SENECA INVESTMENT MANAGERS

Peter Elston: Investment Letter

Issue 11: March 2016

This document is intended for professional investors only

Data as at 29.02.2016

- Emerging markets
- Inflation watch
- Employment watch
- Current fund targets

I will be writing an opinion piece about emerging markets later this month for one of the trade journals. Here are some preliminary thoughts.

The big question with respect to emerging markets is when they'll start performing. Since the second half of 2010, emerging markets have fallen by 45% in relation to developed markets. That by any standards is substantial and has prompted some to suggest that a change of fortunes is imminent. It is particularly interesting given that over the same period the MSCI AC World Growth index has outperformed its 'Value' counterpart by 15% (and by 29% since the end of 2006). If emerging markets embody anything it is 'growth', surely!

The term 'emerging markets' was coined in the early 1980s by then World Bank economist Antoine van Agtmael. He was trying to launch a fund investing in the new asset class and was persuaded that 'The Third World Fund' wasn't sexy enough. Ever since, emerging markets have been considered a great place to invest.

Goodness knows why!

Since the end of 1987, emerging markets have returned 7.4% annually in US dollars. This compares with returns from US equities of 7.7% annually. Given that emerging market equities have been far more volatile than US equities and that economic growth has been much higher, you'd have expected equity returns to be much higher.

Why haven't they been?

It is hard to generalise about a region that constitutes 23 countries and well over 800 companies but a key problem is that high economic growth has not filtered down to minority shareholders. Nowhere is this truer than China. Since 1992, China's nominal GDP has increased 2,217%. Its stock market however has only risen 17% including dividends, equivalent to 4.1% in US dollar terms. On an annualised basis, 4.1% equates to 0.2% per annum. Where on earth did all that GDP go?!

Minority shareholders are just one of several stakeholders in any company. Others include employees, regional and central governments, and local suppliers. It seems that foreign investors who have poured money into emerging markets over the years have sorely underestimated the extent to which these other stakeholders would take their pound of flesh. In China's case, raising wages has been a core tenet of government policy. This has been great for Chinese workers but will almost certainly have been at the expense of earnings per share.

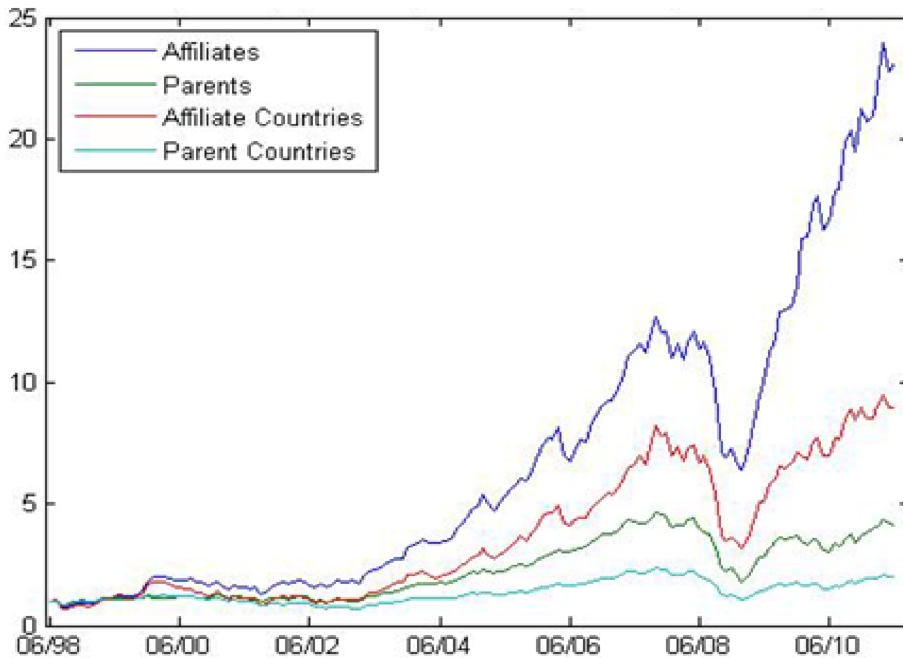
Higher economic growth can be a double-edged sword. It has certainly been the main reason why foreigners have poured money into emerging markets but arguably is also the main reason why investment returns have been poor. Investment opportunities appear plentiful in emerging markets, where incomes are generally low and the scope to increase productivity is high. Companies with grand investment plans tended to be the ones that attracted greater foreign interest and thus cheaper equity finance. Returns on that investment have often fallen far short of expectations, unless of course you were one of the other stakeholders.

Seneca Investment Managers Limited
Tenth Floor, Horton House, Exchange Flags, Liverpool, L2 3YL.
T 0151 906 2450 **E** info@senecaim.co.uk **W** senecaim.co.uk

Seneca Investment Managers Limited is authorised and regulated by the Financial Conduct Authority FRM 208689. Registered in England.
Registered Office: Tenth Floor, Horton House, Exchange Flags, Liverpool, L2 3YL. Company Number 4325961.

This point is one that was well made in a paper written in 2012 by Yale professor Martijn Cremers titled "Emerging Market Outperformance: Public-traded Affiliates of Multinational Corporations". Cremers noted that the really strong performance in emerging markets has come not from the headline-grabbing, capital-absorbing local companies but from the listed affiliates of MNCs, which tend to have pretty dull businesses such as fast moving consumer goods. The combination of dull businesses and strong governance that permeated down from the parent made for a potent mix.

Chart 1: Value of US$1 invested in June 1998



Cremers identified 92 such listed affiliates across emerging Asia, Eastern Europe, Africa and Latin America and found some startling results (see chart 1). Over the period under review, the 92 listed affiliates returned on average a total of 2,229% in US dollar terms. This compares with 1,157% for countries in which the affiliates were listed and 371% for emerging markets broadly (the affiliates tended to be listed in the better performing emerging markets).

The moral of the story is that one should be very selective in emerging markets. Companies with aggressive expansion plans have tended to disappoint while the dull and careful have delivered. In emerging markets, the tortoise wins the race.

Source: Martijn Cremers - Emerging Market Outperformance: Public-traded Affiliates of Multinational Corporations

Finally, a look at valuations. As can be seen in chart 2 below, there has been a stark divergence in price-to-book ratios of emerging and developed market companies. The gap may look appealing compared to where valuations were a few years ago but it has at times been much bigger. Back in the late 90s following the Asian financial crisis, the price-to-book ratio fell to 0.3 times at a time when the tech bubble was powering developed market companies to well over 3 times. While it is hard to imagine emerging markets getting that cheap again, it is worth remembering that if the return on capital is less than the cost of capital, as is often the case with emerging market companies, one should not pay more than 1 times book.

Chart 2: Price-to-book ratio of emerging markets versus developed markets

Source:

Inflation watch

Inflation has such an important bearing on real and financial asset prices, that it deserves its own section.

Table 1: Inflation data releases over past month

Region	Country	Series	Period	YOY%	Versus		
					Survey	Prior	Desired
Developed economies	US	PCE Core YoY	Dec	1.4	↔	↑	↓
	Germany	CPI YoY	Jan	0.5	↔	↔	↓
	UK	CPI Core YoY	Jan	1.2	↓	↓	↓
	France	CPI EU Harmonised YoY	Jan	0.3	↓	↓	↓
	US	CPI YoY	Jan	1.4	↑	↑	↓
	US	CPI ex Food/Energy YoY	Jan	2.2	↑	↑	↔
	EC	CPI YoY	Jan	0.3	↓	↓	↓
	Japan	CPI ex Food/Energy YoY	Jan	0.7	↔	↓	↓
	France	CPI EU Harmonised YoY	Feb P	-0.1	↓	↓	↓
	Germany	CPI EU Harmonised YoY	Feb P	-0.2	↓	↓	↓
	US	PCE Core YoY	Jan	1.7	↑	↑	↓
	EC	CPI Core YoY	Feb	-0.2	↓	↓	↓
BRICS	Russia	CPI Core YoY	Jan	10.7	↔	↓	↑
	SA	CPI Core YoY	Jan	5.6	↑	↑	↑
	China	CPI YoY	Jan	1.8	↓	↑	↔

Source: Bloomberg Mar 2016 (↑/↓/↔):Actual data was higher than/lower than/same as survey/prior/desired)

Perhaps the most important number coming out of the developed world was Europe's February inflation turning negative. This prompted expectations of aggressive action by ECB president Mario Draghi at the central bank's 10 March meeting. At the time of writing, the markets are coming off a little following what was a few hours ago a very positive reaction to the various stimulus measures announced by the ECB.

Employment watch

Most if not all central banks are tasked with maintaining price stability and full employment. This section looks at recent employment trends and what they might mean for monetary policy around the world.

Table 2: Employment data releases over past month

Country	Series	Period	%	Versus		
				Survey	Prior	Full emp
Germany	Unemployment Claims Rate	Jan	6.2	↓	↓	↑
EC	Unemployment Rate	Dec	10.4	↓	↓	↑
US	Unemployment Rate	Jan	4.9	↓	↓	↑
UK	ILO Unemployment Rate	Dec	5.1	↑	↔	↑
Russia	Unemployment Rate	Jan	5.8	↓	↔	↑
Japan	Jobless Rate	Jan	3.2	↓	↓	↑
Germany	Unemployment Claims Rate	Feb	6.2	↔	↔	↑
EC	Unemployment Rate	Jan	10.3	↓	↓	↑
France	ILO Unemployment Rate	4Q	10.3	↓	↓	↑
SA	Unemployment Rate	4Q	24.5	↓	↓	↑
Brazil	Unemployment Rate	Jan	7.6	↓	↑	↑

Source: Bloomberg March 2016

Despite fears of slowing growth, unemployment rates almost everywhere came in lower than expected and, with the exception of Brazil, lower than or the same as the prior month. I'm still inclined to think that economies generally will continue to grow this year.

Current fund targets (as of 3 March 2016, prior month's targets in brackets)

The targets 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 3: Current and previous target weights of our three public funds

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 (25.5)	24.0 (23.0)	33.0 (32.0)
	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	5.0 (5.0)	10.0 (10.0)	9.0 (9.0)
	Emerging Markets	1.0 (1.0)	4.5 (4.5)	3.0 (3.0)
	Global Funds	1.5 (1.5)	1.5 (1.5)	1.0 (1.0)
	Equities Subtotal	**45.0 (44.0)**	**65.0 (64.0)**	**65.0 (64.0)**
Fixed interest	DM Government	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
	EM Debt	5.6 (5.1)	2.0 (2.0)	1.2 (0.0)
	Corporate	25.4 (25.9)	8.0 (9.0)	5.4 (7.6)
	Fixed Interest Subtotal	**31.0 (31.0)**	**10.0 (11.0)**	**6.6 (7.6)**
Specialist investments	Property	5.0 (5.7)	4.0 (4.0)	5.2 (6.0)
	Private equity	2.9 (2.9)	2.9 (2.9)	5.7 (5.7)
	Specialist financial	9.5 (10.2)	12.7 (13.2)	10.4 (10.6)
	Infrastructure	4.6 (5.2)	3.4 (3.9)	4.7 (4.7)
	Specialist Subtotal	**22.0 (24.0)**	**23.0 (24.0)**	**26.0 (27.0)**
Cash		2.0 (1.0)	2.0 (1.0)	2.4 (1.4)
Total		**100.0**	**100.0**	**100.0**

Source: Seneca Investment Managers, March 2016

- Having increased the total equity weight by 2%pts in January, we increased it by a further 1%pt in February for all three funds via an increase in the UK equity target.
- This brought the equity overweight to 5%pts in relation to strategic asset allocation.
- We think that growth will remain sufficient this year to keep equities supported; however, if this is not the case and markets resume their downward trend, we have plenty of powder dry to increase the equity target further.
- The 1%pt increase in the UK target was both top down and bottom up driven; we feel that the market is reasonably good value but the decision was also driven by our UK equity specialist putting forward a new stock idea.
- The idea in question is International Personal Finance (IPF), a home credit provider operating in Poland, Lithuania, Romania, Bulgaria, Czech Republic & Slovakia, Hungary, Spain and Mexico.

- The mostly female agents are remunerated based on loan repayments rather than the amount of loans extended, so are incentivised to get to know their mostly female clients well and to scrutinise credit risk.
- The business has been impacted in recent years by interest rate caps introduced by governments of some of the companies in which they operate.
- This has impacted sentiment towards the stock, which has fallen 60% from its highs in 2013 and is now yielding above 6%.
- There is risk that governments in other countries in which they operate will also introduce interest rate caps but we think this risk is priced into the stock.
- Furthermore, the unintended consequence of introducing interest rate caps is that borrowers are forced into the hands of loan sharks.
- Thus there is also the possibility that interest rate caps are either removed or adjusted as politicians realise the errors of their ways (to the extent that politicians ever do!)
- Elsewhere in portfolios, we reduced 'specialist assets' targets in anticipation of increasing further our equity targets; targets in specialist healthcare REIT Assura were reduced to zero as good performance had pushed the yield down to unattractive levels.

Important Information

Past performance is not a guide to future returns. The information in this document is as at 29.02.2016 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.
The views expressed are those of Peter Elston at the time of writing and are subject to change without notice. They are not necessarily the views of Seneca and do not constitute investment advice. Whilst Seneca has used all reasonable efforts to ensure the accuracy of the information contained in this communication, we cannot guarantee the reliability, completeness or accuracy of the content.
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.
Seneca Investment Managers Limited is the Investment Manager of the Funds (0151 906 2450) and is authorised and regulated by the Financial Conduct Authority and is registered in England No. 4325961 with its registered office at Tenth Floor, Horton House, Exchange Flags, Liverpool, L2 3YL. FP16/52.