SENECA
INVESTMENT MANAGERS

Peter Elston: Investment Letter

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This document is intended for professional investors only

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The most interesting question in the world?

Here's an interesting question: do the low or negative long-term real interest rates that prevail around the world signify a bleak economic outlook or are they what is required to stimulate spending and investment, and thus a bright economic outlook?

Both theories are supported by their own coherent reasoning. And yet one of them must be wrong. You cannot have both a bright and a bleak outlook.

Which is correct?

The argument in favour of the suggestion that (low) long-term real bond yields reflect (poor) long-term economic growth prospects is simple. As an economic agent, one has a choice; one can either invest in financial assets, the benchmark of which is a riskless bond, or in the economy via real assets that will provide a return commensurate with broad long-term GDP growth. Theory says that both should track each other. If economic growth falls, bonds become relatively more attractive. As investors buy them, their prices rise and their yields fall, thus redressing the balance.

There are a number of commentators, some more respectable than others, who believe we are about to enter an economic ice age. In other words, they believe that current low or negative real yields do indeed portend a bleak future.

Or do they?

Economic theory also says that the long-term interest rate is the rate required to keep saving and investment in balance. If you want to live within your means i.e. save, you need there to be someone, somewhere in the world, who wants to live beyond his i.e. invest. Oscar Wilde had great disdain for the former, saying "anyone who lives within their means suffers from a lack of imagination." While one may not like Donald Trump, he and like-minded individuals who over the centuries have persuaded banks to lend them vast sums should be thanked for helping to boost economic activity and thus prop up savings rates.

It must be infuriating for many that their savings accounts are not yielding much (anything!) at the moment (even more infuriating for those who take inflation into account and realise that their savings are being eroded in real terms). However, these low yields reflect an abundance of those wishing to save and a dearth of those wishing to invest. The best way for savers to get better yields on their savings accounts would be to stop saving and start investing. This would boost the economy, and force central banks to put up interest rates!

The situation is not helped by governments that are worrying about their balance sheets when the clear message from bond markets is that they needn't. Furthermore, large swaths of sovereign bonds are owned by central banks, and arguably should not be included in debt-to-GDP calculations.

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Multi-Asset Value Investing

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Governments should instead be taking advantage of the low or negative long-term interest rates. As renowned economist Paul Samuelson famously observed, at a permanently zero or subzero real interest rate, it would make sense to invest any amount to level a hill for the resulting saving in transportation costs.[1]

To be fair, there are tentative signs that the UK government is getting the message. In 2013 the Treasury issued a 65-year linker with a coupon of 0.125%, receiving a price at auction of 99.37% of par. In March of this year it issued a new tranche of £350 million at a price of 184%. The bonds are currently trading at 249%!

If the proceeds are spent on useful (or even useless!) public works projects, the benefits will be clear. First, there is a multiplier effect attached to public works spending that will boost economic activity well beyond the value of the projects themselves. Second, there will be a boost to private sector confidence. If companies and households see the government stepping in to support the economy, they should themselves be encouraged to invest.

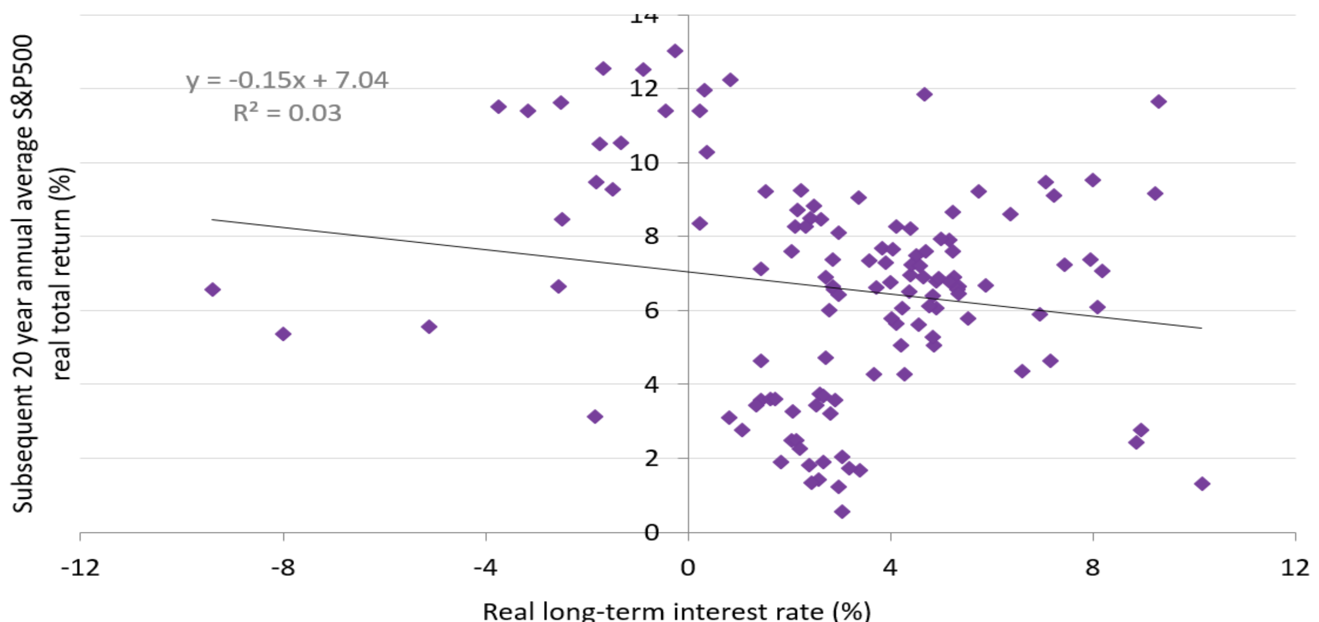
However, it seems to have taken interest rates falling to where they did for the government to have woken from its slumber. In other words, low interest rates are what has been required to stimulate spending and investment and thus secure a rosier outlook.

While both theories about the relationship between growth and interest rates can be argued logically, the debate can be decided once and for all by looking at real world experience. If prevailing real interest rates reflect future economic prospects, there should be a strong and positive statistical correlation between real interest rates and equity returns.

There isn't.

Regressing forward 20-year real total US equity market returns against prevailing US real bond yields, one finds no correlation at all. In fact, if anything, the correlation is very slightly negative (see chart). This is exactly what one should expect if bond yields tend to do whatever they need to in order to keep growth going.

Chart: The relationship between bond yields and equity returns



Source: Bloomberg, Seneca IM

The implications of this are far reaching. First, one perhaps needn't be as bearish about the longer term prospects for equity markets as safe haven bond yields suggest one should be. Second, one needn't be so worried about companies with large pension fund deficits if they are using Gilt yields to discount liabilities, as is common practice. After all, why should a pension fund's equity holdings be expected to grow in real terms in line with the current long-term real Gilt yield of -1.6% if there is no evidence that they should?

That's also an interesting question.

1 http://larrysummers.com/2015/04/01/on-secular-stagnation-a-response-to-bernanke/

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 October 2016 (prior month's targets in brackets)

TAA target Weights (%) (prior month's targets in brackets)		OEICs		Investment Trust
		CF Seneca Diversified Income Fund (SDIF)	CF Seneca Diversified Growth Fund (SDGF)	Seneca Global Income & Growth Trust plc (SIGT)
Equities	UK	25.5 (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	**43.0 (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	**5.4** (4.4)	**5.4** (4.4)	**5.6** (5.5)
	Private equity	4.0 (4.0)	4.5 (4.5)	5.3 (5.3)
	Specialist financial	**8.7** (9.7)	**9.7** (10.7)	**10.8** (10.9)
	Infrastructure	4.9 (4.9)	4.4 (4.4)	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, 31 October 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.

- Funds remain overweight equities in relation to strategic asset allocation in the belief that global credit cycle has further to run as well as valuations that remain below historic peaks
- Tentative signs of economic growth stabilising or picking up, both in developed and developing countries

SDIF

- Reduction in UK Equities target for the income fund related to reconciliation with actual position rather than a change of view
- The position in Liontrust Asian Equity Income Fund was sold and switched into Aberdeen Asian Equity Income Fund, a closed end fund trading on a discount to net asset value
- Pictet Emerging Currency Debt Fund was sold and reinvested into the existing holding in Templeton Emerging Markets Bond Fund, which offers a higher yield
- The position in LondonMetric Property, a UK listed REIT, was increased following price weakness post the Brexit vote; we believe the active property management approach pursued by the manager remains attractive and is likely to add value in a more difficult market environment
- The holding in SQN Asset Finance Income Fund was reduced due to our concerns over the quality of certain assets held and with the shares trading on a premium to net asset value

SDGF

- Oxford Instruments exited – balance sheet is manageable, but more levered than desirable in post Brexit world with limited forward order visibility
- Increased weighting to Twenty Four Monthly Select Income at a discount to NAV and reduced Royal London Short Duration Bond Fund. Potential for stronger absolute returns from former, given dislocation in credit markets, post Brexit, and defensive nature of short duration strategy.
- SQN Asset Finance Income Fund was significantly reduced, due to our concerns over the quality of certain assets held within its portfolio and because the shares trade at a substantial premium to NAV

SGIT

- Several UK equity mid-cap holdings were ‘topped-up’ including International Personal Finance, Senior, Ultra Electronics and Britvic
- The position in Liontrust European Enhanced Income Fund was increased to maintain exposure to European equities
- Japanese equity exposure was reduced via a top slicing of the Goodhart Michinori Japan Equity Fund; the fund had returned over 30% over the past year
- Some switching was carried out within Asian equity fund holdings to consolidate positions
- Property exposure was increased, primarily by adding to the position in LondonMetric Property, a UK listed REIT, where the manager’s active approach to property management will, we believe, add value in more difficult market environments
- The holding in SQN Asset Finance Income Fund was reduced due to our concerns over the quality of certain assets held as well as the shares’ premium to net asset value

Important Information

Past performance is not a guide to future returns. The information in this document is as at 31.10.2016 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 may not be linked to share price performance, and shareholders could 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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