Peter Elston: Investment Letter

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This document is intended for professional investors only

Data as at 30.09.2016

- **High wealth and income inequality**
- **Current fund targets**

It's time to do something about high wealth and income inequality

High wealth inequality is being increasingly cited as one of the main causes of the structurally lower growth that much of the world, particularly the developed world, is currently experiencing. There is both good empirical as well as theoretical support for this relationship, suggesting that policymakers would be wise to start finding ways to lower wealth inequality.

Economic inequality has tended throughout history to be the number one cause of uprisings and revolutions[1], which are not on the whole great for incumbent elites (though they have been great for the likes of inventor of the guillotine Antoine Louis![2]).

In the modern day of course, it is the ballot box that politicians fear. In this, the rise in anti-establishment sentiment around the world is something political and economic elites should take note of.

Why is economic growth currently so low?

Secular stagnation thesis proponents such as former US Trade Secretary Larry Summers suggest that the low growth currently plaguing the world is due to factors such as falling population growth and the decline in demand for debt-financed investment. With respect to the latter, he noted in a speech entitled Secular Stagnation, Hysteresis, and the Zero Lower Bound[3], "Ponder the fact that it used to require tens of millions of dollars to start a significant new venture, and significant new ventures today are seeded with hundreds of thousands of dollars. All of this means reduced demand for investment, with consequences for equilibrium levels of interest rates."

He also suggests that high wealth inequality is a major reason for the low growth. In the same speech, he noted that, "changes in the distribution of income, both between labour income and capital income and between those with more wealth and those with less, have operated to raise the propensity to save, as have increases in corporate-retained earnings."

The point here is that when wealth becomes concentrated in the hands of a small number of individuals, companies or countries, you get a glut of savings. The flipside of a savings glut is a shortage of demand, which means weak economic growth.

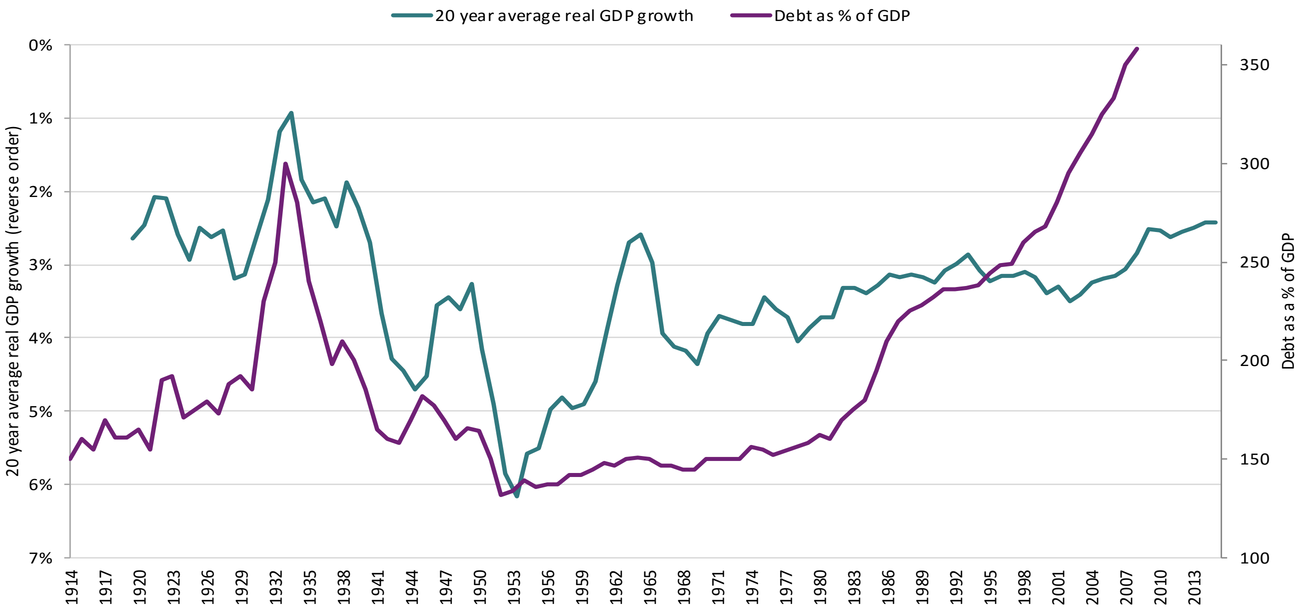
Economic growth relies on there being as many people, companies and governments willing to live beyond their means as there are those wanting to live within theirs. Right now, vast surpluses have been accumulated by an increasing number of billionaires[4], and companies such as Apple, Microsoft and Alphabet[5], as well as countries such as China, Germany, Japan and South Korea[6].

1 https://www.reference.com/history/common-causes-revolution-history-d022271ee8d15436
2 https://en.wikipedia.org/wiki/Guillotine
3 http://larrysummers.com/2014/06/23/nabe-speech-u-s-economic-prospects/
4 http://www.forbes.com/sites/timworstall/2014/10/30/oxfams-new-report-number-of-billionaires-has-doubled-since-the-crash/#551edd7dfbd5
5 http://www.usatoday.com/story/money/markets/2016/05/20/third-cash-owned-5-us-companies/84640704/
6 https://en.wikipedia.org/wiki/List_of_countries_by_current_account_balance

Turning to the empirical evidence linking wealth inequality with weak growth, it may be useful to look at the link between levels of indebtedness and economic growth. Arguably, it is more intuitive that high levels of indebtedness impede economic activity. At an individual level, the more debt you have, the less able you are to spend, and the less you spend, the less you contribute to economic growth.

This works at a country level too. As can be seen from the chart below, over the last one hundred years or so, there is a reasonably close inverse relationship between the level of debt to GDP in the US and the long-term (20 year) average of real GDP growth.

United States: The relationship between growth and debt

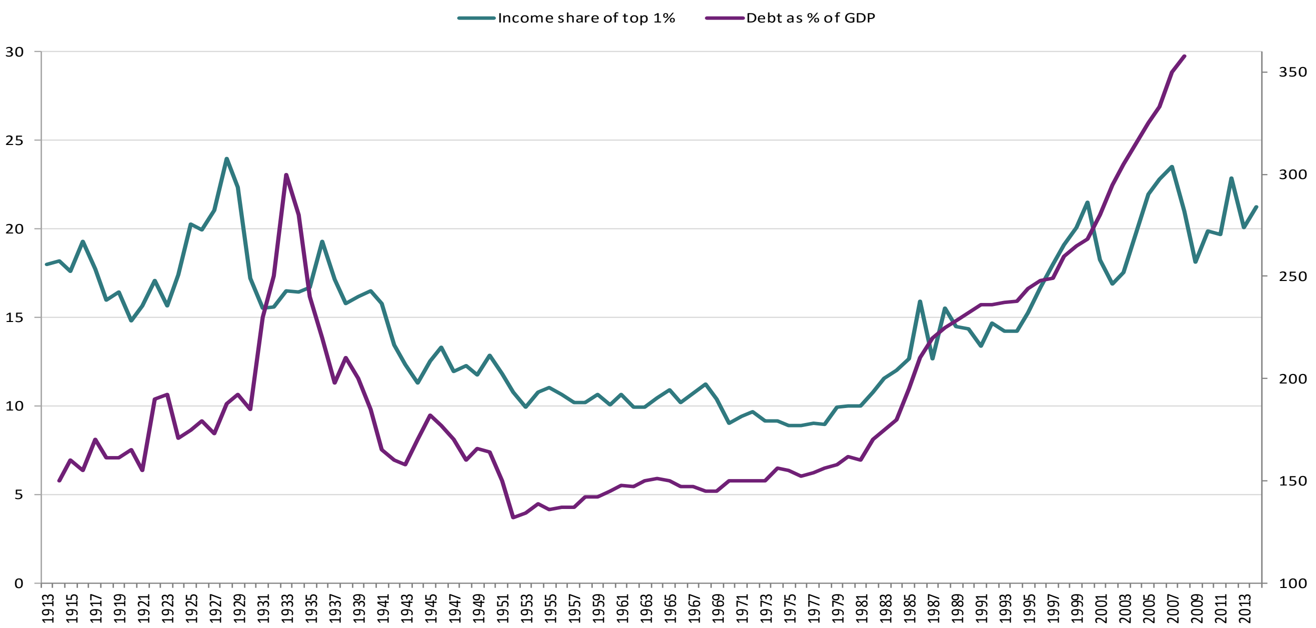


Source: Bureau of Economic Analysis, measuringworth.com et al

The rising level of debt to GDP in the 1920s seems to have preceded the very low growth experienced in the 1930s, while the sharp fall in the 30s and 40s appears to have enabled the higher growth of the 40s and 50s. Furthermore, the rise in debt to GDP seen since the 1970s has gone hand in hand with GDP growth falling from above 4% towards 2%.

The relationship between levels of indebtedness and wealth and income inequality is somewhat less intuitive but just as strongly supported by actual experience, as can be seen in the chart below.

United States: The relationship between debt and inequality



Source: Bureau of Economic Analysis, measuringworth.com et al
http://inequality.org/income-inequality/
http://www.economicnoise.com/total-us-debt-vs-gdp/

Together with the first chart, one does not need to be Sherlock Holmes to deduce that there is an empirical link between income inequality and growth.

For me, the best way to better understand issues like income and wealth inequality is to put them in the context of a system made up of two people, then make extreme assumptions (I remember in my younger days watching Warren Buffett do this to explain trade and it left a lasting impression.)

So, imagine an economic system (society) made up of two agents (people) named Thrifty (T) and Spendthrift (S). There are only five economic activities undertaken in their society: house building, farming, papermaking, ink manufacturing and fishing equipment making. However, T is the sole provider of all of them. He provides shelter (including roof repair services) and food to S, and in return receives IOUs (yes, using T's paper, T's ink and a quill made from a feather kindly donated by one of T's chickens).

Why S is so inactive could be for a number of reasons. It could be because T is so much better – more efficient – than S is at the aforementioned activities. It could be because T would rather hoard IOUs than buy from S. It could be because S is somewhat indolent, very tempting if you can just sign bits of paper then go fishing (yes, you got it).

Whatever the reasons for S's inactivity, the upshot is that T becomes very wealthy, having amassed piles of IOUs. Wealthy on paper that is. Literally.

As for S, he ends up heavily indebted. The wealth inequality could not be more extreme! The question is, what happens when T starts to wonder what his IOUs are worth?

He can't spend them because there is nothing to buy (S doesn't have anything to sell). Instead, he reduces his sales to S so he can reduce the rate at which he is amassing what he has realised are effectively worthless bits of paper. Reduced sales of course mean reduced production. And another word for 'reduced production' is 'recession'. Indeed, since the whole process of rebalancing this two agent economy - providing S with skills needed to start being productive – is such an involved one, it could even mean 'depression'.

In the real world, while there are pockets of economic egalitarianism such as Germany and Japan, there are many large countries, both developed and developing, that have seen wealth and income disparity rising at a fast pace in recent decades and reaching what may well be unsustainable levels. Furthermore, while a number of developing countries have been catching up with their developed counterparts in terms of GDP per capita, there are others that have gone backwards.

It is possible, however, that it is hard to reverse wealth and income inequality that has risen to unsustainable levels. History has taught us that while the free market system is not perfect, is has tended to produce stronger and more sustainable growth than in other systems. Allowing the abler and more enthusiastic members of society to get richer than others has on the whole lifted standards of living for the less able too.

But, there is a flaw.

If you acquire wealth, you are very likely to want to do anything within the law to increase your wealth further.

Indeed, why wouldn't you, either as a company or an individual, make political donations or employ lobbyists in the hope of for example encouraging favourable changes in tax codes? Oxfam head of research Ricardo Fuentes-Nieva, notes that the wealthy "get more resources to influence even more on how the tax code is modified, and thus lock the gains and protect the trend that mostly benefits them"[1].

Now, it can be argued that as long as quality of life is at least maintained for lower income groups, it doesn't really matter how high inequality rises. We live in a world in which the time it takes to make a billion is declining rapidly – I imagine it took Mark Zuckerberg a tenth of the time it did John D Rockefeller. As long as our quality of life is maintained, should we care how many billionaires there are on this planet?

Yes, we should. And not only because rising inequality means too much debt which leads to lower growth. Human nature is such that we care more about relative wealth than absolute wealth. It doesn't matter if our quality life is maintained if we see others doing better than us – also known as 'not keeping up with the Joneses'. This phenomenon has been observed in studies such as that by Prof Christian Elger and Prof Armin Falk at the University of Bonn.[2]

The dissatisfaction that results from feeling left behind economically is what is behind the rise in support for non-mainstream politicians such as Donald Trump, Jeremy Corbyn and Marine Le Pen. The so-called political elite would be well advised to start finding ways to reduce inequality.

The big question is, can they?

1 http://policy-practice.oxfam.org.uk/blog/2013/09/tax-rates-and-the-top-1-percent
2 http://www.telegraph.co.uk/news/science/science-news/3315638/Relative-wealth-makes-you-happier.html

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 30 September 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 (8.0)	11.0 (11.0)	10.0 (10.0)
	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 (44.0)**	**64.0 (64.0)**	**64.0 (64.0)**
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	**4.4** (5.4)	**4.4** (5.4)	**5.5** (5.6)
	Private equity	**4.0** (3.0)	**4.5** (3.8)	**5.3** (5.2)
	Specialist financial	9.7 (9.7)	**10.7** (10.5)	10.9 (10.9)
	Infrastructure	4.9 (4.9)	**4.4** (4.3)	5.3 (5.3)
	Specialist Subtotal	**23.0 (23.0)**	**24.0 (24.0)**	**27.0 (27.0)**
Cash		2.0 (2.0)	2.0 (2.0)	2.0 (2.0)
Total		**100.0**	**100.0**	**100.0**

Source: Seneca Investment Managers, 30 September 2016

Increased ***Decreased***

* 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.

- No changes to top down target asset allocation in September
- Funds remain overweight equities and underweight safe haven bonds, in the belief we are generally at the point in the business cycle when inflation rises (bad for bonds) but employment continues to rise (good for equities)
- SDGF's holding in the Bellevue African Opportunities Fund was sold, with the proceeds being allocated to existing holding Somerset Emerging Markets Dividend Growth Fund; this change was last within overseas equities that related to the restructuring of the fund away from specialised funds towards more general funds
- GCP Student Living was sold from both SDIF and SDGF on the basis that share price strength had pushed down the yield to less attractive levels; proceeds were allocated to Aberdeen Private Equity Fund

- In UK Equities it was decided to sell Ashmore and move the proceeds into Ultra Electronics; Ashmore had risen 75% from its January low and as a result its valuation had become unattractive while Ultra Electronics, already held in SDGF, was generating a dividend yield that made it appropriate for SDIF and SIGT
- Towards the end of the month, our UK Equity specialist Mark recommended the purchase of Phoenix Group, already held elsewhere, for SDGF, believing that the Abbey Life deal was transformational and leaves the shares undervalued.
- Units of the iShares UK Dividend ETF were sold to finance the purchase