Peter Elston: Investment Letter

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This document is intended for professional investors only

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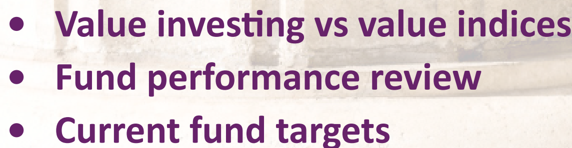

Value investing is not the same thing as value indices

I'm thinking about launching a smart beta ETF called the "Smart Alpha Smart Beta ETF". It would invest only in shares that go up. At the end of every month, the fund would be rebalanced into those shares that will go up the following month. "How do you pick the shares?", I will no doubt be asked. "I don't, the ETF will track an index of shares that go up". "Ah, I see" may be the response, perhaps followed by "Sounds good. Where can I buy?"

There seem to be so many ways of systematically slicing and dicing markets nowadays in an attempt to beat them that I'm sure my idea might get some way before I was rumbled.

The first attempt to set out a framework for picking good-performers was that of Benjamin Graham and David Dodd in the 1930s. They never called it 'value investing' though that is what it later came to be known as. Many investors have since put their own slant on it, to the extent that now it is more a principle than a framework - the principle being that if you buy things that are cheap you have a better chance of beating the market and thus making good money.

The question of course is how you assess the cheapness of a stock.

For Graham and Dodd it was about calculating the intrinsic value of a company, then buying those whose market capitalisation was well below their intrinsic value. It took their bible, Security Analysis, 700 pages to explain how to do this.

In 1992, Eugene Fama and Kenneth French wrote a seminal paper entitled "The Cross Section of Expected Stock Returns". They found that a stock's market capitalisation and price-to-book ratio tended to determine its price performance over subsequent periods (smaller and cheaper stocks often did better than larger and pricier ones).

They called these two factors 'size' and 'value', with the latter quickly coming to be associated with Graham and Dodd's 'value investing'. Indeed, index providers such as MSCI and S&P subsequently constructed indices based on 'size' and 'value' – and others such as volatility, high dividend yield, quality and momentum. According to MSCI, it created 'seven factor indexes based on these six factors (with two indexes for Low Volatility: the Minimum Volatility index and the Risk Weighted index).'

As with Fama and French, indices based on 'value' have also become associated with Graham and Dodd, and it would appear there are now many who think they are the same thing.

They are not.

While stocks identified using Graham and Dodd's framework or a variant thereof may well have low price-to-book ratios – or low price in relation to the various other metrics that value factor indices also seek to capture such as earnings, sales, cash earnings, net profit, dividends, and cash flow – there is a lot more to 'value investing' than a few simple calculations.

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It is the difference between on the one hand a system of analysis that took 700 pages to set out and on the other a few simple calculations that would take a couple of minutes to perform. In other words, the difference is a big one.

Put simply, there are stocks that might look cheap but which in reality are not. A stock may have a low price to book ratio but it may deserve to have a low price to book ratio. Such stocks are known in the trade as 'value traps', and they should be avoided.

How?

By considering in detail all sorts of other aspects that drive a company's longer-term performance, such as industry trends, barriers to entry, balance sheet strength, free cash flow, to name just a few.

In a later edition of Benjamin Graham's second classic, The Intelligent Investor, first published in 1949, Graham noted that IBM was a wonderful investment opportunity. "Smart investors", he wrote, "would long ago have recognised the great growth possibilities of IBM", but "the combination of [IBM's] high price and the impossibility of being certain about its rate of growth prevented [investment funds] from having more than, say, 3 per cent of their funds in this wonderful performer".

There are two key things that one can learn from this.

First, a value stock does not have to be cheap in absolute terms. IBM wasn't, and Graham even uses the term 'growth possibility' to describe it – but 'growth' is supposed to be the antithesis of 'value'! I hear you say. Second, even smart investors can be too timid when it comes to portfolio concentration – 3 per cent can hardly be called 'high conviction'.

At Seneca, we are value investors, but we are not scared of buying stocks that are not cheap in absolute terms. We consider various other factors such as balance sheet strength, return on capital, and industry trends, and if we determine that a stock is cheaper than it should be – in other words, has a dividend yield that is higher than we think it should be – that is good enough for us. Nor are we scared of being high conviction – we only hold around 20 stocks in the UK equity portion of our portfolios.

As a pure multi-asset fund manager, we are trying to add value to our portfolios not just in UK equities, but also in overseas equities, fixed income, specialist assets and indeed tactical asset allocation. We do this by taking the central principle of 'value investing' – buying things cheaply – and applying it to these other areas. We call this 'Multi-Asset Value Investing' and I will be writing about it in more detail in later blog posts.

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Fund performance review

The table below sets out our fund performance as well as that of comparators during periods ending 7 December.

	6m TR	1y TR	3y TR	5y TR	FE Risk Score
CF Seneca Diversified Income	5.7	8.1	18.0	43.9	43
IA Mixed Investment 20-60% Shares	5.9	7.9	16.1	35.0	49*
Vanguard LifeStrategy 40% Equity	6.6	11.6	25.3	45.2	42
CF Seneca Diversified Growth	8.0	7.7	18.2	47.0	58
IA Mixed Investment 40-85% Shares	8.1	9.9	20.5	47.7	65*
Vanguard LifeStrategy 60% Equity	9.8	15.0	29.9	57.2	59
Seneca Global Income & Growth Trust (NAV TR)	6.7	11.6	25.2	63.8	n/a
Global Equity Income (NAV TR)*	12.6	20.7	26.6	66.9	n/a
Flexible Investment (NAV TR)*	8.8	11.1	18.3	30.0	n/a
IA Mixed Investment 40-85% Shares	8.1	9.9	20.5	47.7	65*
Vanguard LifeStrategy 60% Equity	9.8	15.0	29.9	57.2	59
Seneca Global Income & Growth Trust (Price TR)	9.8	15.0	33.4	85.3	43
Global Equity Income (Price TR)	14.8	21.0	27.8	77.3	98*
Flexible Investment (Price TR)	10.8	12.9	19.9	28.1	71*

*median

Source: FE Trustnet. Price total return performance figures are calculated on a bid price to bid price basis (mid to mid for OEICs) with net income (dividends) reinvested. Performance figures are shown in Sterling. FE risk score is calculated on a three year total return basis.

In summary, we think investors should be pleased with our fund performance, though the longer term numbers for our growth fund still have room to improve. Readers will recall that it took a little while to align the growth fund with our multi-asset value-investing style, and this was completed in September this year.

There are four things that differentiate all three of our funds.

- First, we have a mid-cap focus with UK equities (mid-caps tend to outperform large-caps over time and there is less research coverage so there are more stock picking opportunities).
- Second, we do not hold any safe haven bonds (with low or negative real yields they are very expensive).
- Third, our funds we think have less foreign exchange exposure than many of our peers (FX exposure adds a lot in the way of volatility but little in the way of return over time, so is not a risk that we believe our investors should be exposed to).
- Fourth, around a quarter of each of our funds is invested in what we call 'specialist assets', much more than many of our peers (these are generally London-listed investment trusts specialising in areas such as property, asset leasing, infrastructure and direct lending many of which offer high yields with stable, index-linked income streams and thus add something of real value to the portfolios).

We have great confidence in the logic of these positions and believe they will enhance returns over the longer term. The first three of them however worked against us this year (mid-caps underperformed large-caps, sterling fell, and safe haven bonds became even more expensive) and in light of this we are pleased that we kept up to the extent that we did. Over one year, the income fund is ahead of its peer group average, the IA Mixed Investment 20-60% Shares sector. As for the trust, it is also over one year ahead of its more appropriate peer averages, the Flexible Investment sector and the IA Mixed Investment 40-85% Shares sector (formally, the trust sits in the Global Equity Income sector in which it gets compared to pure equity funds). The growth fund had a tricky first quarter, due to some remaining legacy holdings, and so is behind its peer group over one year.

Five year numbers however look excellent for all our funds, particularly when one considers FE Risk Scores of funds and their sectors (for example, our growth fund's performance is bang in line with its sector average but its FE Risk Score of 58 is much lower than the sector median score of 65.

Finally, I have included the relevant Vanguard LifeStrategy fund as a comparator for each of our funds. The passive option is one that we are very aware our investors have, and we think that the Vanguard funds are probably the most popular of these. Over five years, our investment trust and income fund stack up well against their relevant Vanguard fund, with the growth fund a little behind.

As an investor in the Vanguard funds, I would be very concerned about their high exposure to expensive investment grade bonds in what we think will be an environment of rising inflation and rising real interest rates, as well as the high FX risk (sterling is now cheap on a real effective exchange rate basis and thus may well appreciate rather than continue to depreciate). With our additional competitive edges in relation to mid-caps and specialist assets, we very much look forward to the next five years.

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 November 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** (25.5)	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 (43.0)**	**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	**25.0** (26.0)	8.0 (8.0)	5.5 (5.5)
	Fixed income Subtotal	**30.0 (31.0)**	**10.0 (10.0)**	**7.0 (7.0)**
Specialist assets*	Property	5.4 (5.4)	5.4 (5.4)	5.6 (5.6)
	Private equity	4.0 (4.0)	4.5 (4.5)	5.3 (5.3)
	Specialist financial	9.7 (9.7)	9.7 (9.7)	10.8 (10.8)
	Infrastructure	4.9 (4.9)	4.4 (4.4)	5.3 (5.3)
	Specialist Subtotal	**24.0 (24.0)**	**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 November 2016

* 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.

Increased ***Decreased***

SDIF

- UK equities target increased by 1% to realign with other funds
- This increase came out of fixed income, where target was reduced from 31% to 30%
- UK mid-caps resumed their post-Brexit recovery in relation to large caps, following a pause in late-September and October
- Profit was taken on Kier Group, Intermediate Capital and Legal & General following good rallies from their post Brexit lows
- Position in TwentyFour Dynamic Bond Fund was top sliced due to the reduced tactical asset allocation to fixed income
- New investment in Civitas Social Housing. Company floated mid- November to provide a pure-play on Social Housing by acquiring fully occupied residential property portfolios from housing associations and local authorities. The company is targeting a yield of 5% from quasi-government backed cash flows, which are index-linked
- Funding for the Civitas purchase was largely provided by the sale of GCP Student Living, which had been a good investment but where the yield of just under 4% was, we felt, now offering less value

SDGF

- No asset allocation target changes during the month
- UK mid-caps resumed their post-Brexit recovery in relation to large caps, following a pause in late-September and October
- The US dollar was strong on the back of expectations that Trump government would boost growth and thus increase need for interest rate hikes
- Sterling also recovered somewhat, following four months of weakness
- Inflation expectations and bond yields continued to rise
- New position in One Savings Bank (OSB), a specialist mortgage lender to predominantly professional buy-to-let landlords. OSB is a high return on equity business, on a depressed valuation, with a healthy dividend yield, well covered by earnings
- New investment in Civitas Social Housing. Company floated mid- November to provide a pure-play on Social Housing by acquiring fully occupied residential property portfolios from housing associations and local authorities. Company is targeting a yield of 5% from quasi-government backed cash flows, which are index-linked

SIGT

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- Inflation expectations and bond yields continued to rise
- New position in One Savings Bank (OSB), a specialist mortgage lender to predominantly professional buy-to-let landlords. OSB is a high return on equity business, on a depressed valuation, with a healthy dividend yield, well covered by earnings
- IShares FTSE UK Dividend Plus ETF sold to finance OSB purchase
- New investment in Civitas Social Housing. Company floated mid- November to provide a pure-play on Social Housing by acquiring fully occupied residential property portfolios from housing associations and local authorities. Company is targeting a yield of 5% from quasi-government backed cash flows, which are index-linked
- Funding for this purchase was largely provided by the sale of GCP Student Living, which had been a good investment but where the yield of just under 4% was, we felt, now offering less value
- Overseas equity fund consolidation continued with sales of Schroder Oriental Income being used to increase the existing holding in Aberdeen Asian Equity Income, which was bought on a discount to NAV

Important Information

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