Peter Elston: Investment Letter

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This document is intended for professional investors only

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An interesting essay by San Francisco Fed President, John Williams

Having written about secular stagnation and the natural rate of interest in my August letter, it was interesting to see San Francisco Fed President, John Williams, write about low natural interest rates in his latest Economic Letter. I'm no expert, but it seems to me that Williams is the leading authority on the subject, having written a seminal paper[1] alongside colleague, Thomas Lauback, back in 2001. Therefore, I think he's worth listening to.

Indeed, his conclusion is an appeal to central banks and governments to "share responsibilities" [for boosting growth]. He goes on to invoke Machiavelli, suggesting that "we can wait for the next storm and hope for better outcomes or prepare for them now and be ready" (one wonders to what extent his essay swayed opinion at the Jackson Hole Symposium).

To recap, the natural rate of interest is essentially the rate that keeps inflation stable. It has nothing to do with monetary policy and everything to do with structural factors such as demographics, trend productivity and economic growth, emerging markets reserve accumulation as well as general global demand for savings. Williams points to the decline in the natural rate of interest to what are now very low levels over the past quarter century and considers what can be done to increase it. As should be evident, the prevailing natural rate of interest reflects future economic growth prospects, which is why it is so important for investors.

It is a shortage of private investment demand in combination with an oversupply of savings that has caused the natural rate of interest as well as long-term real bond yields to fall as far as they have. In the developed world, it seems to me, private investment is weak either because population growth is low, because economies are already advanced, or because there is no new productivity-busting technology out there (past examples include the plough, the steam engine, the internal combustion engine and the computer). There isn't much we can do about the first two, but governments should be doing everything they can to encourage the commercialisation of new productivity-busting technologies (please excuse the pun, but driverless cars should be getting a smoother ride). Furthermore, in the absence of strong private investment, surely there is a strong case for a big increase in public investment, particularly in infrastructure.

In a critique of Williams' essay[2], former US Treasury Secretary and proponent of the secular stagnation thesis, Larry Summers, suggests that Williams does not put enough emphasis on infrastructure investment as a means of stimulating growth and thus raising the natural interest rate. Summers is convinced that debt-financed infrastructure investments pay for themselves, essentially as a result of multiplier effects (economist Philip Milton received rapturous applause when he suggested similar on BBC's pre-Brexit Question Time[3]). Williams does write that, "returns on infrastructure and research and development investment are very high on average", though it seems Summers wanted him to be much bolder.

1 **Measuring the natural rate of interest** https://www.federalreserve.gov/pubs/feds/2001/200156/200156pap.pdf

2 http://larrysummers.com/2016/08/18/6937/

3 https://www.youtube.com/watch?v=0dUUDFTFzOo

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

As for the savings glut, while developing countries seem intent on accumulating safe haven bonds, this is not the only problem. Take the savings industry in the developed world, for example. In many respects, allowing companies to close defined benefit pension schemes was one of the biggest mistakes ever made by governments. If you are saving for yourself rather than in a pool with others, you are naturally going to over-save. I am guilty of this myself as I believe I have to assume that I and/or my wife are going to live to 110. We are both hopeful that we will be gone by 90, but we have to assume the worst. Scale this behaviour up, and the resulting increased demand for savings is a huge drag on economic growth. As Oscar Wilde said, “Anyone who lives within their means suffers from a lack of imagination”.

To illustrate just how damaging the abandonment of pooling with respect to pension savings has been, imagine if we did the same for another industry where pooling is central: insurance. The idea of insuring yourself is of course absurd.

Let’s hope that in the not too distant future governments can start applying some common sense either with respect to infrastructure investment, putting more incentives in place with respect to new technologies, or discouraging over-saving.

Current fund targets

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 1: Current fund tactical asset allocation (TAA) target weights (as of 31 August 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	**8.0** (10.0)	**11.0** (13.0)	**10.0** (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	**44.0 (46.0)**	**64.0 (66.0)**	**64.0 (66.0)**
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)	1.5 (1.5)
	Corporate	26.0 (26.0)	8.0 (8.0)	5.5 (5.5)
	Fixed income Subtotal	**31.0 (31.0)**	**10.0 (10.0)**	**7.0 (7.0)**
Specialist assets	Property	**5.4** (5.0)	**5.4** (5.0)	**5.6** (5.2)
	Private equity	**3.0** (3.1)	**3.8** (3.9)	**5.2** (5.5)
	Specialist financial	**9.7** (9.3)	**10.5** (10.1)	**10.9** (10.5)
	Infrastructure	**4.9** (4.6)	**4.3** (4.0)	**5.3** (4.8)
	Specialist Subtotal	**23.0 (22.0)**	**24.0 (23.0)**	**27.0 (26.0)**
Cash		**2.0** (1.0)	**2.0** (1.0)	**2.0** (1.0)
Total		**100.0**	**100.0**	**100.0**

Source: Seneca Investment Managers, 31 August 2016

Increased *Decreased*

- We reduced the equity targets for all three funds by 2 percentage points in light of recent strong market performance
- Reductions came entirely out of Europe ex UK; although the region has underperformed over the last year or so, our level of conviction has decreased somewhat following the Brexit vote and the political difficulties it exposed
- We remain 3 percentage points overweight in Europe which reflects the decent yields on offer both in absolute terms and in relation to history
- Furthermore, Europe's business cycle has further to run than in the UK and US, thus there remains better potential for earnings to rise
- As for use of target proceeds, 1 percentage point went into cash and 1 percentage point to Specialist Assets
- We will consider uses for the 1 percentage point cash in the coming weeks as opportunities arise
- As for the increase in Specialist Assets, the 1 percentage point was spread across eight existing holdings within REITs, Specialist Financial and Infrastructure

SDIF

- Profit was taken on several UK equity holdings bought at much lower levels in the market falls post the Brexit vote
- The Essentra position was increased following price weakness on CEO leaving announcement
- The position in Schroder European Alpha Income was sold to reduce overall exposure to European equities
- Baillie Gifford High Yield Bond Fund was sold - switched into Muzinich Short Duration High Yield to improve portfolio income
- We increased investment in Royal London Sterling Extra Yield Fund, Royal London Short Duration Global High Yield Fund and Twenty Four Select Monthly Income Fund, to further consolidate holdings

SIGT

- Several UK equity holdings were top sliced - taking profit on purchases made in the market sell-off post Brexit
- The holding in Essentra was increased following price weakness on announcement of CEO departure
- Schroder European Alpha Income Fund was sold to reduce exposure to European equities
- We purchased Invesco Perpetual European equity Income Fund to increase emphasis on Value managers, which was partly funded by reduction in Blackrock Continental Income Fund
- US equity holdings were consolidated with sale of IShares MSCI USA Dividend ETF - switched into existing holding in Cullen Global North American Dividend Value Fund

SDGF

- Consolidated European and Japanese holdings down to two in each geography, thereby increasing weighting to Invesco Perpetual European Equity Income Fund and Goodhart Michinori Japan Equity Fund
- We significantly reduced our holding in the Polar Capital Biotechnology Fund on strength, with a view to ultimately exiting sector specific funds. The proceeds were invested in the iShares MSCI USA Dividend IQ UCITS ETF, pending the completion of due diligence on a new active manager

Important Information

Past performance is not a guide to future returns. The information in this document is as at 31.08.2016 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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