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Peter Elston: Investment Letter

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This document is intended for professional investors only

Introduction

A warm welcome to this, my first monthly investment letter. The intention is for it to be thought-provoking. Simple as that.

At Seneca, we are value investors. I hate to give him even more publicity than he already has, but Woodford Patient Capital Trust's Neil Woodford puts it well: "Valuation", he says, "is the best form of capital protection." I wholeheartedly agree.

Important risk, is the risk of permanent loss of capital, not volatility which measures temporary losses (and gains) of capital. In markets, what goes down more often than not goes up again: volatility should be thought of as the cost of good long term performance, not a risk to be concerned about (mine, not Woodford's).

What is important to me, to my colleagues, to our customers, is to avoid investing in things that go down, but not up again. In other words, permanent loss of capital. How does one do this? By buying things well below their intrinsic value. In other words, by value investing. Indeed, put like that it's difficult to understand why anyone would be anything other than a value investor!

In fact, it's not difficult to understand: being a value investor is hard. It requires you to be contrarian, which human beings are not built for (we like to conform, to be part of a crowd). It requires you to be very analytical and objective, assessing numbers and facts rather than listening to the mass emanation of nonsense. It requires you to accept periods of underperformance: there can be periods of up to 2-3 years when the expensive outperforms. It requires you to be a bit dull – talking about discount to intrinsic value is, let's face it, not as sexy as talking about the latest fad. But the hard work is all worth it. Funds managed by value investors generally have very good long-term track records.

Now, value investing is most commonly associated with equity investing. At Seneca we're applying it to multi-asset investing.

Take government bonds as an example. Right now, the yield of the 30 year inflation-linked Gilt is -0.9% which means that buying and holding it to maturity will lose you 24% of your real capital. If you measure risk in terms of volatility, be my guest and invest – these things 'look' really safe. If you measure risk in terms of potential for permanent loss of capital, step away from the table, leaving the crumbs that may be left on it for someone else.

So, at Seneca, we apply a value investing ethos to everything we do: tactical asset allocation (the above case of government bonds being a good example), stock selection (where Graham and Dodd began), fund selection (we like managers who themselves have a value investing ethos), and sector/trend research (the value investing articulated by Graham and Dodd was as much about looking for quality and reliability, similar to that which can be found in some long-term trends, as it was about valuation measures).

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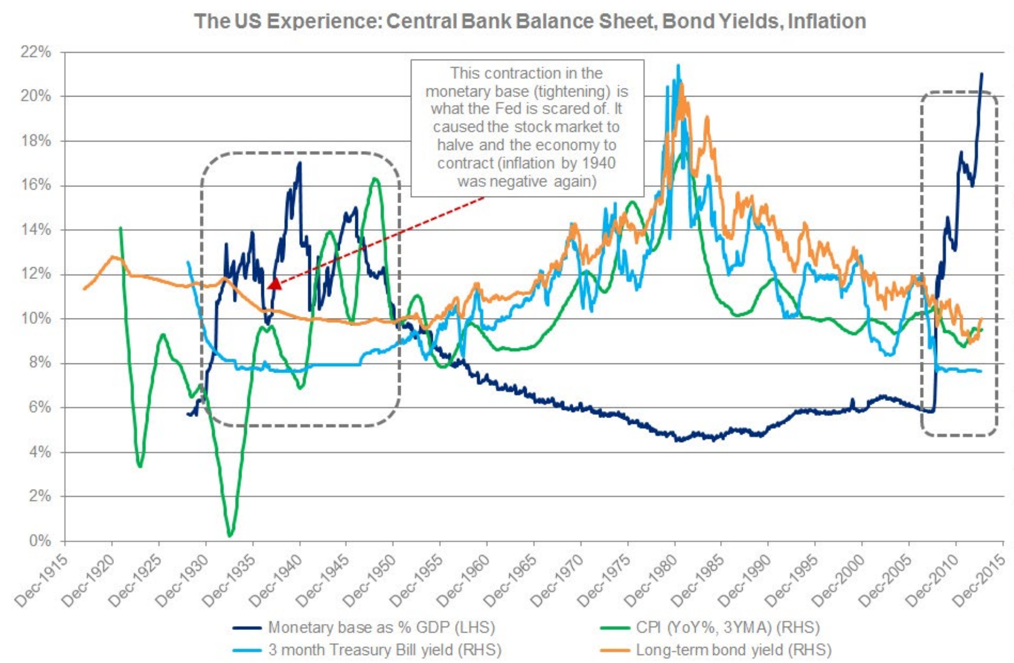
The Big Picture

Looking back, the biggest events over the last 18 months have been the substantial falls in G7 bond yields and the oil price as well as the sharp rise of the US Dollar.

To be clear, what has been happening in bond markets is almost without precedent. Bond markets are thus a source of uncertainty and potential instability. Excellent real returns since the early 1980s have been driven by three things: the high level of the yield itself in real terms, falling inflation, and falling real interest rates. We are now at a point where neither inflation nor real interest rates can fall much further, so predicting poor returns from bonds has never been easier surely. But then that's what most were doing – us included - at the back end of 2013 and look where that got them. 2014 saw US and European sovereign long bonds return 24.9% and 12.8% respectively, hardly poor.

Although one can be absolutely sure that the bond bull market will end, timing it is hard. Bond yields in the US stayed low throughout the 1930s, 40s and 50s, only rising sustainably above 4% in the mid-60s (see chart) though real returns would have been negative for some of this time as a result of high inflation during the war years.



In a debt soaked world it is very hard to get growth going. Classical economics text books ignore debt as a factor of growth, arguing that on a net basis it sums to zero. Instead, they present economic growth as a function of workforce growth plus productivity growth. I'm not trained as an economist – a good thing, I keep telling myself – but it seems to me that an underleveraged economy has the potential to grow faster as credit spreads throughout an economy (imagine how much more activity can place if a product can be exchanged for a promise rather than another product!) This is a good thing – credit, what is essentially an IOU, is one of man's greatest inventions - but it does mean that the same must from time to time happen in reverse. The deleveraging of Japan's private sector over the last twenty or so years stands as testament to this.

In June 2013, then Fed governor Bernanke commented that US growth forecasts were being revised up and that the Fed would soon begin tapering its bond buying program, causing bond yields to rise sharply. After hitting 3% at the end of 2013, the ten year yield has since slipped back to below 2%, defying pretty much everyone's expectations. Despite the Fed's optimism, it gradually became apparent that the economy would not be strong enough to absorb the ending of QE. The falling oil price only served to increase the downward pressure on inflation and thus bond yields.

It seems extraordinary that six years after the crisis we are none the wiser as to how economies will be weaned off “unconventional monetary policy”. One thing that is clear however is that central bank money printing has not led to the runaway inflation that many feared. Indeed, the opposite is the case: inflation is running below central banks’ targets for much of the developed world, and in fact is now negative in Europe. How can this be, given all the stimulus?

Economists such as Larry Summers and Robert Gordon argue that global growth is stagnating as a result of weak demographic trends and the absence of some game changing technology such as the steam engine, internal combustion engine or the silicon chip. It is also possible that workers have so much competition nowadays from robots, other labour-substituting technology as well as workers elsewhere in the world that a rise in real wages quickly results in a shift to alternatives, particularly when the cost of capital is so low.

It seems therefore that one can view currently low bond yields in two ways. The pessimist would argue that they reflect a flight to safety and fears of yet-to-surface instabilities within economies and financial systems. The optimistic view would be that they reflect low inflation which is a good thing, as well as the aforementioned structural issue surrounding labour costs. In such a world, the owners of capital are the winners. You don’t get rewarded for investing in government bonds because there is no or little risk with respect to credit or interest rates.

I tend to side with the optimists, though that doesn’t mean I think bonds are a good investment. Although there may not be a new game changing technology about to burst onto the scene in the way that the steam engine and the internet did, there is certainly technological progress that does not get celebrated widely in the media. As economists Brian Wesbury and Robert Stein of First Trust Advisors note, “tablets and phones that cost a few hundred Dollars today have capabilities that cost millions just 20 years ago. Shale oil drillers are successful on most of the wells they drill versus much lower percentages of success in the days of wildcatters. 3-D printing reduces prices, while increasing flexibility in production. Low cost apps, websites, and the cloud undermine the need for brick and mortar investment.” Furthermore, although technological progress may often be linear, its effects can most certainly be non-linear. For example, photovoltaic cell efficiency may well be closing in on a tipping point at which usage takes off.

Oil

Despite some proclaiming that the price fall was a sign of a weakening global economy, I suspect that increased supply has been mostly to blame. Since 2009, global supply of crude oil has increased from around 84 million barrels per day to around 94 million bpd. At the same time there has been a huge increase in the supply of energy from renewable sources. True, renewable energy still only accounts for a small percentage of total, but it is at the margin where its effects are felt.

The changing supply/demand dynamics in the energy industry represent a paradigm shift, something that the Saudis appear to have recognised. They know that the global economy can tolerate a price of \$100 per barrel – after all, one barrel contains the energy equivalent of roughly twelve years of human work (based on 40hrs per week, 48 week working year) which would be valued much more highly – but also feel that they alone should not bear the responsibility for keeping it there, particularly in a world that is being weaned off the substance.

So, OPEC – for which read ‘the Saudis’ – has decided that if no one else is going to cut production, it won’t either. The resulting price fall has been forcing production cuts on the less efficient producers, rather than them being offered voluntarily. This is ultimately how a well-functioning market should operate, and demonstrates that the process of creative destruction is alive and well.

What perhaps is slightly unusual is that, unlike in most other industries, in the case of energy it is likely to be the most recent entrants – shale oil and renewable energy suppliers – who will get weeded out first, rather than the veteran incumbents in the Middle East. This is a shame, at least in the case of renewable energy, but should ultimately be seen as a good thing; the lower oil price will boost aggregate demand as well as increase pressure on renewable energy companies to improve efficiency further.

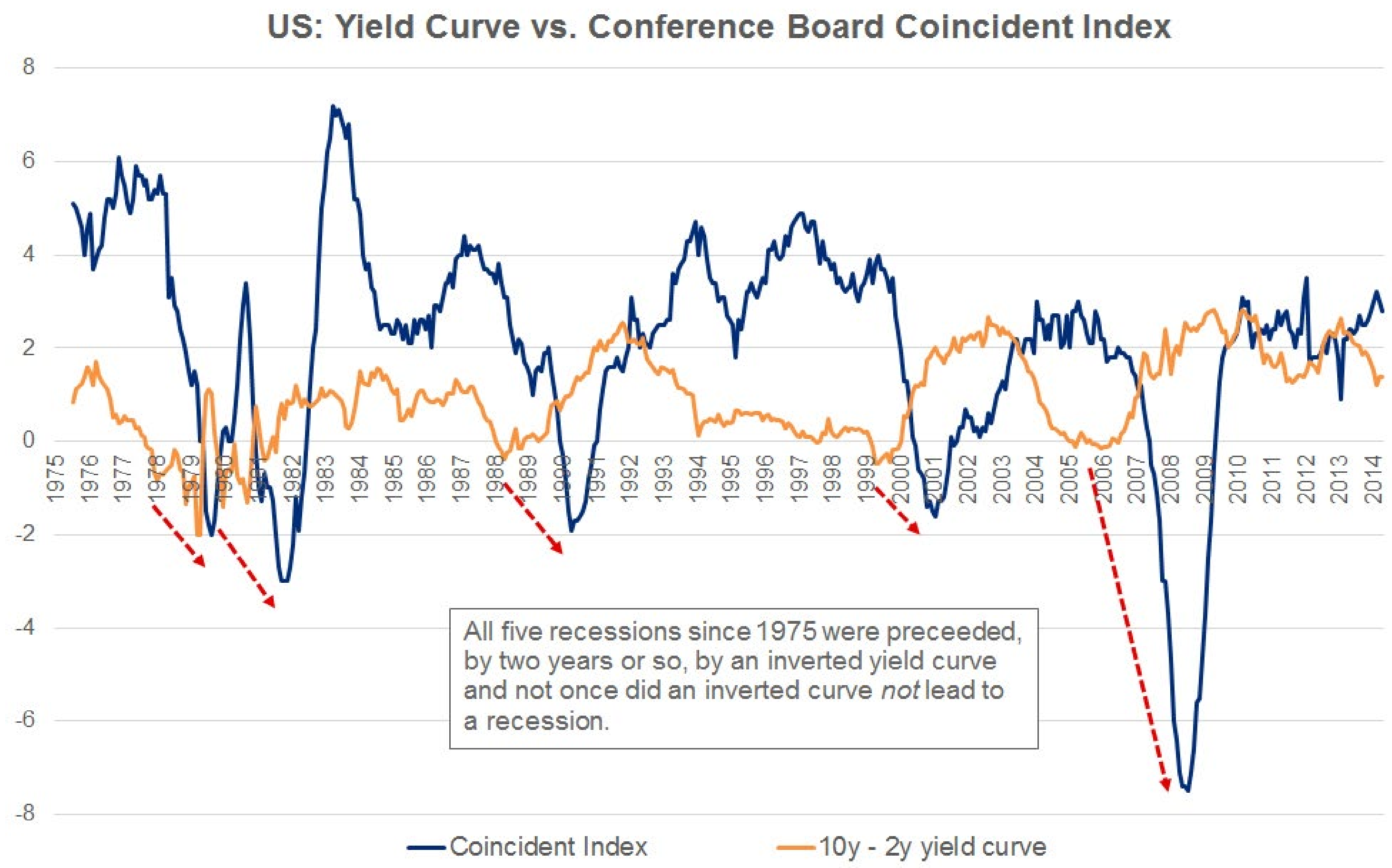
That said, I cannot see the oil price falling much below $50, despite Saudi oil minister Naimi’s unusually blunt comment that OPEC will not cut production even if the oil price falls to $20. This is game theory at its purest, with OPEC apparently attempting to engineer swift production cuts by higher cost operators so that the market can return to a more balanced state and prices back to normal, even if this is still well below $100.

The falling oil price was one of the factors behind the strength in the US Dollar but by no means the only one. Changes in expectations with respect to monetary policy are, as usual, the key factors. The reality is that by ending its bond buying program the Fed has been tightening policy. Furthermore, expectations are that the Fed will raise interest rates within the next year or so. In Europe and Japan on the other hand, expectations are for policy either to remain loose or to be loosened further. The rise in the Dollar has been exacerbated because of its status as a funding currency; as it starts to rise, many who have borrowed in US Dollars seek to pay them back, thereby adding to the strength.

Looking Ahead

The critical question I think has to be whether or not the global economy is at risk of sliding into recession. If the risk of this is low or negligible, as I think is the case given that central banks and governments generally remain very supportive, then the outlook for stocks should still be reasonable – after all, dividend yields are still decent while profitability of companies as measured by return on equity is not stretched.

In this regard, I think we still need to watch very closely for signs that the rise in the Dollar or the fall in the oil price is impacting growth in the US, the latter through closures of shale oil developments which have provided a boost to the economy is recent years. As of now, the yield curve is still steep, albeit it less so than a year ago, suggesting that a recession is not looming (see chart overleaf).



Coincident Index: shows the current state of economic activity within a particular area. Compiled using employment, real earnings, average weekly hours worked in manufacturing and the unemployment rate.

Indicators can be classified into three groups based on the time period that is being measured. Lagging indicators change after the economy as a whole changes, coincident indicators show the current state of the economy and leading indicators show where the economy is going. Coincident indicators are often used in conjunction with leading and trailing indicators to get a full view of where the economy has been and how it is expected to change in the future.