SENECA
INVESTMENT MANAGERS

Peter Elston: Investment Letter

Issue 8: December 2015

This document is intended for professional investors only

Data as at 30.11.2015

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As we approach Christmas, this month's letter will be a little shorter and thus I hope easier to digest, at least than the average Christmas feast! Furthermore, since January's letter will include my market outlook for 2016, I thought that this issue should look back at 2015, particularly with respect to how our three public funds have performed. Of course the year is not over yet and anything (or nothing!) can still happen in the weeks remaining, but at least as far as our peer group standings are concerned there should not be much change between now and the end of the month.

A review of 2015

In what was a fairly trendless and thus tricky year for markets, our three funds performed well in both absolute terms and relative to their respective peer groups in the calendar year to 4 December. Given our strategic asset allocations, our expected long term real returns for each asset class, our fund costs and the value added we expect to generate from tactical asset allocation, stock selection and fund selection, we would hope over the longer term to achieve a real return of around 5% per annum for the CF Seneca Diversified Income Fund and 6% for both the CF Seneca Diversified Growth Fund and Seneca Global Income & Growth Trust.

In the 49 weeks so far, we have achieved, in nominal terms, 4.9%, 5.6% and 7.2% for the income fund, the growth fund and the trust respectively. Given that the UK consumer price index rose just 0.2% in the ten months to October, this means that the performance of our funds in real terms has either been very close to or exceeded our long-term return expectations. Furthermore, the three funds have performed considerably better than their respective peer group average (see table 1 over the page).

It should be noted that in the case of the investment trust and its peer group, the performance and volatility numbers are based on total shareholder return, a measure of net asset value including dividends rather than share price including dividends. Also, the volatility number is the volatility of daily total returns which is then annualised. Finally, I have also included for comparison purposes four other IA sectors that may include multi-asset funds and thus which should be considered relevant.

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Table 1: Total return and volatility statistics

	Year to date total return (%)	Annualised volatility (%)
MSCI UK	-2.2	17.1
CF Seneca Diversified Income Fund	***4.9***	***4.3***
IA 20-60% Shares sector	1.3	6.4
CF Seneca Diversified Growth Fund	***5.6***	***6.5***
IA 40-85% Shares sector	2.3	9.1
Seneca Global Income & Growth Trust plc	***7.2***	***8.8***
AIC Global Equity Income sector	1.8	13.6
IA 0-35% Shares sector	0.6	4.5
IA Absolute Return sector	1.3	6.1
IA Unclassified sector	1.5	11.5
IA Flexible sector	1.8	10.8

Source: Bloomberg

What is also pleasing is that our funds' volatility has been considerably lower than that of the respective peer group.

The primary reason for our good performance has been our exposure to UK mid-caps. All our funds invest directly in the UK, which not only helps to keep our costs down but by focussing on the mid-cap space exposes us to better idiosyncratic and systematic returns than would be the case with large-caps. Research coverage is thinner among mid-caps so the opportunities to find under-valued situations are more prevalent. Furthermore, we would expect mid-caps to continue to outperform large caps over time – since March 1995, mid-caps have outperformed large-caps by 131% (4.1% per annum) and have outperformed in 72% of rolling 12 month periods.

Within overseas equities our biggest tactical position is a 5 percentage point overweight (in all three funds) in Europe ex UK which was worked largely because the majority of the exposure has been in currency hedged funds. At the end of 2014 we felt that the likely direction of monetary policy would be positive for equity markets but negative for the Euro which indeed has been the case. As for fixed interest, we maintained our zero position in G7 government bonds. This position detracted in 2014 but has started to work in 2015. The DB Global Government Hedged GBP index has returned 1.4% this year and although this is still the right side of zero, it is less than previous years and also less than other areas of the fixed interest market we have been exposed to such as high yield.

Our fourth asset class is what we call 'alternatives' where we invest in specialist funds such as renewable energy, asset leasing, REITs, private equity, loans and reinsurance (note that we do not invest in hedge funds, structured products or tangible assets such as precious metals, art, coins and stamps). Our REITs have performed particularly well this year, with Assura, GCP Student Living, LondonMetric and Tritax Big Box all posting double digit returns. We think 'alternatives', which is well represented in all our funds' strategic asset allocations, is an area that will continue to enhance both the return and risk characteristics of our funds.

Finally, as a result of the good performance in 2015, our 3 and 5-year quartile rankings have improved. These are of course the periods on which we should ultimately be judged (see table 2 below).

Table 2: Annualised returns

	1 year annualised (%)	3 years annualised (%)	5 years annualised (%)
CF Seneca Diversified Income Fund	3.9	6.5	5.0
Quartile position	1st	2nd	3rd
CF Seneca Diversified Growth Fund	4.8	7.5	5.9
Quartile position	1st	3rd	3rd
Seneca Global Income & Growth Trust plc	9.5	13.9	9.0
Quartile position	1st	1st	1st

Source: Morningstar

Inflation watch

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

Inflation data releases over past month

Country	Series	Period	YOY%	Versus			Overall
				Survey	Prior	Desired	
Europe	PPI	Sep	-3.1	↑	↓	↓	↓↓
Germany	CPI	Oct	0.3	⇔	⇔	↓	↓
Germany	CPI (EU harmonised)	Oct	0.2	⇔	⇔	↓	↓
France	CPI (EU harmonised)	Oct	0.2	↑	↑	↓	↑
France	CPI	Oct	0.1	⇔	↑	↓	⇔
US	PPI Final Demand	Oct	-1.6	↓	↓	↓	↓↓↓
US	PPI ex Food & Energy	Oct	0.1	↓	↓	↓	↓↓↓
Europe	CPI	Oct	0.1	↑	↑	↓	↑
UK	CPI Core	Oct	1.1	↑	↑	↓	↑
UK	PPI Output Core	Oct	0.3	↓	↑	↓	↓
US	CPI ex Food & Energy	Oct	1.9	⇔	⇔	⇔	⇔
Germany	PPI	Oct	-2.3	↓	↓	↓	↓↓↓
US	PCE Deflator	Oct	0.2	↓	⇔	↓	↓↓
US	PCE Core	Oct	1.3	↓	⇔	↓	↓↓
Japan	Nat'l CPI ex Food & Energy	Oct	0.7	↓	↓	↓	↓↓↓
Germany	CPI	Nov	0.4	⇔	↑	↓	⇔
Germany	CPI (EU harmonised)	Nov	0.3	⇔	↑	↓	⇔
Europe	PPI	Oct	-3.1	↑	⇔	↓	⇔
Europe	CPI Estimate	Nov	0.1	↓	⇔	↓	↓↓
China	CPI	Oct	1.3	↓	↓	↓	↓↓↓
China	PPI	Oct	-5.9	⇔	⇔	↓	↓

Source: Bloomberg

What is particularly notable about the table above is that inflation almost everywhere is lower than desired. The only place where inflation is close to where the central bank would like it is the US, where CPI ex Food & Energy is running at 1.9%. Even so, other measures in the US are weak. For example, the PPI ex Food and Energy index at the end of October was only 0.1% higher than a year earlier.

It is also notable that in general, inflation data around the world are still coming in lower than expected and also lower than the previous month. In such an environment one would have thought that despite the talk to the contrary there is still a decent chance that the Fed will hold off raising rates at its December meeting.

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.

Employment data releases over past month

Country	Series	Period	%	Versus			Overall
				Survey	Prior	Desired	
Japan	Jobless Rate	Sep	3.4	↔	↔	↑	↑
US	Unemployment Rate	Oct	5.0	↔	↓	↑	↔
US	Underemployment Rate	Oct	9.8	↓	↓	↑	↓
Japan	Jobless Rate	Oct	3.1	↓	↓	↑	↓
Germany	Unemployment Claims Rate	Nov	6.3	↓	↓	↑	↓
Europe	Unemployment Rate	Oct	10.7	↓	↓	↑	↓
US	Unemployment Rate	Nov	5.0	↔	↔	↑	↑

Source: Bloomberg

Unemployment continued to fall across the developed world but in all cases remains about what should be considered full employment. I am reassured by these trends. If we started to see unemployment rising across the globe, this would be indicative of economic growth stalling and perhaps the proverbial 'canary in the coalmine' with respect to a looming global recession. Employment conditions continuing to improve with inflation pressures remaining benign or weak should be conducive for equity markets.

Captain Murphy's diary

Murphy's Law says that what can go wrong, will go wrong. It is thought to be named after Captain Ed Murphy, an aircraft engineer who, frustrated with the work of an incompetent colleague, is alleged to have remarked, "If there is any way to do it wrong, he will." This section is dedicated to combing the financial markets for risks that are lurking out there, preparing to pounce.

I've always enjoyed reading Financial Times columnist Martin Wolf's articles. His approach to economics often focusses on the balance between savings and investment and how that balance helps explain such things as growth and the level of interest rates. If there are more companies and individuals who want to save than want to invest then it follows that real interest rates must fall to a level that encourages more investment and less saving.

Wolf's latest piece (Corporate surpluses are contributing to the savings glut, November 17th) is about the excess of savings in corporate sectors around the world – particularly those in developed countries - and how this is impacting interest rates and growth. Wolf points out that the imbalance is as much about a lack of investment as it is about too much saving. Is this imbalance temporary or is it structural and thus perhaps something to be more deeply concerned about?

Oscar Wilde said that "people who live within their means lack imagination". I doubt that he meant it in relation to economic systems but nevertheless its relevance in this regard is rather neat. The fact is that if everyone on the planet wanted to live within their means the global economy would collapse. Economic growth relies on people or businesses who are prepared to take risks and spend more than they earn. If you want to live within your means – meaning that you want to spend *less* than you earn – there needs to be someone else doing the opposite. It is a mathematical identity or truism that in aggregate spending must equal income, savings must equal investment. Those who live beyond their means (borrowing to fund ideas and dreams) should be applauded; it is their risk taking that drives growth.

As to why corporate investment is weak, Wolf puts forward three reasons. First, demographics; if societies are aging and population growth falling, there is less need for corporate investment to grow capacity. Second, globalisation has meant relocation of investment from high-income developed countries to lower-income developing countries. And third, technological innovation. As Wolf points out, “much innovation seems to reduce the need for capital: consider the substitution of warehouses for retail stores”.

I wonder if the internet isn’t almost single-handedly to blame. True, computers changed our lives, but for me it is the internet that has transformed them. It has been a hugely deflationary force, with high street shops being replaced with online shops and people now able to organise things themselves rather than having to engage and thus pay an intermediary, travel being a good example.

Will the global economy find ways to employ the excess capital and labour that now exists? Almost certainly. It has for the last several thousand years without too much trouble. It’s just it’s never had to do it this quickly.

Current fund targets as at 7th Dec 2015 (previous month’s targets in brackets)

The targets in the table below are where our 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.

Target Weights (%) (previous month in brackets)		OEICs		Investment Trust
		CF Seneca Diversified Income Fund	CF Seneca Diversified Growth Fund	Seneca Global Income & Growth Trust plc
Equities	UK	23.5 (23.5)	21.0 (21.0)	30.0 (28.0)
	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 (0.0)	8.0 (8.0)	4.5 (4.5)
	Asia Pacific ex Japan	5.0 (5.0)	10.0 (10.0)	9.0 (9.0)
	Emerging Markets	1.0 (1.2)	4.5 (4.5)	3.0 (3.0)
	Global Funds	1.5 (2.3)	1.5 (1.5)	1.0 (1.0)
	Equities Subtotal	42.0 (42.0)	62.0 (62.0)	62.0 (60.0)
Fixed Interest	DM Government	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
	EM Debt	5.1 (5.1)	2.0 (2.0)	0.0 (0.0)
	Corporate	25.9 (25.9)	10.0 (10.0)	7.6 (11.0)
	Fixed Interest Subtotal	31.0 (31.0)	12.0 (12.0)	7.6 (11.0)
Alternatives	Property	6.9 (8.2)	5.0 (5.0)	7.4 (8.9)
	Private Equity	2.9 (2.9)	2.9 (2.9)	5.7 (5.7)
	Specialist Financial	10.2 (10.2)	13.2 (12.7)	10.6 (8.6)
	Infrastructure	5.2 (4.7)	3.9 (2.9)	4.7 (4.8)
	Commodities	0.0 (0.0)	0.0 (1.5)	0.0 (0.0)
	Alternatives Subtotal	25.2 (26.0)	25.0 (25.0)	28.4 (28.0)
Cash		1.8 (1.0)	1.0 (1.0)	2.0 (1.0)
Total		100.0	100.0	100.0

- Very little change to tactical asset allocation in November.
- SIGT's total equity target was increased to 62% to bring the trust in line with the two OEICs i.e. 2 percentage point overweight.
- This was effected through an increase in UK equity target from 28% to 30% which also brings the trust more in line with the two OEICs in terms of the position relative to strategic asset allocation.
- At a holding level in the UK we added Senior plc to both the growth fund and SIGT. The company is a "build-to-print" manufacturer of high technology components and systems for original equipment producers, principally in aerospace, defence, land vehicles and energy markets. The stock offers a 2.8% dividend yield for CY2015 which is 3.1 times covered. Return on equity is a respectable 18%.
- In Japan we added the Coupland Cardiff Japan Income & Growth Trust to all three funds – this is an IPO and a closed ended version of Coupland Cardiff's successful open ended version. We like the value oriented approach of the manager and the fact that the trust is hoping to achieve a 3% yield, unusual for a Japanese equity fund.
- In the growth fund we reduced the holding in iShares Gold Producers ETF. This followed it being reclassified from 'alternatives' to 'overseas equities' as well as a more general move away from passives on our part.
- In 'alternatives' we reduced the target weight in Tritax Big Box. The distribution and logistics property specialist has performed extremely well and as a result its yield has fallen to the point where better opportunities exist elsewhere in the REITs sector.
- As far as broad asset class views are concerned there has been little if any change.
- Equity market yields generally remain above their historical averages and thus offer reasonable value.
- Within fixed interest, developed market sovereigns remain overvalued, with real yields that are either low or negative.
- Both the above views are predicated on the belief that monetary and fiscal policies in large or developed countries will continue to prevent economies from slipping into recession. Recession on a global scale would of course be negative for equities and positive for save haven bonds.

Important Information

Past performance is not a guide to future returns. The information in this document is as at 30.11.2015 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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