Peter Elston: Investment Letter

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This document is intended for professional investors only

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Fund objectives and the search for harmony

We think that over a 'typical' investment cycle, our income fund (CF Seneca Diversified Income Fund) and our two more growth-oriented funds (CF Seneca Diversified Growth Fund and Seneca Global Income and Growth Trust) can achieve returns in the order of CPI+5% and CPI+6% respectively ('real returns' of 5% and 6%).

During a 'typical' investment cycle, which I define below, we expect certain real returns from each asset class/market. For example, we expect developed market government bonds to generate real returns of 2% per annum over the long term, based on historical data that go back to 1849 as well as on some forward looking assumptions. If this is what should be expected over the long term, it is also what should be expected over a 'typical' investment cycle.

We also have a good idea of how much value our active management decisions relating to tactical asset allocation and holding selection (stocks and funds) can add, in light of each fund's *ex ante* tracking error. For example, our investment trust's tracking error in relation to strategic asset allocation is 5.1% as at 13.03.17, which gives it plenty of scope to add a decent amount of outperformance before fund costs. If tracking error was only 1%, this wouldn't even cover fund costs.

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Multi-Asset Value Investing

Taking everything into account, we can therefore have a good idea of what each fund's total real return should be over a typical investment cycle.

In the case of our income fund, we expect to get 4.3% annualised in real terms from strategic asset allocation and 1.9% from active decisions. This adds up to 6.2% before fund costs. Subtract fund costs of 1.3% and you get to 4.9%, close to 5%. This is not an exact science, and the 5% should not be thought of in precise terms; there are many independent variables involved that will affect the actual outcome. However, it is important that if you have an outcome-oriented objective such as CPI+5%, you must have a logical framework for it, as we do.

So, what is a 'typical' investment cycle?

Firstly, we think of an investment cycle as being in synch with a business cycle, which comprises a period of economic expansion and a period of economic contraction. According to the National Bureau of Economic Research in the US, the average business cycle since 1945 has lasted around 6 years.

A *typical* investment cycle is one in which real returns from asset classes and markets are in line with their long-term averages. From 1849 to 2016, US Treasuries have returned 2.1% per annum in real terms (this feels about right, given that with such safe haven bonds there is duration risk but minimal credit risk). So, in a typical investment cycle, we would expect US Treasuries and other developed market government bonds to generate a real return of 2.1% per annum, which we round to 2%.

An *atypical* cycle on the other hand might see US Treasuries perform much worse (or better) than their long-term average. For example, the period from 1940 to 1981 saw them fall by 2.7% per annum in real terms, which means that there would have been investment cycles during this period when returns were very poor indeed. Indeed, given where real interest rates and inflation are today, it is very possible that the next few investment cycles may see similarly challenged returns.

During such cycles, it would be hard to achieve real returns of 5 or 6%. Furthermore, rising inflation that causes the real returns of bonds to be poor will likely cause real returns from equities to be below their 'typical' cycle returns too. This was the case during the aforementioned period from 1940 to 1981, though US equities still achieved a decent 5.9% per annum in real terms, compared with their long-term average of 6.4%.

We are very committed to thinking in terms of "CPI+" objectives, but we think it is important that our investors know that a period of high and rising inflation would make them hard to achieve.

What we *do* believe however is that by understanding the behaviour of different asset classes in various inflation regimes, we have a better chance than others of achieving decent real returns, even if they fall short of some real return objective.

Another potential issue with CPI+ objectives is that funds employing them can be mistaken for absolute return funds. After all, a CPI+ objective is far more "absolute" than, say, a composite index comprising equity and bond indices (a common example would be 50% MSCI World/50% Barclays Global Aggregate).

However, although CPI+ is more "absolute" than a composite index, this does not mean that funds that use them are absolute return funds, particularly if they use clear qualifiers such as 'over a typical cycle'. Our funds use CPI+ objectives because they are "outcome oriented" funds. They are absolutely *not* absolute return funds.

The difference is a significant one.

An absolute return fund is generally one that seeks to generate positive returns over short periods, at most three years. Our funds on the other hand are looking to achieve positive real returns over a 'typical' investment cycle, which means around six years.

Since equity markets are quite volatile over shorter periods, absolute return funds tend to employ all sorts of complicated ways to smooth returns. Such methods might include long-short strategies, pair trades, derivatives, momentum strategies, curve arbitrage etc. Furthermore, since equities and other risky assets that underlie these strategies tend to be unpredictable over shorter periods as well as volatile, you can see the difficulties that absolute return funds face.

When things are going well, it is easy not to be bothered about how returns are produced. When, however, things are not going so well, it's a different story.

Excluding the two money market sectors, the IA Targeted Absolute Return sector has been the worst performing of 37 sectors over 1, 3, and 5 years to end December 2016. In real terms, it has returned -0.5%, 1.4% and 2.0% per annum over these periods, compared with 16.0%, 8.7% and 11.2% on average for the other 36 sectors. This is a tragic opportunity loss for investors, which sadly must be considered mostly a permanent one. A bear market might see the gap narrow but likely only marginally.

The point is that because equities, credit and commodities are unpredictable in the short term, it is very hard to use them to produce high and stable short-term returns. I know of only two investors who have been able to achieve this holy grail of investing: Bernard Madoff and Renaissance Technologies' Jim Simons.

I remember attending a conference a few years ago at which a representative of Renaissance Technologies was talking about its supercomputer, which according to him was the largest in the world (at least the largest that was owned *privately*). It used this supercomputer to predict price movements over short timeframes, and it did this faster and more accurately than anyone else to produce high and stable returns.

And Madoff? Well, we all know why his returns were high and stable. They were faked.

Our funds at Seneca do not use any of the aforementioned complex investments and strategies. Nor are we trying to smooth short-term performance, other than that which is a natural result of our diversification, either within or across asset classes.

Take a look at our portfolios and you'll see investments and funds that are easy to understand, whether UK midcap companies, fixed income and overseas equities funds, REITs, infrastructure funds, aircraft leasing vehicles or direct lending funds. We hope to be able to soften the blow of bear markets through the use of enhanced income funds that would enable our two income oriented funds to reduce exposure to equities while at the same time maintain their capacity to generate income (our growth fund, which has no income mandate, would shift towards cash or money market funds).

In summary, we think we sit nicely between, on the one hand, traditional balanced funds that invest only in bonds and equities and, on the other, complex structures that are hard to understand and indeed may not perform very well. In fact, we'd call our funds 'harmonious'.

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 28 February 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	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	**6.0** (7.0)	**9.0** (10.0)	**8.0** (9.0)
	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	**42.0 (43.0)**	**62.0 (63.0)**	**62.0 (63.0)**
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)	1.5 (1.5)
	Corporate	25.0 (25.0)	8.0 (8.0)	5.5 (5.5)
	Fixed income Subtotal	**30.0 (30.0)**	**10.0 (10.0)**	**7.0 (7.0)**
Specialist assets*	Property	5.5 (5.5)	5.5 (5.5)	5.8 (5.8)
	Private equity	4.0 (4.0)	4.5 (4.5)	5.4 (5.4)
	Specialist financial	9.3 (9.3)	8.1 (8.1)	10.2 (10.2)
	Infrastructure	5.0 (5.0)	4.7 (4.7)	5.4 (5.4)
	Specialist Subtotal	**23.8 (23.8)**	**22.8 (22.8)**	**26.8 (26.8)**
Cash		**4.2** (3.2)	**5.2** (4.2)	**4.2** (3.2)
Total		**100.0**	**100.0**	**100.0**

Source: Seneca Investment Managers, 28 February 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

- February was a good month for financial assets across the board, as economic growth in many key countries continued to improve
- Sterling slipped slightly, following reports that the Scottish Nationalist Party was preparing for a second referendum on independence
- Equities overweight reduced from 3%pts to 2%pts as recent strength in markets has made valuations less compelling
- The 1% reduction came out of Europe ex UK where political risks are if anything still rising; the proceeds were moved into cash
- Essentra rose 33%, after reporting full year results. New CEO and turnaround specialist, Paul Forman, is going down well with investors
- National Express and Morgan Advanced delivered healthy results ahead of expectations, as did Senior, although the latter had a cautious tone
- Invesco Perpetual European Equity Income Fund was reduced, following a decrease in the tactical asset allocation for European equities
- BlackRock World Mining Trust announced a valuation uplift to its investment in a Brazilian based mine, which has moved from development to commercial production
- TwentyFour Dynamic Bond Fund was reduced to keep overall fixed income exposure at close to 30% (SDIF only)
- Blue Capital Global Reinsurance saw its significant discount narrow to some degree as it continues to deliver relatively stable NAV returns
- UK Mortgages Ltd announced the completion of its third acquisiton of a parcel of mrotgages which fully commits their initial capital in assets that are demonstrating solid credit quality