Peter Elston: Investment Letter

Issue 13: May 2016

This document is intended for professional investors only

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Introduction of our new investment process – one year on

Our new investment process reached the grand age of one in April. We thought it might be useful for clients and other readers to take a look back at how things have gone during the first year.

To recap, we are a multi-asset specialist and have three public multi-asset funds: our investment trust Seneca Global Income & Growth Trust and our two OEICs, CF Seneca Diversified Income Fund and CF Seneca Diversified Growth Fund. Each has its own strategic asset allocation which is linked to its specific long-term return objective. For example, in the case of the Growth Fund we expect over the long term to achieve a total real return net of costs of 6%. To achieve this, its strategic asset allocation comprises 60% equities (20% in UK and 40% non-UK), 15% fixed income and 25% specialist assets. For internal purposes, we use this strategic asset allocation as the fund's performance benchmark, assigning an appropriate market index to each of the sub asset classes e.g. US equities, emerging market debt and so forth. Indeed, since December 2000, the Growth Fund's strategic asset allocation has achieved a real trend return of 5.2% per annum. When expected value added from tactical asset allocation and holding selection in each of the four asset classes as well as fund costs are taken into account, this would get us to a real return of 6% per annum. It should also be noted that the last 15 years have included two particularly nasty bear markets in equities, so this trend return would have been depressed compared with previous decades. That said, this trend rate would also have been boosted somewhat by the strong performance of safe haven government bonds over the period.

So, the theoretical modelling is consistent with our actual fund objectives. What is not clear of course, and never will be, is whether markets over the medium to long term will perform as expected. Perhaps more importantly, whether we will be able to generate the value added that we expect to is also not guaranteed.

Back to the process.

Without doubt the two most important aspects of our new investment process relate to our investment style and the organisation of our research effort.

An investment style describes a framework for how investment decisions are made. Employ many different investment styles and you not only reduce your chance of making money – think "Jack of all trades master of none" – but you are also very likely to confuse your investor base. But having a clear investment style is not enough: buying only those companies with the colour orange in their logo is exceptionally clear but has no empirical or theoretical basis (you could quite easily be Tangoed).

Our new investment style which we formally introduced a year ago is called "Multi-Asset Value Investing".

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Multi-Asset Value Investing

What does this mean?

It means that every investment decision we make is on the basis that something is fundamentally cheap (decisions to sell are made if something has become expensive). For example, a tactical asset allocation decision to overweight a particular equity market is made because we believe that the market in question is under-valued. In the UK, we invest directly, so a decision to buy a particular stock is made because it's under-valued. Outside of UK equities we generally invest in third party funds, so we're looking for managers who have some sort of value-oriented approach or who have identified cheap assets in a particular specialist area.

The theory is simple: cheap assets are more likely to appreciate in value than expensive ones. The empirical evidence is strong as well: various studies have found that high dividend stocks have outperformed low dividend stocks and that bull markets have generally begun when equity market yields are high.

Buying cheap assets won't necessarily dampen volatility in the short term – an under-valued asset can often move even further away from its intrinsic value before moving towards it. What it *will* do however is help avoid permanent loss of real capital in the longer term. An example of this is developed market long-term government bonds. With their negative real yields, they are guaranteed to lose you money if held to maturity. However, by not holding them, fund volatility in the short term increases slightly, as not only are they low volatility but they also tend to be negatively correlated with so-called risky assets.

As for our other major change, we introduced in April last year specialist research responsibilities for each member of the investment team. Whereas previously it was the named fund managers who would decide what was in their funds, across all asset classes, under the new process it is a team effort. For example, Rich is a named fund manager on our Income Fund but is also now our specialist assets research specialist. This means he is responsible for analysing investments in his specialist area and deciding which ones we should own for *all* of our funds. Alan, Mark and Tom are responsible respectively for fixed income, UK equities and overseas equities whilst I cover asset allocation (strategic and tactical).

Research specialists make precise recommendations that require the approval of at least two of the other four members of the investment team, with approval granted if it is felt that sufficient research has been carried out and that the recommendation fits with our value-oriented investment style. This approval process we think is an important risk control, since it would be unwise to allow decisions to be made without any scrutiny of them or indeed to place all the responsibility for a decision on the shoulders of one person. But it is also important that the process is not too onerous and that specialists are allowed the scope to define how they do things in their asset classes within the broad parameters relating to our investment style. We believe we have the right balance.

As a direct result of these two key changes we have increased the commonality of holdings across funds. Previously our Growth Fund tended to buy growth stocks and our Income Fund only higher yielders. Tactical asset allocation could also be inconsistent. Under the new process the Growth Fund is a growth fund not because it owns different investments because it has a higher exposure to risky assets. So it now has many holdings in common with the income fund. This means that greater consistency in investment performance will be seen across all our funds. More often than not, if one of our funds is doing well in relation to its peer group, the others will be too.

As far as implementation is concerned, the Income Fund and our Investment Trust were fairly closely aligned with the new investment style to begin with – both funds had income-oriented mandates which lent themselves naturally to a more value-oriented approach. The Growth Fund however still requires further alignment and there remain five or six holdings to be exited. Indeed, over the last year the Income Fund and the Investment Trust have performed very well in relation to their respective peer groups, while the Growth Fund has languished somewhat. This is a direct consequence of the extent to which funds were already employing a value-oriented approach. Holders of the Growth Fund are assured that it will be fully aligned with the new investment process by the end of the third quarter of this year. We expect this to result in better long-term returns for investors in the fund.

Looking back at one or two of our investment decisions over the last year that help illustrate how the process is working in practice, perhaps the best examples are to be found at the beginning of this year. Mark, as UK equities specialist, wanted to recommend the purchase of three UK stocks that he believed had become cheap. He had the option to replace or reduce some of his existing UK equity holdings but I as tactical asset allocation specialist believed it was appropriate to increase the equity targets, given the extent to which markets had fallen. The question then for me was how we should fund this increase, whether by reducing our fixed income or our specialist assets positions (we generally run low cash balances unless we think markets are very overvalued). Our fixed income allocations were already on the low side, so after consultation with Rich, it was decided to reduce specialist assets (Rich agreed that many of his specialist assets had held up well and in fact two or three of them had seen their yields compress as a result of strong performance).

The three UK stocks that we added to funds in January and February were Royal Dutch Shell, International Personal Finance (IPF) and Victrex (we have a bias towards mid-caps which not only tend to outperform over time but also are less researched so present better opportunities to find hidden gems).

When Shell fell to below £13 in January, its historic yield reached around 10%, clearly discounting a big and permanent cut in future dividends. We felt that although a big cut was very possible (and still is), the high yield presented a big margin of safety – a 50% cut would still leave the shares yielding above 5%. Furthermore, although Shell's upstream business was under pressure as a result of the low oil price, its downstream business was doing just fine, and in fact was to some extent benefitting from low oil prices. Finally, as far as the upstream business was concerned, Mark had noted that the forward oil curve was extremely steep, with prices two years out around 50% above prevailing spot prices. This suggested the spot price was particularly depressed for technical reasons such as speculative shorting or storage issues, and would thus likely rise. We bought the shares at an average of around £13.50. As of 12 May, they were trading at £17.54.

As for IPF, this is an emerging market home credit provider that had been spun out of Provident Financial in 2007. By 2013, the stock was a darling of growth fund managers, and the shares traded on a high valuation. In recent years however, countries in which it operated have introduced interest rate caps, which impacted the stock. Early this year the shares hit a yield of close to 6%, compared with well below 2% in its heyday. Now, interest rate caps may on balance hurt IPF's business, but by no means terminally. Even at lower rates, the company is still able to find sufficiently high quality credits. Two other things. First, the mostly female agents get to know their mostly female customers by visiting them often and they are rewarded not on how much they lend but on how much they get back – a hark back to the early days of banking! Second, when governments realise that by introducing interest rate caps they are simply playing into the hands of loan sharks, they may well reconsider the legislation.

Outside of UK equities, a specialist asset that is illustrative of the new process is AEW UK REIT plc (indeed we purchased it at IPO in May 2015 and it was the first purchase made in *any* asset class under the new process). While we felt that prime property was becoming expensive, AEW was interesting because it was non-prime in the sense that it was focussing on smaller lot sizes, with shorter leases, and properties that needed more asset management (refurbishment). The management team was targeting 8-9% yields once fully invested, with dividends fully covered by income. Active asset management of the properties would be expected to bring total returns into the teens. We met the team in Liverpool and liked them. Since listing, the shares have returned 2.8% compared with a fall in the broad UK equity market of close to 10%. Furthermore, the annualised volatility of the shares has been 7.7%, nearly half that of the equity market.

To conclude, we have a unique and strong investment proposition. As an active manager, to produce good investment performance for investors, it is not only preferable to be different but essential – follow the crowd and you're very likely to end up with poor performance net of costs.

We are different in a number of ways. We know that our "Multi-Asset Value Investing" investment style is unique – Google the term and you'll only find Seneca. Buying things cheaply sounds like such an obvious thing to do but surprisingly few seem to follow the doctrine, at least in a formal, organised way. Investing directly in the UK and in mid-caps is also different and allows us not only to improve investment performance but to avoid the costs associated with third party funds. We have what we think is a high allocation of 25% of all our funds to specialist assets. These are mostly listed on the LSE, and in many cases offer high yields and stable, index-linked cash flows. Examples would be specialist REITs, asset leasing vehicles and renewable energy funds. They not only offer an alternative to equities but also to bonds. Finally, we have a well organised portfolio management and research system, with specialists responsible for maintaining target weights in their area of responsibility, for every mandate we manage. Named managers are given some discretion to deviate from targets but there are strict limits.

The new investment process has been well received and scored a number of successes in its first year. We thus hope and expect returns to continue to improve. So, on the occasion of its first birthday we extend to all our investors, the prospect of many happy returns.

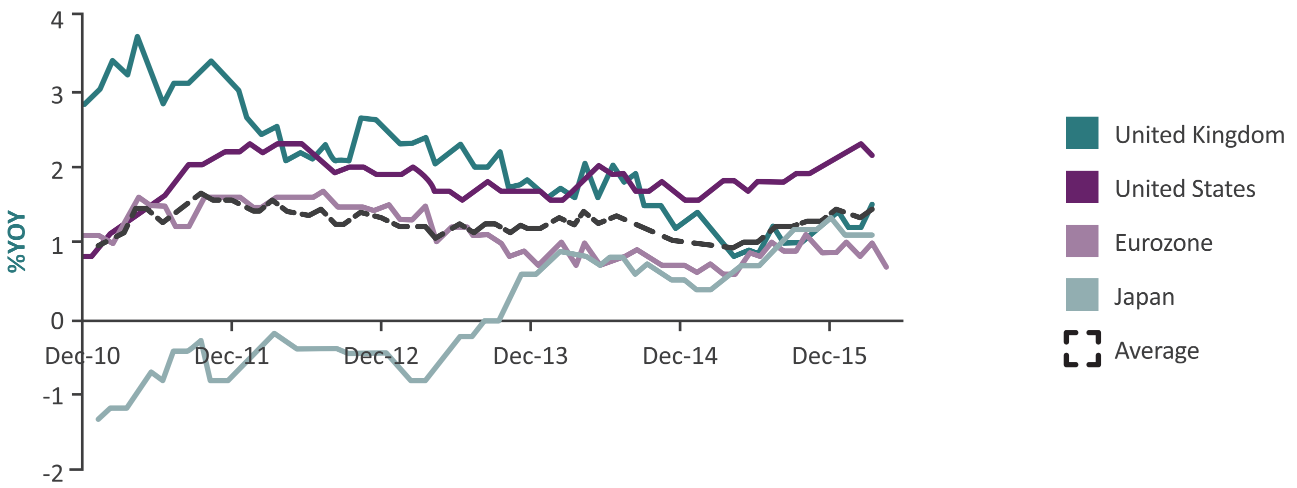
Inflation watch

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

It is interesting that despite rising concerns about the outlook for global economic growth in recent months, there has been no noticeable decline in core inflation (CPI less food and energy) across the developed world (see chart 1). Indeed, core inflation has actually been rising over the last 12 months in the US, the UK and Japan, though there has been a slight decline in Europe. The simple average for the four series is 1.4% as of March which although below what should be considered the target for developed country central banks, is not cause for serious concern. On the contrary, it means that monetary policy will remain loose which should be supportive of risky assets (bear markets tend to start when central banks are trying to bring inflation down).

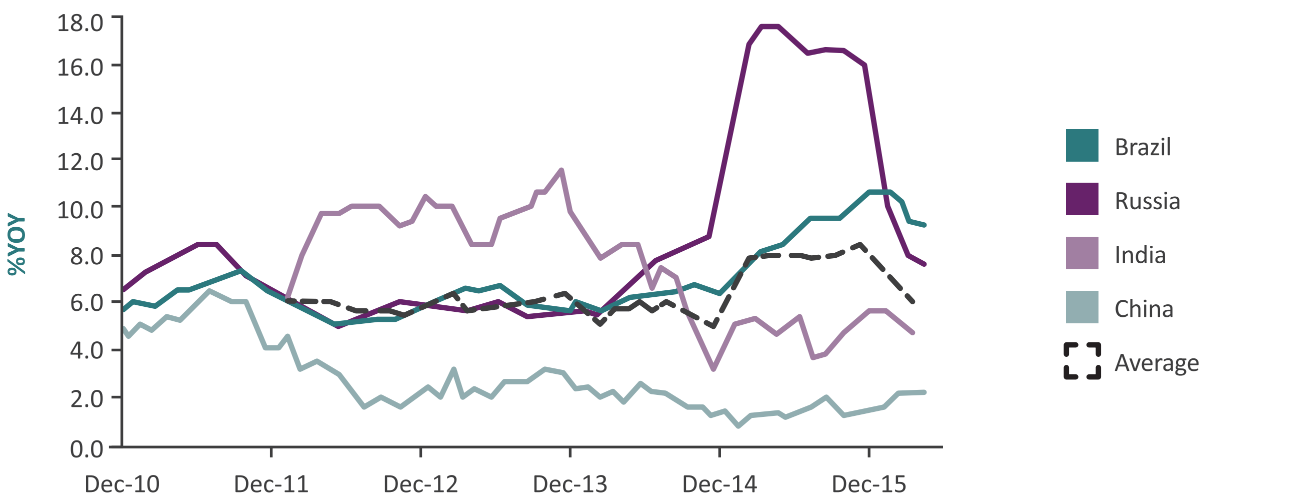
As for emerging countries, there are signs of improvement (see chart.2). China's inflation rate, which has been too low, has been rising, while Brazil's and Russia's, which have been too high, have been falling. India's has been nudging up to around 5% over the last couple of years. This might be considered slightly on the high side, though is a vast improvement on the 10% rates seen in 2012 and 2013.

Chart 1: Core consumer price inflation – developed economies



Source: Bloomberg

Chart 2: Consumer price inflation – emerging economies



Source: Bloomberg

Employment watch

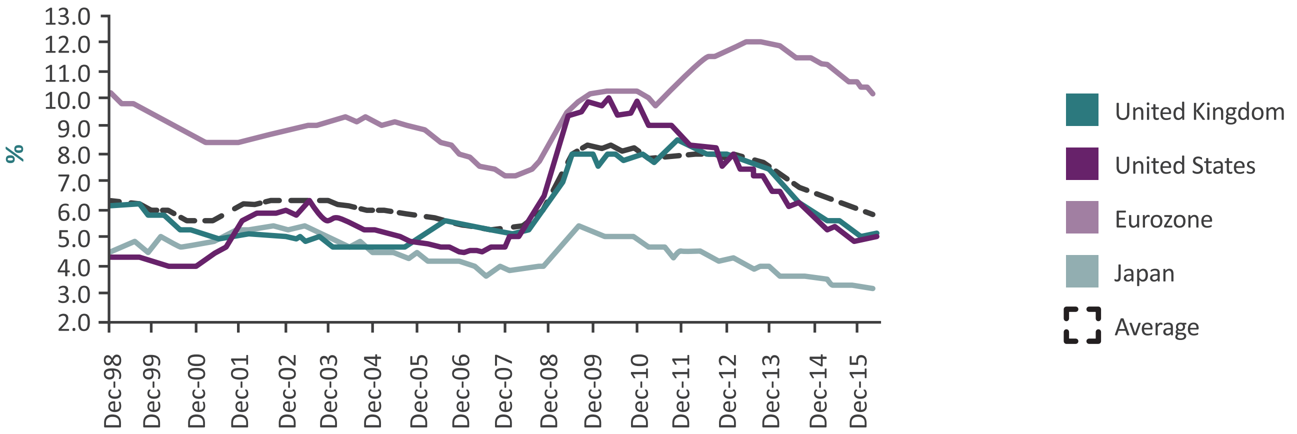
Most if not all central banks are tasked with maintaining price stability and full employment. This section looks at recent employment trends and what they might mean for monetary policy around the world.

Unemployment rates across the developed world have continued to improve (see chart 3). There seems to have been some fall in the rate of improvement in the US, the UK and Japan but this is only to be expected given that unemployment rates have been falling since 2009 (in Europe, unemployment only started to improve in 2013, and from much higher levels, so there the pace of improvement is if anything rising). The average of the four series stood at 5.9% as of March which should mean there is still plenty of scope for it to fall further. Indeed, during the last cycle from 2003 to 2008, the unemployment rate continued to fall for a further three years or so after it first hit 5.9%.

Furthermore, there are reasons to think that it can fall further and for longer than it did during the last cycle. In the case of the US, for example, although the unemployment rate has fallen a long way already, this masks the fact that the workforce has shrunk as a result of people having left the workforce. If as a result of the continued improvement many of them decide to re-enter it, this could well prolong the cycle (in fact this has started to happen, as evidenced by the rising participation rate). Second, there is evidence to suggest that the unemployment rate at which inflation starts to rise (also known as the NAIRU – the non-accelerating inflation rate of unemployment) has fallen. The Fed's estimate of NAIRU fell from 5.6% in 2013 to 4.9% towards the end of last year. There is no reason to think it hasn't fallen further since, meaning that employment may continue to rise without causing the Fed a headache.

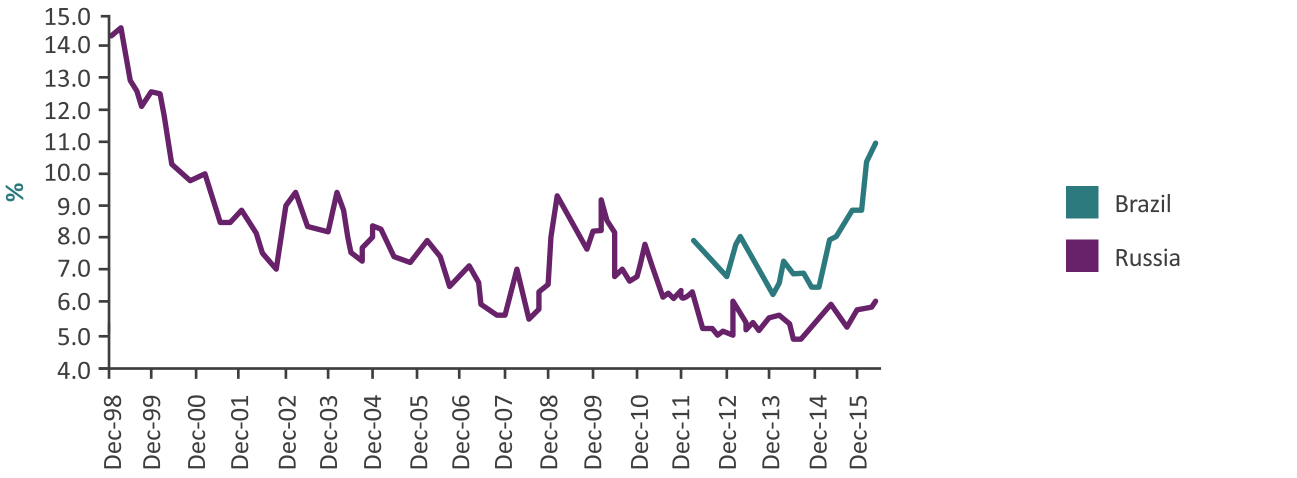
As for emerging economies, data is sparse (see chart 4). Brazil is undergoing a nasty recession but the improvement in the inflation picture as noted in the previous section is encouraging.

Chart 3: Unemployment rate – developed economies



Source: Bloomberg

Chart 4: Unemployment rate – emerging economies

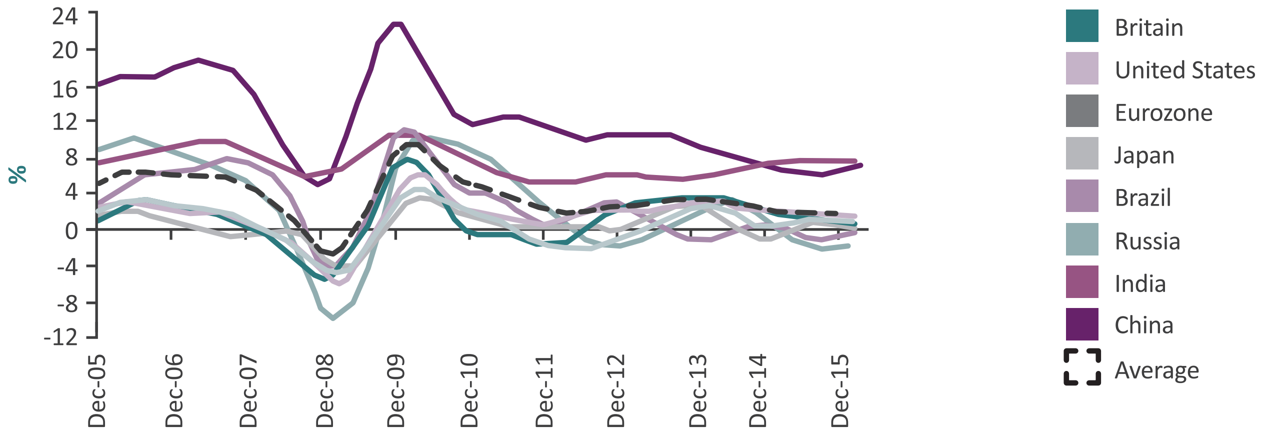


Source: Bloomberg

Other business cycle indicators

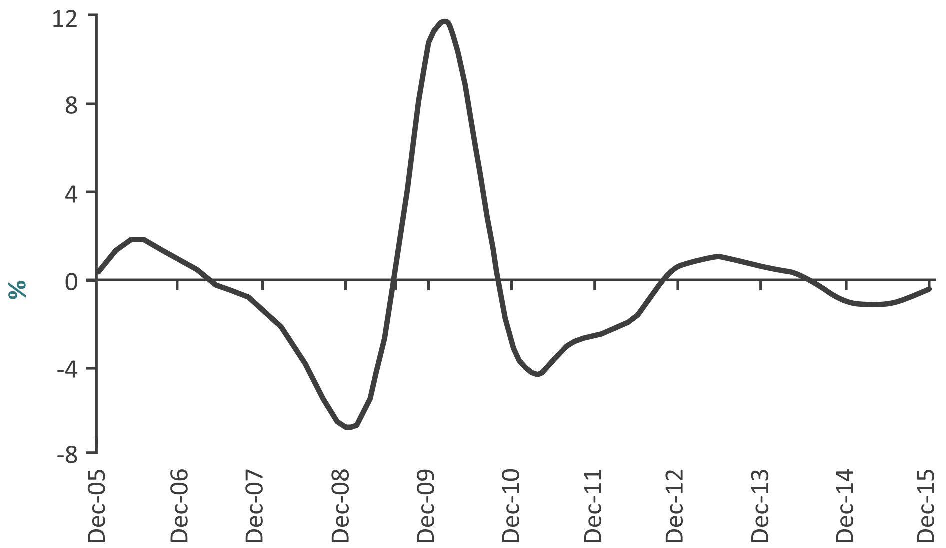
The OECD calculates leading indices every month for a large number of countries. Chart 5 below shows the year-on-year change in the leading indices for the UK, the US, Europe and Japan, as well as the four BRIC countries. It can be seen that the average growth rate over the last five or so years has been considerably lower than the 6% or so rate that prevailed prior to the 2008 financial crisis. However, it is still positive at around 2% and appears to be stabilising. This stabilisation is evident in chart 6 below which shows the rate of change of the rate of change of the average (known as "the second derivative"). I would suggest that this is an improvement that has yet to be fully appreciated by equity markets.

Chart 5: OECD composite leading indicators (trend restored YoY%)



Source: Bloomberg

Chart 6: The rate of change of the average in Chart 5 ("the second derivative")



Source: Bloomberg

Table 1: Current fund tactical asset allocation (TAA) target weights (as of 10 May 2016, prior month's targets in brackets)

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.

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
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 (5.5)	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	**46.0 (46.0)**	**66.0 (66.0)**	**66.0 (66.0)**
Fixed income	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 inc subtotal	**31.0 (31.0)**	**10.0 (10.0)**	**6.6 (6.6)**
Specialist assets	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 (1.0)	1.0 (1.0)	1.4 (1.4)
Total		**100.0**	**100.0**	**100.0**

Source: Seneca Investment Managers, 10 May 2016

- No asset allocation changes in April.
- Introduced Primary Healthcare Properties (PHP) to all portfolios via its £150 million fundraising; having sold Assura earlier in the year on valuation grounds, PHP's higher yield combined with its strong track record allowed us an opportunity to regain exposure to this interesting sector.
- The purchases of PHP were funded by sales of Ediston Properties whose shares Rich felt had become too illiquid. He also felt that new stamp duty rules would make it harder for the management team to grow the REIT going forward.
- Our investment trust sold its holding in BHP Billiton during the month, with proceeds moving into Arrow Global (a stock that was already held in the growth fund). Mark felt that the 70% rise in the share price since January presented an excellent opportunity to sell the holding, particularly given that both he and I felt the rally in commodity prices that had driven the appreciation was unsustainable.
- The Growth Fund sold its holdings in its emerging markets healthcare ETF and its China fund (in favour respectively of the Somerset Emerging Markets Dividend Growth Fund and the First State Asia Pacific Leaders Fund). These sales were part of the aforementioned realignment of the Growth Fund, with neither fitting our investment style. The recipients of the proceeds are both funds that have good track records and value-oriented styles.

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Past performance is not a guide to future returns. The information in this document is as at 30.04.2016 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

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.

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