Peter Elston: Investment Letter

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This document is intended for professional investors only

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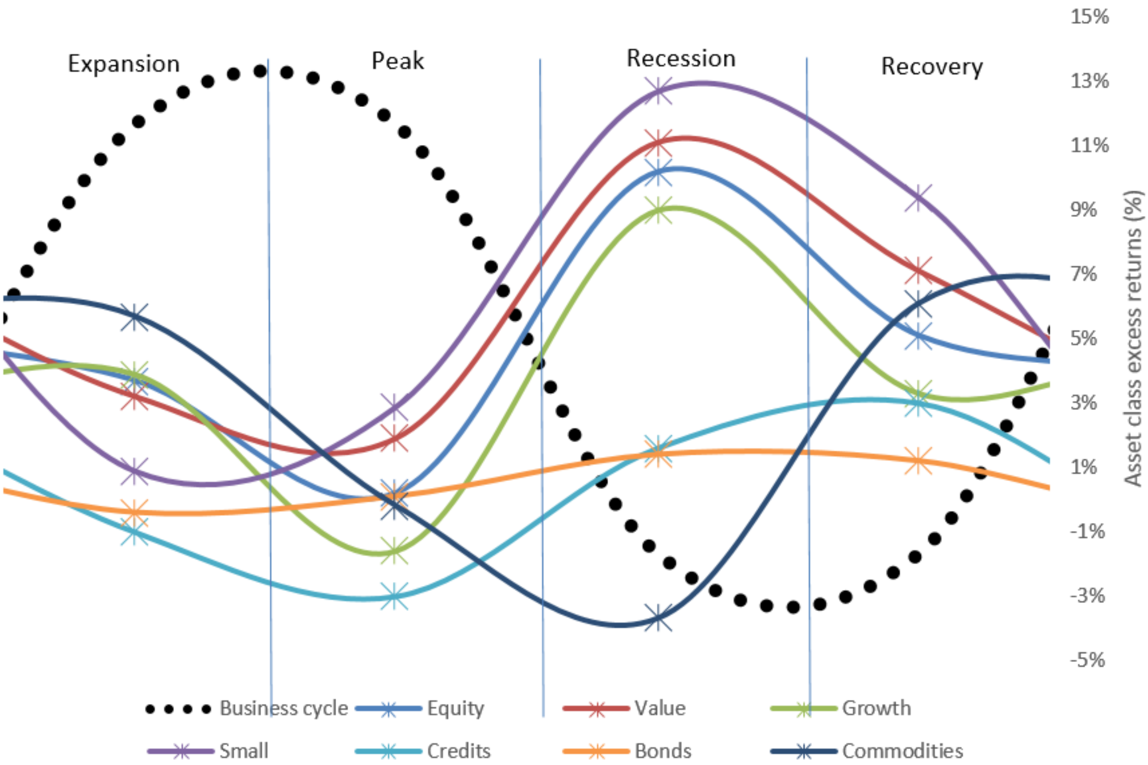
February Investment letter

My framework for tactical asset allocation is based on business cycle analysis and the documented findings that asset classes tend to exhibit distinct performance in each phase of the business cycle. For example, equities and bonds tend to perform best during the recession phase, credit in recovery phase, and commodities in expansion and recovery phase. By implication, cash is best held during peak phase when all aforementioned asset classes tend to exhibit below average performance.

Chart 1: asset class performance versus the business cycle



Source: Dynamic Strategic Asset Allocation, van Vliet & Blitz (2009)

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Multi-Asset Value Investing

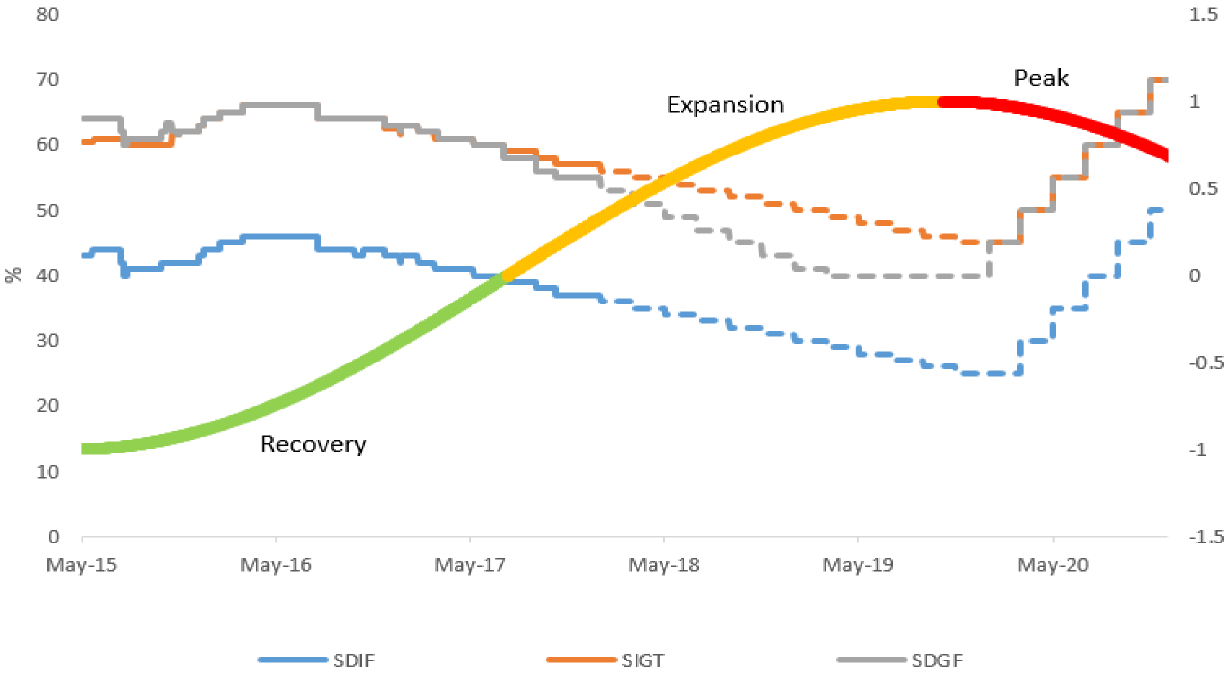
Chart 1 illustrates the relationship between asset class performance and the business cycle. One of the key points of the chart is that equity bear markets occur during the peak phase of the cycle, when economic growth is declining but central banks have yet to come to the rescue. Another key point is that equities perform best during the recession phase. This is the phase in which economic growth is negative and when central banks have loosened monetary policy substantially to support economies. In some ways it is counterintuitive that equities perform best during recessions but if you think about it, it makes sense. Equities are forward looking and once monetary policy is loose, they can anticipate economies emerging from recession, even if the recession is still ongoing. Think back to 2009 and you will recall that equity markets performed very strongly during first, second and third quarters of 2009, when global economies were in recession.

The next step is to assess where economies are in the cycle. I do this by considering just a few simple indicators: unemployment, inflation, central bank policy rates, and the yield curve. These in aggregate will give me a good idea of whether economies still require support or are overheating. I can then determine where economies sit on the business cycle and thus what asset class returns to expect.

Given the above chart, I want to be most underweight so-called 'risky assets' when we move from expansion to peak, then move fairly rapidly from underweight to overweight as the peak phase progresses.

Our total equity target gives a very good indication of our total exposure to 'risky assets' as it will constitute the bulk of the exposure. Thus Chart 2 illustrates how our exposure to risky assets has changed over the last two and a half years and is expected to change over the next 2-3 years.

Chart 2: Seneca funds' total equity target versus the business cycle (dotted lines represent expected future path)



Source: Seneca Investment Managers (Jan 2018)

As you can see, we started reducing equities in mid-2016 as the economic recovery was making, in our opinion, good progress. But we remained overweight equities in relation to our strategic asset allocation until the third quarter of last year and have since moved further underweight.

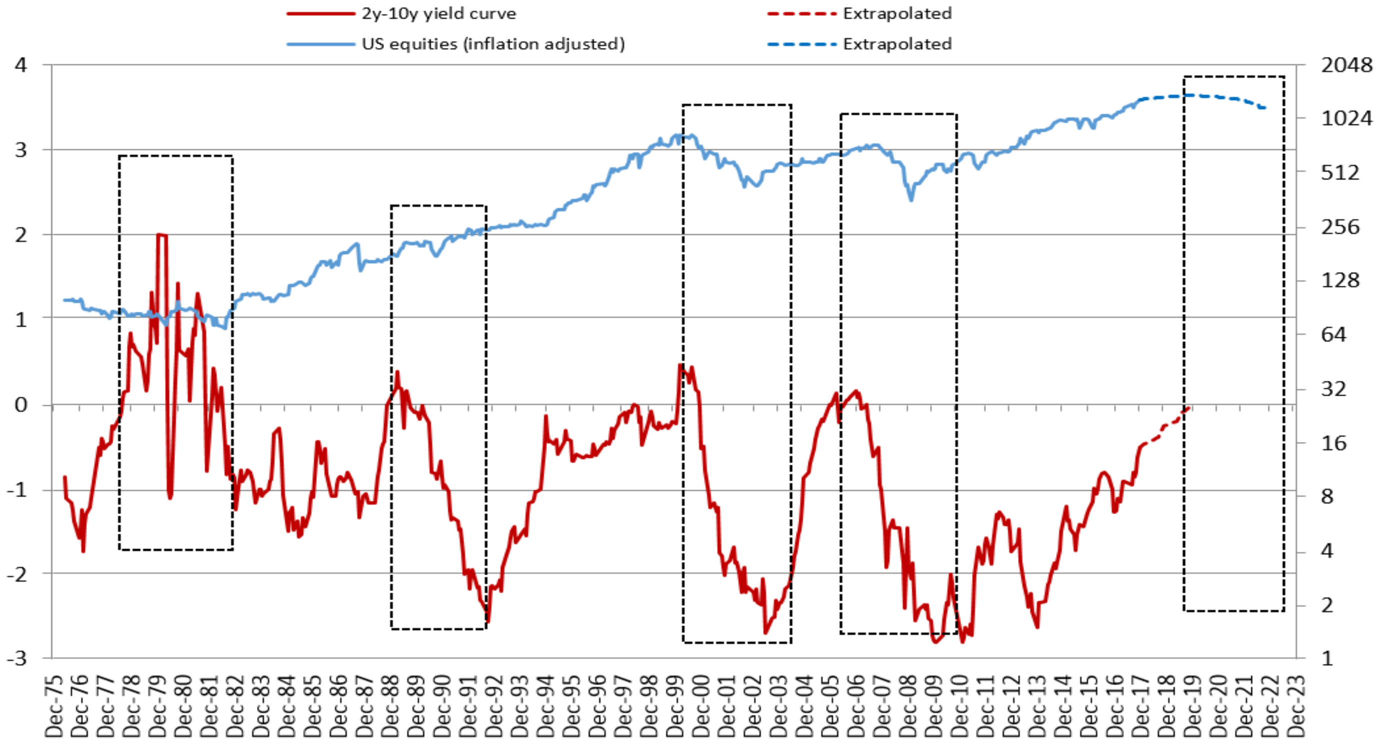
My expectation is that the world economy will not enter peak phase until 2020, and I intend to continue to reduce our equity targets until then.

A couple of points to note. In the real world, the business cycle is not a neat wave as it is in theory - it is messy and there are times when economies can go backwards rather than forwards. Secondly, the timing of the peak is very hard to estimate – my prediction of early 2020 will almost certainly be wrong. This is why changes in tactical asset allocation should be gradual not sudden. If I am late, I will have reduced to some extent already. If I am early, I can continue reducing. Like driving, you should slow down as you approach a bend rather than when you reach it.

Furthermore, gradual moves keep portfolio turnover low and steady.

As for the yield curve, chart 3 below shows that in the case of the US it has been a very good predictor of equity bear markets (or at worst below average returns). Selling equities when the yield curve inverts, and buying as it becomes steep, would have helped avoid periods of poor equity market performance as well as captured good ones (the yield curve is not a perfect indicator but 'perfect' does not exist in financial markets).

Chart 3: US equities versus the yield curve



Source: Bloomberg, Seneca Investment Managers (Jan 2018)

Over the last five or so years, the yield curve has been flattening markedly, and a simple extrapolation has it inverting in late 2019. I expect other economies around the world to have exhibited something similar, given the connectedness of the global economy. Thus, by late 2019 I intend our funds to be significantly underweight equities.

Finally, some of you may ask what the business cycle has to do with 'Multi-Asset Value Investing', our declared investment style. The answer is 'everything'. The business cycle informs the monetary policy cycle and the monetary policy cycle tells you whether various asset classes are worth holding in relation to cash. In other words, whether they are over-, under-, or fairly valued. Indeed, relative valuations of equity markets are more important than absolute ones. Markets can appear expensive in absolute terms, as they indeed may have as early as 2014, but if real cash deposit rates are negative, they can keep going up. Only when cash is worth holding will it become a viable alternative to equities and other financial assets. Those central bankers really are worth watching.

Monthly review and outlook

Review

January on the whole saw economic data releases that were consistent with key economies either having entered expansion phase or approaching it. Unemployment rates either stayed steady as was the case in the US, UK and Europe or rose as in Japan. While there is still scope for rates to fall further, as we close in on the end of the cycle we are likely to see more months where they do not fall or indeed may begin to rise. That said, in Japan's case, the slight rise in unemployment is no cause for concern given that the dominant trend is an increase in the size of the workforce as more and more women join it.

The period of global economic strength that began in 2016 is now clearly evident. Real GDP growth rates in the US, Europe and Japan are now all 1%pt higher than they were back in the first half of 2016. Only in the UK has there been some slippage, perhaps reflecting the impact on real wages and thus consumer spending of the higher inflation induced by sterling's fall in the wake of Brexit. It certainly seems to be taking some time for the benefits of the weak currency on the external sector to be feeding through, this is not entirely unexpected.

Inflation data released in January were mixed. In terms of headline CPI, Japan's rose, and the UK's fell which were both welcome developments as it had been too low in the former and too high in the latter. But Europe's fell to 1.3%, an indication that deflationary forces there are still prevalent. That said, the more important core inflation numbers painted a better picture, with all but Japan showing either a fall towards the comfortable level of 2% or a rise towards it (in Japan it was steady).

In emerging economies, inflation generally rose slightly. This is something to watch closely, though rates are still well below the point at which they indicate a threat rather than just buoyant economies.

As for financial markets, January saw the dollar's decline accelerate and bond yields rise sharply in major developed markets. The former may be due to the perception that the recent tax cuts in the US may be the start of a trend of declining fiscal discipline, or perhaps the expectation that although there are more interest rate increases on the way in the US, there are more on the way in other economies, the UK being a case in point. As for the rising bond yields, it is possible that markets are catching on to the fact that inflation may continue to rise and that real rates were low anyway.

In the UK, longer dated LIBOR yields crept up, perhaps reflecting the fact that although not imminent, further interest rate hikes are on the way.

Equity markets were generally buoyant in local currency terms but in US dollar terms were particular strong given the dollar's fall.

Commodity prices were also firm, but this was due more to dollar weakness than to a rise in real prices.

Outlook

The march towards the peak in the global economy continues and there was nothing in January to suggest otherwise. It is true that equity market yields are a lot lower than they were five years ago but they are still well above historic lows so have scope to fall further. It should also be noted that cash is yet to provide competition for risk assets, given that real short-term interest rates remain low or negative. We reduced our funds' equity weights further in January and expect to continue to reduce them for the next two or so years.

Table 3: Current fund tactical asset allocation (TAA) target weights as of 31st January 2018 (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	**20.5** (21.5)	**17.0** (19.0)	**31.0** (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	**36.0 (37.0)**	**53.0 (55.0)**	**56.0 (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		**2.7** (1.7)	**6.2** (4.2)	**3.3** (2.3)
Total		**100.0**	**100.0**	**100.0**

Source: Seneca Investment Managers, 31 January 2018
* 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

- In order to maintain SDIF's and SIGT's required income stream, we have started investing in an enhanced income fund that uses derivatives to provide a higher yield
- The US dollar continued to decline in January, as prospects of looser fiscal policy and higher interest rates elsewhere increased
- Equity markets, commodities prices and bond yields all rose during the month
- The TAA reduction to UK equities was faciliated by reducing holding target weights across several holdings, rather than exiting a position
- Dairy Crest delivered a strong trading update with total revenue rising 7%, driven by strong sales of Cathedral City and Frylight
- Due to the sell-off experienced by the listed infrastructure vehicles regarding concern over PFI and exposure to Carillion, we added to the holding of International Public Partnerships which has the smallest exposure to PFI type assets and no material impact from Carillion

SDGF

- The fund's equity target was reduced by 2%pt towards the end of the month, with proceeds being moved into cash
- The bond selloff has been particularly pronounced, as the investors priced in a stronger global economy and higher inflation
- We trimmed back positions in Japan, reducing both the CC Japan Income & Growth Trust and Goodhart Michinori Japan Equity Fund, following good performance
- Overweight positions in the BlackRock World Mining Trust and Somerset Emerging Markets Dividend Growth Fund were also brought back into line with their respective target weights

SDIF

- The fund's equity target was reduced by 1%pt towards the end of the month, with proceeds being moved into cash
- Two small reductions were made to the CC Japan Income & Growth Trust and BlackRock World Mining Trust, in order to bring back towards target weight
- We added to short duration, high yield exposure, bringing the Royal London Short Duration Global High Yield Bond Fund and Muzinich Short Duration High Yield Fund to target weights

SIGT

- The fund's equity target was reduced by 1%pt towards the end of the month, with proceeds being moved into cash
- We added to short duration, high yield exposure, bringing the Royal London Short Duration Global High Yield Bond Fund up to target weight