Peter Elston: Investment Letter

Issue 34: March 2018

This document is intended for professional investors only

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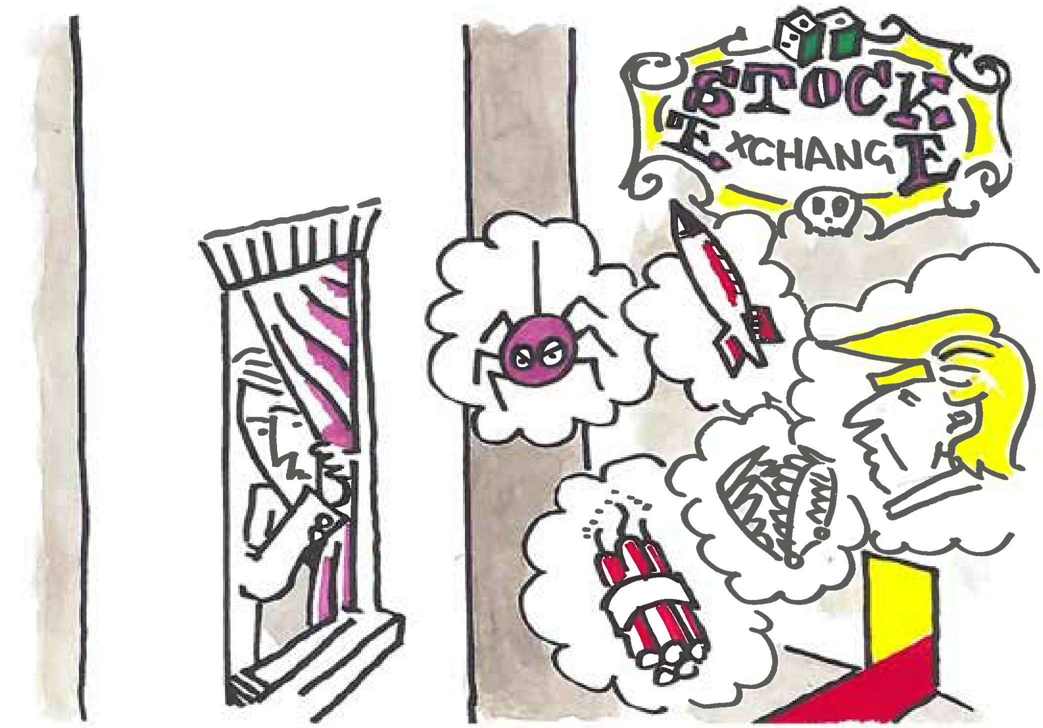
Behave yourself!

I've been writing quarterly articles for Trustnet over the last couple of years. The first four were on the subject of 'investment risk', the second four on 'value investing'. This year, I will be writing four pieces on the subject of 'behavioural investing' (and the related topics of 'behavioural economics' and 'behavioural finance').



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Multi-Asset Value Investing

It is irrational human behaviour that links these three areas of study. Until fairly recently it was believed that our choices and decisions were always optimal or rational. Robert Shiller, Daniel Kahneman, Amos Tversky, Shane Frederick and Richard Thaler among many others have in recent decades shown us just how wrong this assumption was and how irrational we humans can be.

This makes sense when you understand that what we think of as objective reality is not objective at all. We use our senses to perceive the world around us, whether sight, smell, touch or indeed consciousness or awareness itself. These processes happen in our brains and so the world around us as we perceive it is inside us not outside us (by definition, you cannot perceive reality without using your perception - I suggest you give it a try!). Thus reality is subjective not objective.

And our perception is naturally imperfect. Imagine how hard each day would be if you could perceive every single smell or noise within a five-mile radius. We filter to survive, but this filtering can cause problems. These filters can be thought of as mental shortcuts or rules of thumb, the technical term for which is heuristics. And mental shortcuts drive 95% of our decisions.

There are many recognised heuristics. One example is the availability heuristic. This short cut is used to make judgments about the probability of events by calling on examples that spring to mind. If I told you that the probability of two people in a room of thirty having the same birthday was 71%, I suspect you'd be surprised. What you – or rather your brain! – probably did was work out that probability of two people in a room of two having the same birthday was very low and multiply that by 30 to arrive at 'low'.

All individuals use a combination of two brain processes to answer these sorts of questions, the "X-system" and the "C-system". The former is the default option — a spontaneous response — while the latter is reflective, requiring a deliberate, conscious effort.

Yale professor Shane Frederick designed what he called the cognitive reflection test (CRT) to brutally expose the flaws in our thinking. The test involved the below three questions.

1. A bat and a ball cost $1.10 in total. The bat costs $1.00 more than the ball. How much does the ball cost? _____ cents
2. If it takes 5 machines 5 minutes to make 5 widgets, how long would it take 100 machines to make 100 widgets? _____ minutes
3. In a lake, there is a patch of lily pads. Every day, the patch doubles in size. If it takes 48 days for the patch to cover the entire lake, how long would it take for the patch to cover half of the lake? _____ days

The CRT was designed to measure the extent to which people are able to interrupt their more instinctive X-system response, and replace it with the slower, but more logical, C-system process, to produce the correct answer. Turns out, it is harder than you might think (answers at the end of this letter).

Frederick carried out the test at 11 locations on more than 3,000 individuals — mostly students — and found that they averaged just 1.24 correct answers. His results, detailed in his 2005 paper Cognitive Reflection and Decision Making, are instructive at several levels.

For example; those who incorrectly answered the first question thought that 92 per cent of people would answer it correctly. Those that did answer it correctly thought that just 62 per cent of respondents would get it right.

The point here is that people whose X-system is dominant — that is the ones who answered instinctively, and therefore incorrectly — have an over-inflated sense of confidence, misreading the difficulty of challenges.

The point is that the X-system response served us humans very well in certain 'life and death' situations. When faced with a sabre-toothed tiger, it wouldn't generally have been a good idea to sit back and slowly weigh up all the options. You might have got to "Run away as fa...".

But it does get in the way when it comes to investing.

One thought flaw that manifests itself frequently when it comes to investment decisions is the inability to distinguish between 'pattern' and 'noise'.

There are countless issues that people worry about and that thus may play a role in their investment decisions, whether Brexit, Trump, Little Rocket Man, Catalonia, hacking, fracking, disappearing bees, killer bees, killer Frisbees, knocking knees, chopped down trees or micro beads.

You may well want to care more for the environment which most would agree without any doubt whatsoever is a good thing to do. However, believing that issues that are broadcast incessantly by a profit-incentivised media will have a negative impact on financial markets will more often than not be a mistake. The reality is that they either do not have any noticeable effect or if they do it's too late to do anything about it. In other words – it's 'noise'.

A good example of this is Brexit.

On the face of it, our funds were horribly positioned for Brexit. We had no exposure to safe haven bonds, limited foreign currency exposure and our UK equities were mostly mid-caps. In the days following the referendum vote on 23 June 2016, bond yields, sterling and mid-caps all plummeted.

The chart below shows the performance of our income fund relative to the average of its peer group (the IA Mixed Investment 20-60% Shares sector).

Chart 1: Performance of LF Seneca Diversified Income Fund versus the IA Mixed Investment 20-60% Shares sector

Discrete annual performance (%)	31.01.2018	31.01.2017	31.01.2016	31.01.2015	31.01.2014
LF Seneca Diversified Income Fund	9.5	15.3	- 0.1	5.8	5.8
IA Mixed Investment 20-60% Shares	6.8	13.4	-3.4	8.2	4.7

Source for all performance data: FE Analytics. Basis: Bid to Bid, net income reinvested and net of fees in UK Sterling terms and refers to the 'B' share class. 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.

The referendum vote is viciously apparent on the chart. But what is also apparent is that the fund outperformed its sector by a very respectable 8 percentage points over the entire five years (and it did this with lower than sector average volatility not higher).

Brexit fears played no part in our investment thinking and continue to play no part. We changed nothing ahead of the vote and nothing after. I as asset allocation specialist believed like most that the country would vote to remain. I was wrong but it didn't matter. What mattered was that we remained calm and rational and, as before the vote, changed nothing after it. In fact, our fixed target weight system meant that we were buying mid-caps and sterling in the days, weeks and months following the vote, as market movements took us underweight target. These actions significantly boosted fund performance over the last year and a half (we couldn't sell Gilts as we didn't have any but that too would have been a great thing to do).

As asset allocation specialist, my focus is on the business cycle, taking advantage of the fact that different financial asset classes exhibit distinctive performance at each of the four stages: expansion, peak, recession and recovery. If you can gauge where you are on the cycle, which you can by looking at simple things like employment and inflation, you can use business cycle analysis to make informed predictions about how financial markets will behave over the next few years.

Pattern. Not noise. Simple really.

Monthly review and outlook

Review

February will be remembered for the sharp fall in equity markets across the world at the beginning of the month. Our view was at the time and remains that it was not the start of something more pronounced but simply markets letting off a bit of steam following months of rises.

Economic data during the month again suggested that the global economy continued to strengthen. Low unemployment rates are beginning to feed through to wages, which at some point will lead to higher inflation. Wage growth rates in the US, the UK, and Japan are all now higher than they were last year (Eurozone data is delayed). In the US, it was announced that the rate of growth of average hourly earnings increased to 2.9% in January from 2.7% the previous month. A similar trend is seen in the UK where wage growth rose to 2.5%. Japan's growth rate, though rising, is a little lower but this makes sense because there is still some slack in the labour force. One might ask why this is the case, with the unemployment rate at just 2.8%. The reason is that although Japan's unemployment rate is low in absolute terms, it is still high in relation to historical lows. Furthermore, the female participation rate is now rising strongly, which is helping to keep overall wage pressures lower than they might otherwise have been.

Core inflation rates announced in February thus either rose (US and UK) or stayed the same (Japan and Europe). This again makes sense, given relative positioning on the business cycle. Interest rate rises have taken place in the US and the UK but not Japan and Europe, reflecting respective price pressures.

As for the emerging world, inflation rates fell in Brazil, China, India and Russia. It was particularly reassuring to see inflation fall in India, where it had risen in recent months to levels that might have been keeping the central bank awake. Consumer price inflation fell from 5.2% to 5.1% while wholesale price increase fell from 3.6% to 2.8%. It is becoming increasingly clear that inflation in the emerging world is much less of a problem than it used to be, a very welcome development.

As for financial markets, the main activity was in equity land. Having been rising for many months, and in an increasing stable manner, equity markets around the world fell sharply in the first week of February. The falls around the world were very similar, suggesting that it was automated trading systems that were to blame. In light of the fact that monetary policy was still very supportive, yield curves steep, and economic output gaps not stretched, it seemed unlikely that the declines were the start of a protracted bear market. Indeed, markets subsequently bounced back quite strongly.

On the currency front, the US dollar had a strong month. But this must be considered in the context of significant weakness over the last year. As for bond yields, performance was mixed. They rose further in the US, remained the same in the UK, and fell in Europe and Japan.

Outlook

There was nothing in February'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. Cash does not yet present any sort of competition for equities. Real deposit rates across the developed world are negative, presenting anyone selling equities with a challenge of what to do with the proceeds.

Answers to cognitive reflection test:

1. 5 cents
2. 5 minutes
3. 47 days

Table 3: Current fund tactical asset allocation (TAA) target weights as of 28.02.2018 (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 (20.5)**	**17.0 (17.0)**	**31.0 (31.0)**
	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 (36.0)**	**53.0 (53.0)**	**56.0 (56.0)**
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	7.4 (8.1)	7.4 (8.1)	7.9 (8.4)
	Private equity	4.4 (4.4)	4.8 (4.8)	5.6 (5.6)
	Specialist financial	10.3 (10.3)	9.5 (9.5)	10.8 (10.8)
	Infrastructure	6.5 (6.3)	6.6 (6.4)	6.9 (6.7)
	Specialist Subtotal	**28.6 (29.1)**	**28.3 (28.8)**	**31.2 (31.5)**
Cash		**3.2 (2.7)**	**6.7 (6.2)**	**3.6 (3.3)**
Total		**100.0**	**100.0**	**100.0**

Source: Seneca Investment Managers, 28 February 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*

February commentary

SIGT, SDIF and SDGF

- February will be remembered for the sharp fall in equity markets around the world during the first week of the month
- We did not believe this to be the start of something more protracted but merely markets 'letting off steam' following months of rises
- The US dollar was strong but this must be viewed in the context of significant weakness over the last year
- Inflation rates in the developed world either rose or stayed the same, indicating continued strength in the global economy
- Results from Senior suggested margins have troughed. The shares trade on a price to sales below 1.2x vs a historical peak of over 1.6x, meaning there is plenty of scope for a continued re-rating in the valuation.
- Phoenix announced a major acquisition - Standard Life Assurance, which will enable the dividend to increase 3% and enhance its sustainability. The shares yield 6.4% on a flat dividend.
- New holding in the HMG Global Emerging Markets Equity Fund. The manager invests in a portfolio of emerging market listed subsdiaries of large multi-national organisations. The Fund adheres to the principles of value investing, with a bias to small capitalisation companies.
- We exited the ordinary shares of Civitas Social Housing REIT due to the financial problems at one of its leaseholder Housing Associations which we feel will hold the shares back.
- The expansionary fund raising of PRS REIT gave us an opportunity to bolster the position as it rolls out its portfolio of build to rent family homes.

SIGT and SDGF

- No activity in fixed income over the month.

SDIF

- The holdings in Muzinich Short Duration High Yield Fund and TwentyFour Select Monthly Income Fund were added to, in order to bring to target weight.