Peter Elston: Investment Letter

Issue 40: September 2018

This document is intended for professional investors only

- Our valuation methodology as applied to US equities
- Macro and markets monthly
- Current fund targets

Our valuation methodology as applied to US equities

In June, we moved to a zero weight in US equities across all our funds. This is obviously a very high conviction position given that the US accounts for more than one third of total global equity market capitalisation. However, it has caused our funds to slip a bit in the peer group rankings in recent months, given the substantial outperformance of US equities since the end of April.

I make no apologies for being high conviction – over time, this is really the only thing that can produce alpha for our customers well in excess of costs. That said, I thought it would be worth reminding readers of our reasons for holding no US stocks.

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Multi-Asset Value Investing

We are value investors so, to put it simply, we think US equities are considerably overvalued. At some point in the months and years ahead we expect the US equity market to be well below where it is today. This does not of course mean it will not continue to go higher in the short term but as value investors we refuse to participate in what we now see as speculative (late cycle) moves higher. Our promise to our investors is that we will remain rational, committed and patient.

So, how do we value the US equity market? Our methodology is simple, but then 'keeping it simple' is a philosophy that permeates much of what we do on the investment team. As asset allocation specialist, what I seek to do is estimate current trend or normalised earnings, then assess the PE ratio of the market based on these trend earnings.

The process I use to estimate current normalised earnings is to normalise a) sales (in relation to both trend and GDP, b) operating profits in relation to sales, and c) net profits (EPS) in relation to operating profits. It must be emphasised that this is not a precise, scientific exercise. There are all sorts of simplifications and assumptions that are made here. The point is that a valuation ratio based on normalised earnings that is either very expensive or very cheap is meaningful on the basis that the same would apply even if some margin for error were built in. This is particularly the case if some conservative assumptions are used along the way.

Chart 1 shows the progression of S&P 500 sales per share since 1989 (the starting point of the data series) along with the trend line. On the face of it, it appears that current sales are bang in line with trend, suggesting that no adjustment is required.

However, on the basis that there should be a link of some sort between sales per share and GDP, it must be noted that the Great Financial Crisis (GFC) saw a trend change in GDP that should be taken account of. This trend change is evident in Chart 2, and it is clear that since the GFC, GDP is marching to a new beat.

This I believe means that (since the GFC) sales are also very likely following a new trend. Charts 3 and 4 depict this new trend and suggest that current sales are 3% above it. In other words, normalised sales are 3% below current sales.

Chart 5 suggests that operating profit margins are currently well above historical average. But on the basis that some of this may be attributable to structural (permanent) factors, a conservative estimate of normalised operating profit margin would be 12.5%.

The final chart (chart 6) shows the ratio of net profit to operating profit. In many respects, this is a proxy for the inverse of corporate tax rates. The fact that it has been increasing steadily in recent decades rightly reflects falling tax rates over the period, but of course this cannot continue indefinitely (unless the US government wants to bankrupt itself).

While the historical average of the net profit to operating profit ratio is around 65%, it would not be right to suggest that this is a normalised level. But then the current 81.1% seems unsustainably high. So, a normalised ratio of 75% is assumed, which can be considered conservative.

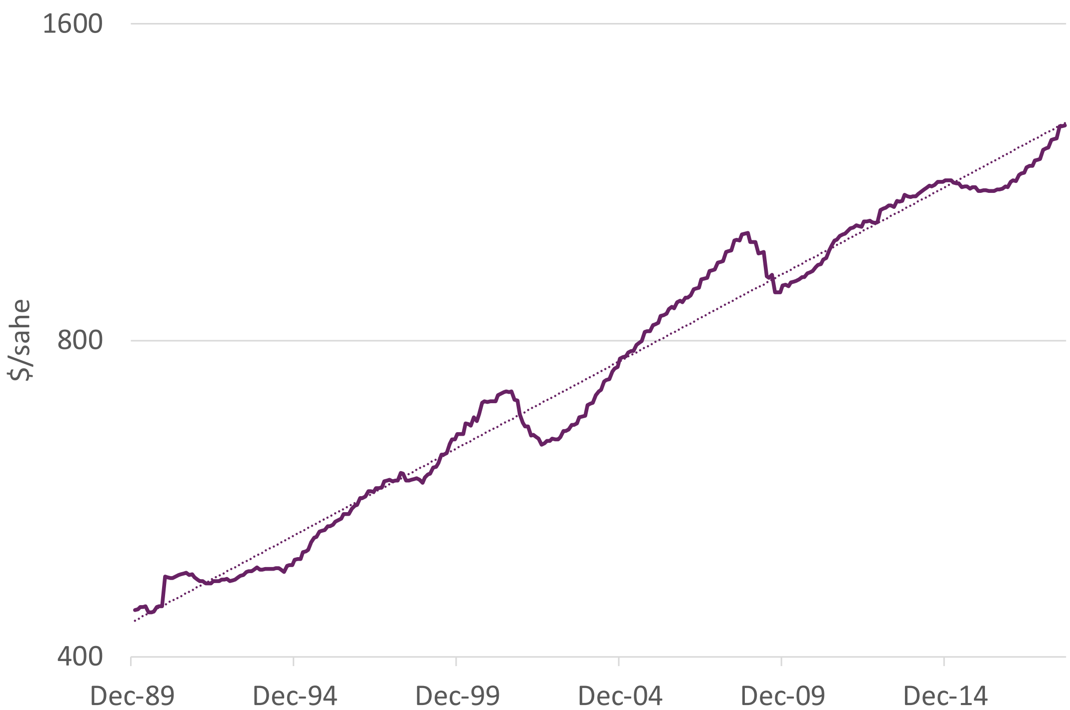
Applying the three adjustments (sales down by 3%, OPM to 12.5%, and NP/OP to 75%) to current sales, one comes out with normalised earnings (EPS) of 116.5. Based on the S&P500 index level of 2,900 as of end August, this implies a normalised PE ratio of 25 times.

In absolute terms, this is very high, suggesting that US equities are now very expensive. One mitigating factor is that real bond yields, that represent a valuation benchmark for equities, are quite low at the moment and will probably remain so for years to come. This might mean that US equities are not quite as expensive in relation to expensive bonds (low yields). However, by the same argument, equities in the UK, Europe and Japan are even more attractive.

This analysis does not provide a guide as to when US equities will stop rising – this is more about inflation and monetary policy. But it is the basis of our valuation methodology and thus provides the required evidentiary support for our zero position in US equities.

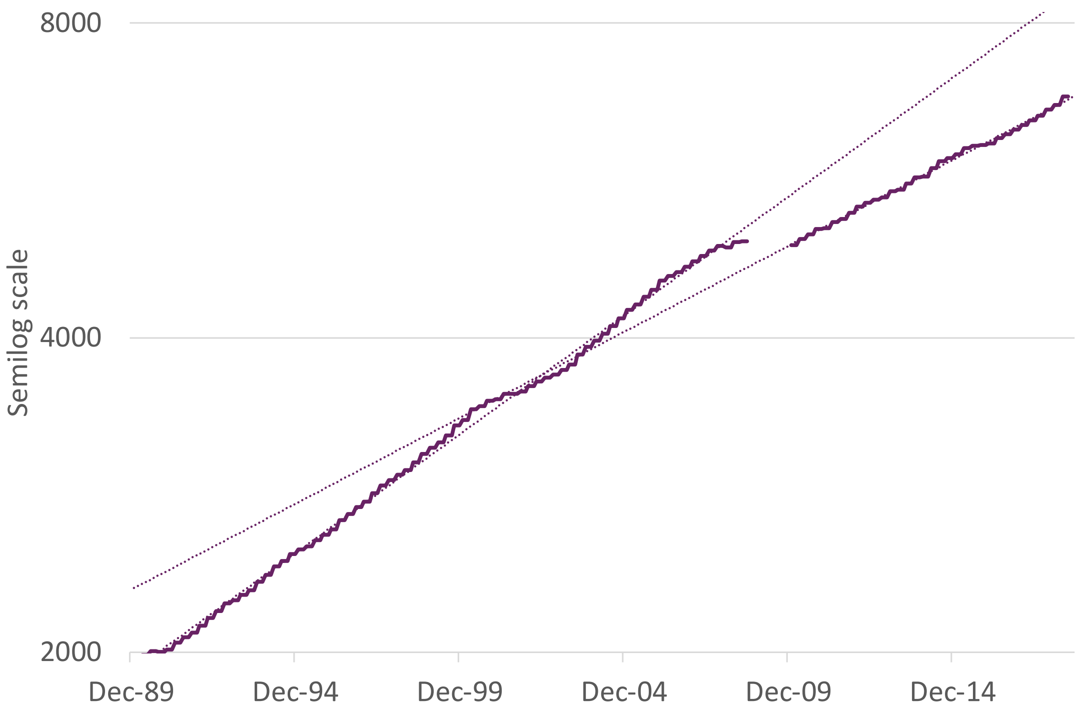
Coincidentally, Robert Shiller, well known for his CAPE (cyclically adjusted PE) ratio, was cited in the press recently saying that his measure now stands at 33 times. This is higher than any time since the late 19th century, other than a few months leading up to the end of the tech bust that began in March 2000. This certainly represents further support for our position.

Chart 1: Sales per share (S&P 500 Index)



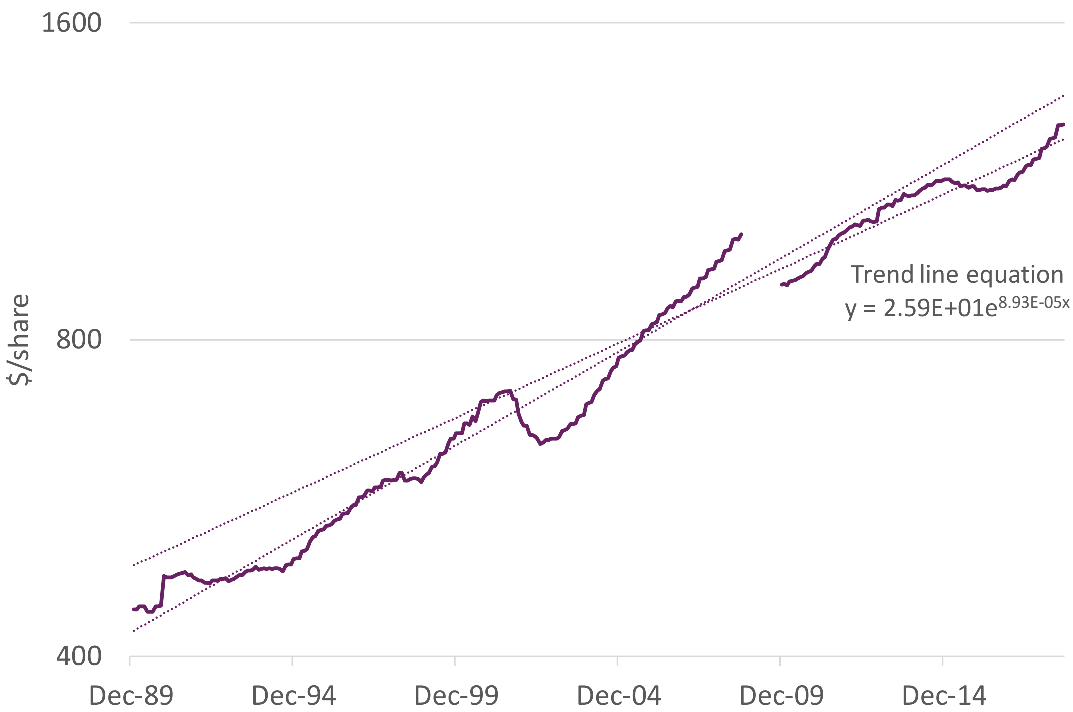
Source: Bloomberg

Chart 2: Nominal GDP ($b)



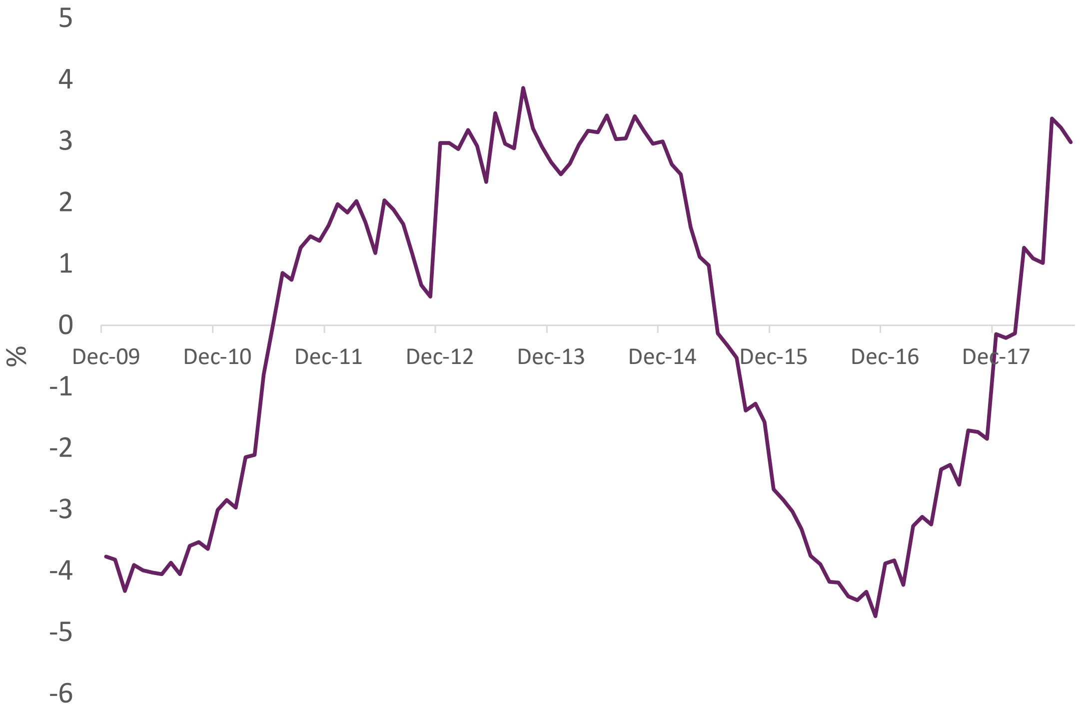
Source: Bloomberg

Chart 3: Sales per share (two distinct periods) (S&P 500 index)



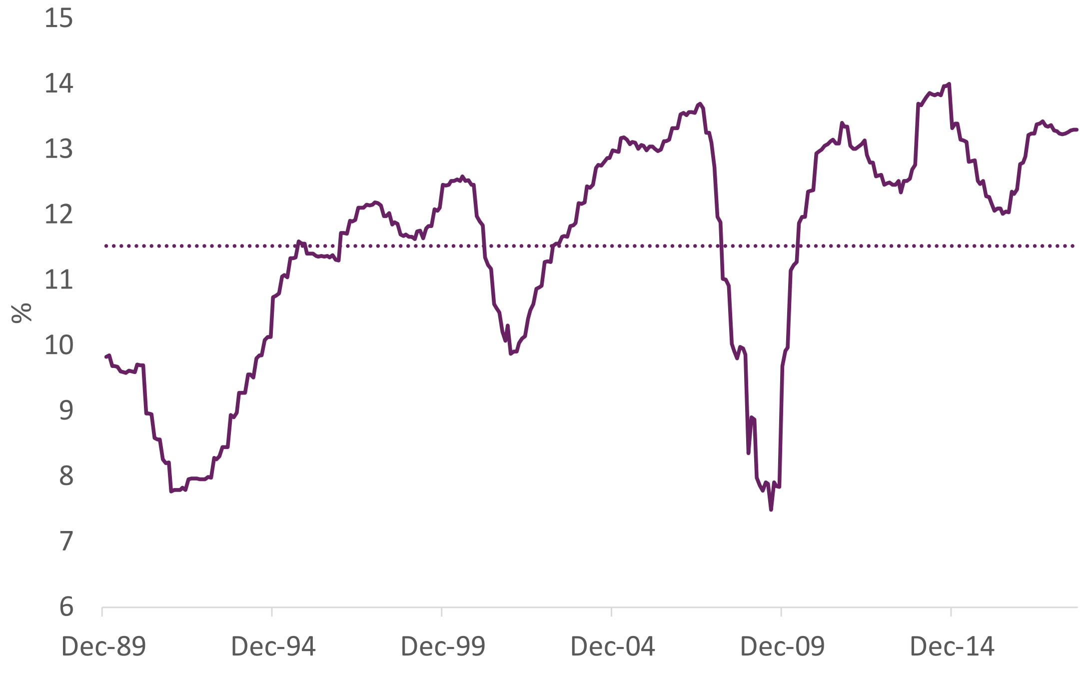
Source: Bloomberg

Chart 4: Sales per share relative trend (since great financial crisis)



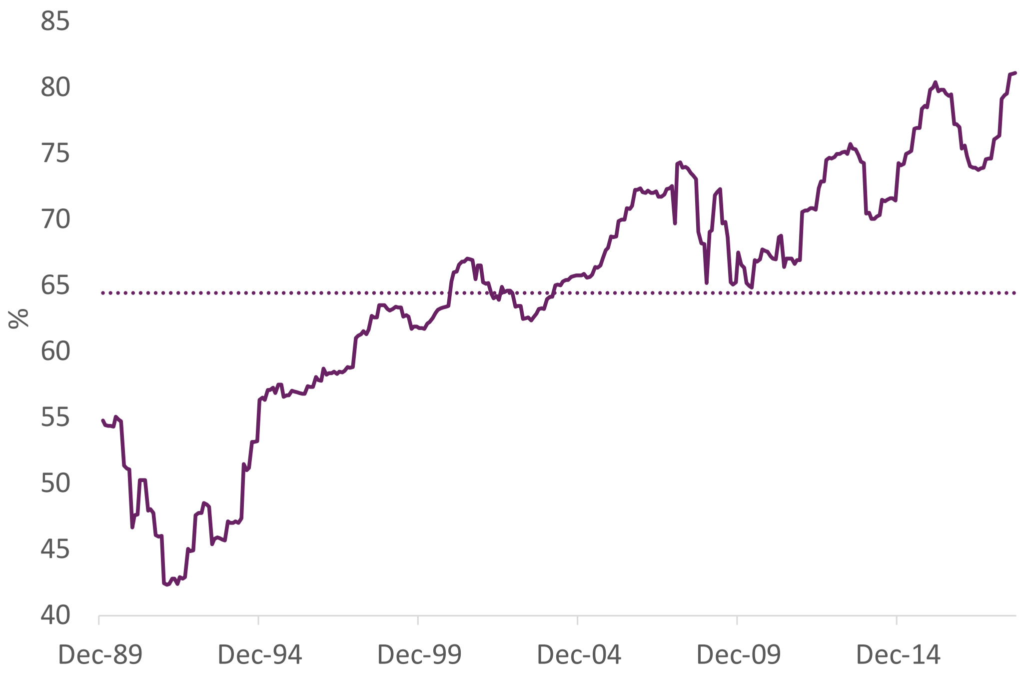
Source: Bloomberg

Chart 5: S&P 500 operating profit margin



Source: Bloomberg

Chart 6: S&P 500 net profit as % of operating profit



Source: Bloomberg

Review and Outlook

Most equity markets had a disappointing August with the exception of the US. The outperformance of growth stocks versus value has been exceptionally strong in 2018 and showed no signs of abating this month.

The S&P 500 outperformed the Eurostoxx 50 by almost 8% in August. This is a significant difference. A key driver of this will have been Amazon +14% and Apple +21% in GBP terms closely followed by many of the other technology behemoths such as Paypal and Microsoft. Both companies have now breached the trillion dollar market cap, though Amazon's visit to the trillion dollar club lasted less than a day before retreating. Government bond prices and the Dollar also increased on the back of growing geopolitical risk.

The Emerging markets index struggled with political issues in Turkey, South Africa and Brazil. Trade war tensions simmered and the US re-introduced sanctions against Iran. Turkey's relationship with the US deteriorated further as did its currency. Turkey has had problems all year with a widening trade deficit (now at 6% of GDP). Its problems with the US escalated this month after talks broke down over the release of US pastor Andrew Brunsun (arrested in Turkey after the 2016 coup d'etat). US president Trump was then quick to announce a doubling of tariffs on Turkish steel and aluminium.

In the UK, the Bank of England, as expected, raised the base rate from 0.5% to 0.75%. Despite this, sterling was weak as Brexit concerns heightened.

Activity on the fund has been minimal. There were no asset allocation changes. In the infrastructure space, a recent cash offer for John Laing Infrastructure has had a positive read across to our holdings in International Public Partnerships and John Laing Environmental Assets.

Table 1: Current fund tactical asset allocation (TAA) target weights as of 31.08.2018 (prior month's targets in brackets)

TAA target Weights (%) (prior month's targets in brackets)		OEICs		Investment Trust
		LF Seneca Diversified Income Fund	LF Seneca Diversified Growth Fund	Seneca Global Income & Growth Trust plc
Equities	UK	**19.0 (19.0)**	**15.5 (15.5)**	**29.5 (29.5)**
	North America	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
	Europe ex UK	5.0 (5.0)	8.0 (8.0)	7.0 (7.0)
	Japan	1.0 (1.0)	8.0 (8.0)	3.0 (3.0)
	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	**33.5 (33.5)**	**48.5 (48.5)**	**53.5 (53.5)**
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)	1.9 (1.9)
	Corporate	27.7 (27.7)	10.5 (10.5)	7.8 (7.8)
	Fixed income Subtotal	**32.7 (32.7)**	**12.5 (12.5)**	**9.7 (9.7)**
Specialist assets*	Property	6.5 (6.5)	6.6 (6.6)	7.0 (7.0)
	Private equity	3.8 (3.8)	4.0 (4.0)	3.4 (3.8)
	Specialist financial	8.9 (8.6)	8.2 (7.9)	9.5 (8.7)
	Infrastructure	10.5 (10.5)	10.7 (10.7)	11.3 (11.3)
	Specialist Subtotal	**29.7 (29.4)**	**29.5 (29.2)**	**31.2 (30.8)**
Cash		**4.1 (4.4)**	**9.5 (9.8)**	**5.6 (6.0)**
Total		**100.0**	**100.0**	**100.0**

Increased *Decreased*

Source: Seneca Investment Managers, 31 August 2018

* 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.

September Commentary

SIGT, SDIF and SDGF

- The Bank of England, as expected, raised the Base Rate from 0.5% to 0.75%. Despite this, sterling was weak due to Brexit related concerns, though it did strengthen towards the end of the month.
- Emerging country currencies and financial markets continued in general to come under pressure as a result of problems faced by Argentina and Turkey, as well the strong dollar and trade concerns.
- There were no asset allocation target changes in August.
- Polypipe delivered a resilient set of interim results, against a backdrop of mixed market conditions. Second half trading has started well.
- Essentra returned to profit growth for the first time since 2015, as the company's recent transformation starts to bear fruit.
- No activity in Overseas Equities.
- Participated in new issue of equity by the TwentyFour Select Monthly Income Fund. The manager is seeing additional opportunities across the corporate bond market.
- We finalised the exit from Civitias Social Housing.
- Listed infrastructure assets benefited from a recommended cash offer for John Laing Infrastructure which has had a positive read across to International Public Partnerships and John Laing Environmental Assets in terms of potential valuation and attractions from overseas investors.

SDIF

- Addition to existing holding in Royal London Sterling Extra Yield Bond Fund.