. The market's violent reaction suggested this result was both unexpected and perceived as negative for the UK economy, though equities have since recovered. It seems the most likely outcome is that at some point the British government triggers Article 50 of the Lisbon Treaty, thereby setting in motion the process to leave the EU. But it is far from clear when – and perhaps even if – this will happen.

In the meantime, there is scope for all sorts of developments. One of these must be for Brits to ponder whether the UK should seek to remain in the single market. If yes, we would have to accept free movement of people as Norway and Switzerland have. If no, we would have to accept tariffs on trade in goods and services with the EU. New UK Prime Minister, Theresa May, has said, "It must be a priority to allow British companies to trade with the single market in goods and services — but also to regain more control of the numbers of people who come here from Europe." This is all very well, but the EU has made it clear that the UK cannot have both.

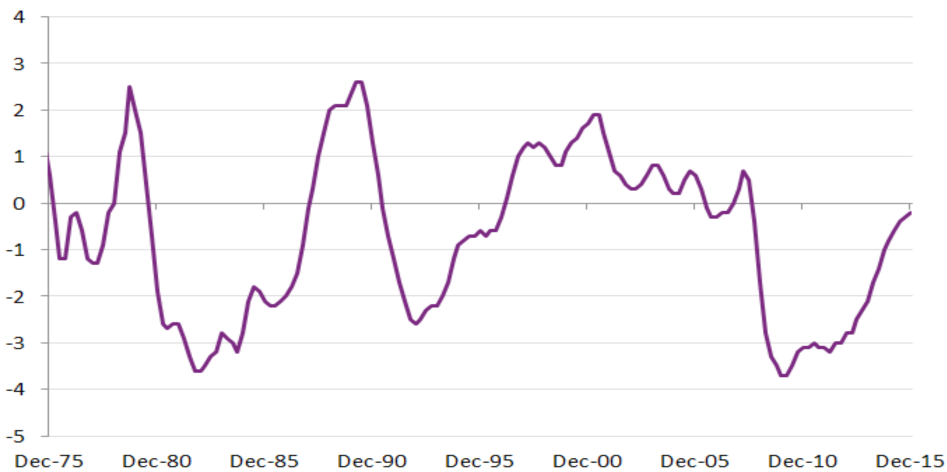
The pound has fallen sharply. In some respects, this is a good thing as the UK's current account deficit as a percentage of GDP had reached an unsustainable 7%[1] (see chart 1). That said, the initial effect of the pound's weakness will be to widen the deficit even further as imports cost more and exports are worth less. Longer term, the fall in the currency will be stimulative, though how much spare capacity the UK economy has to absorb this stimulus is unclear. Although wage pressures remain relatively subdued, Bloomberg Intelligence's estimate of the UK's output gap suggests that much of the excess capacity that prevailed after the Great Financial Crisis has now been removed (see chart 2).

Chart 1: UK current account deficit as % GDP



Source: Bloomberg

Chart 2: UK output gap (%)



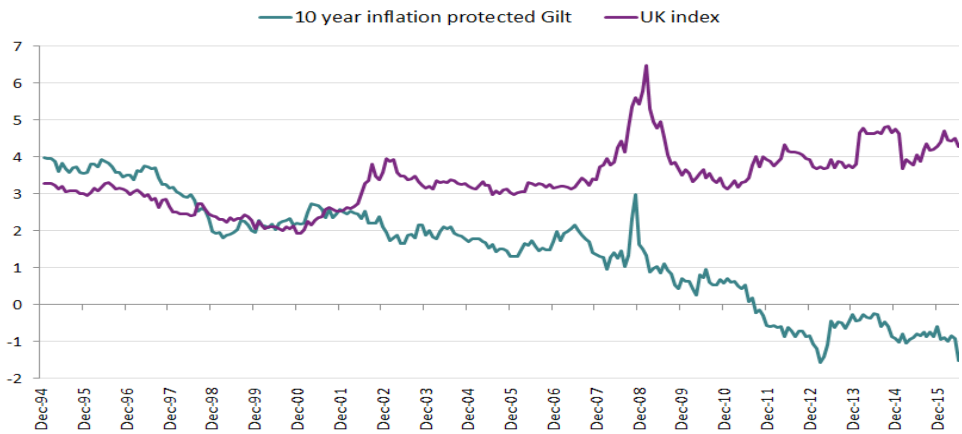
Source: Bloomberg

Bond yields have fallen sharply. As of 4 July, the yield on the 10-year Gilt stood at 0.83% compared with 1.37% on the day of the referendum. Interestingly, this was not due to a fall in inflation expectations. Quite the opposite in fact - the inflation rate expectation embedded in 10 year yields actually rose following the referendum, from 2.31% to 2.34%. In other words, it was a fall in real yields rather than inflation expectations that drove the fall in nominal yields.

Putting this fall in real yields in a longer term context as well as in the context of equity market yields is particularly interesting (see chart 3). The yield of -1.503% on the 10-year inflation protected Gilt as of 4 July suggests that if you bought it and held it to maturity you would make a total real return of -14% (for the 30-year the number is -33%).

1 Average of Q4 2015 and Q1 2016

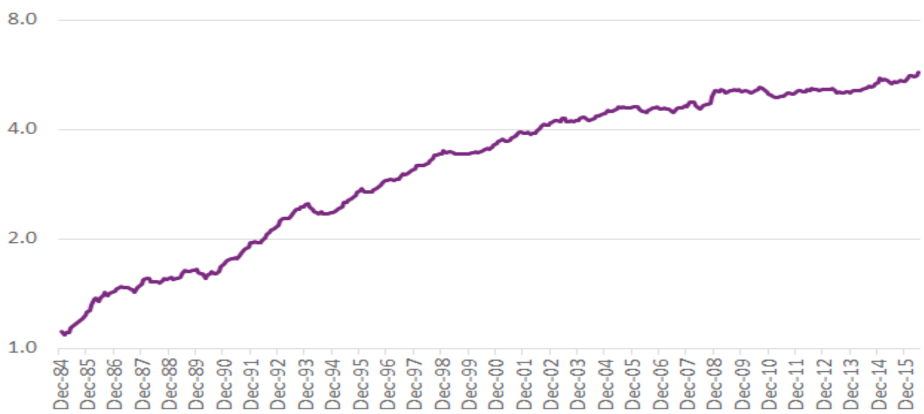
Chart 3: Long term yields



Source: Bloomberg

Bank of England governor Mark Carney has hinted he'll loosen monetary policy over the summer. Furthermore, former Chancellor, George Osborne, backtracked on his longer term budget targets. It is clear therefore that both the Bank of England and the Treasury expected the impact of Brexit on the UK economy to be negative, perhaps considerably so. At the same time, evidence of an immediate impact is sparse. As of 4 July there were only 22 items on the FT's Brexit Business Impact Tracker, a log of the expected impact of Brexit through company announcements and similar. Given all the warnings from UK companies ahead of the vote, it is perhaps surprising there have not been more announcements of cuts of some sort.

Chart 4: Citi WGBI GBP hedged (inflation adjusted)



Source: Bloomberg

There are many other things that have changed since the referendum that I have not mentioned. However, the point of those that I have chosen to highlight is that it remains very unclear what the longer term economic impact will be of the vote to leave the EU.

What we do know is that developed market government bonds are even more expensive now than they were prior to the referendum (the chart above suggests that the great bond bull market is running out of steam but taking a long time to end!) We also know that equity market yields are generally well above long-term historic averages. Therefore, as far as the big asset allocation call between bonds and equities is concerned, this suggests pretty clearly that one should underweight the former and overweight the latter. We are thus sticking with our current positioning.

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 2016, 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	26.5 (26.5)	24.0 (24.0)	33.0 (33.0)
	North America	0.0 (0.0)	4.0 (4.0)	2.5 (2.5)
	Europe ex UK	10.0 (10.0)	13.0 (13.0)	12.0 (12.0)
	Japan	1.0 (1.0)	8.0 (8.0)	4.5 (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	**46.0 (46.0)**	**66.0 (66.0)**	**66.0 (66.0)**
Fixed income	DM Government	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
	EM Debt	5.6 (5.6)	2.0 (2.0)	1.5 (1.5)
	Corporate	25.4 (25.4)	8.0 (8.0)	5.5 (5.5)
	Fixed income Subtotal	**31.0 (31.0)**	**10.0 (10.0)**	**7.0 (7.0)**
Specialist assets	Property	5.0 (5.0)	4.0 (4.0)	5.2 (5.2)
	Private equity	2.9 (2.9)	2.9 (2.9)	5.7 (5.7)
	Specialist financial	9.5 (9.5)	12.7 (12.7)	10.4 (10.4)
	Infrastructure	4.6 (4.6)	3.4 (3.4)	4.7 (4.7)
	Specialist Subtotal	**22.0 (22.0)**	**23.0 (23.0)**	**26.0 (26.0)**
Cash		1.0 (1.0)	1.0 (1.0)	1.0 (1.0)
Total		**100.0**	**100.0**	**100.0**

Source: Seneca Investment Managers, 30 June 2016

Increased ***Decreased***

- No asset allocation changes in June
- SDGF: we switched Prudential into Legal & General, after material outperformance by the former
- Ocean Dial Gateway to India exited, following strong performance and a preference going forward for regional, rather than country specific exposure within Asia
- Thomas Cook was exited to fund a new investment in Essentra, a global manufacturer and distributor of small but essential components, e.g. plastic screw caps, as well as health and personal care packaging
- SDIF: we introduced two new names: Essentra and Arrow Global
- The relative strength of fixed interest assets enabled us to fund the equity purchases with reductions in our two Royal London fixed interest funds. These sales followed reductions earlier in the month in emerging market debt (Pictet and Templeton)
- Strong performance through the month enabled us to take some profits from specialist assets, thereby releasing capital for other areas of undervaluation

- SIGT: Holding in BHP Billiton was sold due to uncertain outlook for commodity prices and following recent cut in dividend
- A new holding namely Essentra was introduced to the portfolio with the company having seen a significant derating following a profit warning in early June
- Asian equity holdings were reduced following strong performance over recent months – bringing overall exposure back towards target weightings
- Several specialist asset holdings were top sliced to provide funding for UK equity purchases

Important Information

Past performance is not a guide to future returns. The information in this document is as at 30.06.2016 unless otherwise stated. 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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CF Seneca Funds

These funds may experience high volatility due to the composition of the portfolio or the portfolio management techniques used. Before investing you must read the key investor information document (KIID) as it contains important information regarding the funds, including charges, tax and fund specific risk warnings and will form the basis of any investment. The prospectus, KIID and application forms are available from Capita Financial Managers, the Authorised Corporate Director of the funds (0345 608 1497).

Seneca Global Income & Growth Trust plc

Before investing you should read the Trust's listing particulars which will exclusively form the basis of any investment. Net Asset Value (NAV) performance is not linked to share price performance, and shareholders may realise returns that are lower or higher in performance. The annual investment management charge and other charges are deducted from income and capital.

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