SENECA
INVESTMENT MANAGERS

Peter Elston: Investment Letter

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This document is intended for professional investors only

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During a break at a conference I attended recently I was chatting to someone who said he thought that multi-asset investing was a gimmick. I tried hard to smile, saying simply that the idea of spreading one's investments across different types of assets was as old as the hills, which it is.

But the reality is that multi-asset investing does have a bit of an image problem and as a multi-asset specialist we have to deal with that. Part of the problem, as with so much in our industry, relates to the use of jargon. When I began my career in 1988 with a large UK fund management house, most of the firm's assets under management were "multi-asset" - in the form of defined benefit pension scheme assets. Many of these funds had around half their assets invested in UK equities, another fifth or so in overseas equities, another fifth in bonds and the rest in property and cash. To all intents and purposes they were multi-asset funds. We just didn't call them "multi-asset".

Then, over the course of the next couple of decades, the consultants took over, recommending to pension fund clients which manager they should select to manage which bucket of assets. They themselves would take on the job of asset allocation, while fund managers would be picked on the basis of their selection skills in equities, bonds or other asset classes.

To be fair to the consultants, the asset allocation function was ripe for an overhaul. At the firm where I started, it was the manager of the UK equity portion who was the central figure, with the job of asset allocation left to one individual who every quarter would look at the positioning of other pension funds as provided by CAPS or WM and tweak weightings accordingly. It was not sophisticated and the investment consultants, with their clever mean-variance optimization models, had a field day.

However, retail and wholesale demand for what would commonly become known as multi-asset funds was starting to rise. Alongside this, the absolute return fund came into being, as well as numerous other ways of making asset allocation decisions with the aim of generating good volatility-adjusted returns. As of 11 April, there were 573 OEICs across the six IA sectors that are either strictly multi-asset or, as is the case with targeted absolute return, have objectives that can be thought of as similar to those of multi-asset funds [1] . The multi-asset landscape it seems is one that is competitive for us and confusing for our client base.

The way we try to address this is to get a good balance in our funds between simplicity and sophistication. The sophistication comes in the form of:

- good diversification at an asset class level across equities, bonds and specialist assets that helps dampen volatility in the shorter term (though we certainly don't purport to be absolute return managers);
- a value oriented investment style that identifies assets which are undervalued and should thus perform well over the longer term;

1 IA Flexible Investment, IA Mixed Investment 0%-35% Shares, IA Mixed Investment 20%-60% Shares, IA Mixed Investment 40%-85% Shares, IA UK Equity & Bond Income, IA Targeted Absolute Return

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- a high-conviction approach with respect to tactical asset allocation and security/fund selection that ensures funds are given the potential to produce value added in excess of fund costs.

The simplicity aspect is about steering clear of complex structured products, derivative strategies and hedge funds, as well maintaining a longer-term investment time horizon. Look at our funds' holdings as well as our portfolio turnover and it should be pretty clear what we're trying to do, something that we don't think can be said of that many of our competitors.

Another major trend that was already underway in the late 1980s was the move towards passive investing. This trend was centred on equity funds where it was plain for all to see that the average actively managed fund in a particular geography underperformed its benchmark or the relevant benchmark index. More recently, funds that are designed to track more complex indices that are tilted towards a particular subsector or factor such as high dividend yield or high quality have grown in popularity. These funds are known as smart- or strategic-beta funds.

Although at a much earlier stage, there is a similar move towards passive and smart beta happening in the world of multi-asset. However, although similar, there are some key differences.

First, multi-asset funds use different types of benchmark, unlike equity funds that mostly use a stock market index (and in a particular geography, one benchmark index tends the prevail, an example being the S&P 500 index in the US). Some multi-asset funds use a composite index, the simplest being a 50/50 equity/bond index, some use the relevant peer group average, some use a nominal fixed return, some a real fixed return, and others still do not specify a benchmark at all.

Second, multi-asset funds, even within the same sector, can also vary enormously with respect to the volatility of their returns. Look at one of the IA multi-asset sectors and you will see a wide range of volatilities, unlike equity land where the ranges tend to be much narrower.

Third, and this is related to the first point, there are few 'independent' composite benchmarks in existence and fewer still funds that employ them. One example is the Dow Jones Global Composite Yield Index that is itself comprised of indices in five asset classes: equities, real estate, alternatives, corporate bonds, and sovereign bonds. However, although the first three of these are their own, Dow Jones uses Credit Suisse indices for the last two. Furthermore, I have been unable to find any funds that actually use it as their benchmark. All passive multi-asset funds that I have come across use their own composite benchmarks. Active funds that use a composite index as a benchmark also tend to create their own using different indices from different providers.

The world of multi asset does not easily lend itself to smart beta either. In the world of equities, it is now well understood that there are certain factors that tend to perform well over time such as smaller companies or stocks with high dividend yields. Furthermore, it is also well understood that creating indices to capture these factors is fairly straightforward.

Not so in multi-asset.

There have been attempts to create multi-asset indices whose weightings in underlying assets classes vary according to certain systematic rules. But these rules are necessarily bespoke and thus not becoming universally accepted and understood, as is the case in equity land. Their mystique may prevent them from enjoying the same success. The risks of something going wrong are surely too great.

Perhaps the biggest problem I see with passive multi-asset funds is that they may naturally have a significant and permanent weighting towards what are now extremely expensive government bonds. This may mean that they perform well over the short term, as has certainly been the case in recent months, but the negative long-term real yields that prevail in most if not all advanced countries mean one thing: over the longer term they are guaranteed to lose you money in real terms.

At Seneca, we believe that our active approach to multi-asset, one that avoids obviously expensive assets, is one that will over time produce stronger performance than a passive equivalent. Our volatility-adjusted investment performance numbers we think show just that.

Inflation watch

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

As anticipated, inflation turning negative in the Eurozone in February did indeed prompt drastic action by the ECB, which announced a greater than expected increase in asset purchases. Elsewhere, it is encouraging to see Japan's headline and core inflation numbers rising slightly in February, though no doubt the recent Yen strength will dampen prices down the line. As for emerging markets, both Brazil's and Russia's inflation rates have been falling noticeably which should be welcomed, though in both cases the numbers remain well above what would be considered comfortable levels.

Table 1: Inflation data releases over past month

Region	Country	Series	Period	YOY%	Versus		
					Survey	Prior	Desired
Developed economies	Germany	CPI EU Harmonised	Feb	-0.2	↔	↔	↓
	France	CPI EU Harmonised	Feb	-0.1	↔	↔	↓
	US	CPI	Feb	1.0	↑	↓	↓
	US	CPI ex Food & Energy	Feb	2.3	↑	↑	↔
	EC	CPI	Feb F	-0.2	↔	↔	↓
	UK	CPI	Feb	0.3	↓	↔	↓
	UK	CPI Core	Feb	1.2	↔	↔	↓
	Japan	Nat'l CPI	Feb	0.3	↔	↔	↓
	Japan	Nat'l CPI ex Food/Energy	Feb	0.8	↔	↑	↓
	US	PCE Core	Feb	1.7	↓	↔	↔
	Germany	CPI EU Harmonised	Mar	0.1	↑	↑	↓
	France	CPI EU Harmonised	Mar	-0.1	↔	↔	↓
BRICS	Russia	CPI Core	Feb	8.9	↓	↓	↑
	Brazil	IGBE Inflation IPCA	Feb	10.4	↔	↓	↑
	China	CPI	Feb	2.3	↑	↑	↓
	S Africa	CPI Core	Feb	5.7	↑	↑	↑
	Russia	CPI Core	Mar	8.0	↓	↓	↑
	Brazil	IGBE Inflation IPCA	Mar	9.4	↔	↓	↑

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

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.

Unemployment in most regions remains above what might be considered full employment though we are getting close in the US and the UK. In the US, we are finally starting to see a rise in the participation rate, as those who previously left the workforce are being encouraged to return. This suggests employment can continue to rise for a while longer without impacting the unemployment rate and thus wage costs.

Table 2: Employment data releases over past month

Country	Series	Period	%	Versus		
				Survey	Prior	Full emp
EC	Unemployment Rate	Jan	10.3	↓	↓	↑
US	Unemployment Rate	Feb	4.9	↔	↔	↑
UK	ILO Unemployment Rate	Jan	5.1	↔	↔	↑
Russia	Unemployment Rate	Feb	5.8	↓	↔	↑
Japan	Jobless Rate	Feb	3.3	↑	↑	↑
US	Unemployment Rate	Mar	5.0	↑	↑	↑
EC	Unemployment Rate	Feb	10.3	↔	↔	↑
Brazil	Unemployment Rate	Feb	8.2	↓	↑	↑

Source: Bloomberg March 2016

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 3: Current fund tactical asset allocation (TAA) target weights (as of 12 April 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 (5.0)	10.5 (10.0)	9.5 (9.0)
	Emerging Markets	1.0 (1.0)	4.5 (4.5)	3.0 (3.0)
	Global Funds	2.0 (1.5)	2.0 (1.5)	1.5 (1.0)
	Equities Subtotal	**46.0 (44.0)**	**66.0 (64.0)**	**66.0 (64.0)**
Fixed interest	DM Government	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
	EM Debt	5.6 (5.6)	2.0 (2.0)	1.2 (1.2)
	Corporate	25.4 (25.4)	8.0 (8.0)	5.4 (5.4)
	Fixed Interest Subtotal	**31.0 (31.0)**	**10.0 (10.0)**	**6.6 (7.6)**
Specialist investments	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 (2.0)	1.0 (2.0)	1.4 (2.4)
Total		**100.0**	**100.0**	**100.0**

Source: Seneca Investment Managers, March 2016

- During March we increased the overall equity TAA target weight for all funds by 1 percentage point. This was something we had anticipated doing at some point, having in February raised cash by reducing the target in specialist assets.
- The 1 percentage point equity target increase was spread across global funds, where we increased the target in Blackrock World Mining Fund, and Asia Pacific ex Japan.
- Blackrock World Mining Fund remains very attractive, on a historical yield of 9.9%. It is very possible that the dividend will be cut this year, but even factoring this in, the yield is attractive.
- As for Asia Pacific ex Japan, we think the region is becoming more attractive, having been underperforming for the last few years.
- Elsewhere, we exited UK holding UBM plc for all funds. Following a very strong run since early February, the valuation is now less attractive. The current 17 times prospective PE is the highest since before the financial crisis.
- The reduction in the UBM target was reassigned to different holdings depending on the fund. Indeed, our UK equity specialist took the opportunity to increase the commonality of holdings across portfolios.

Important Information

Past performance is not a guide to future returns. The information in this document is as at 31.03.2016 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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Seneca Global Income & Growth Trust plc

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