

Regular Content:

Inflation Watch & Captain Murphy's Diary

Updates On:

Recent Market Volatility, Strategic Asset Allocation, Our Response to an Article, Current Fund Targets & Our Macro and Market Data Sheet



This document is intended for professional investors only

Recent Market Volatility: Are we Entering a Bear Market?

What do the sharp falls in equity markets across the world portend? Were they simply the inevitable result of prices that had gone up too much in recent months or do they reflect significantly overvalued markets in combination with some sort of material deterioration in the underlying fundamentals? Of course there is also a third option to consider: that economic fundamentals will deteriorate as a direct result of the recent sharp falls in equity markets, the so-called negative wealth effect.

Looking first at valuations and underlying economic fundamentals, there is nothing on the face of it to be particularly alarmed about. Even before the recent market declines, equity market dividend yields across the spectrum were generally above historic averages. This is encouraging and supportive of a view that markets will soon bounce back: the 2000-2002 and 2007-2009 bear markets began when yields were low in relation to their history. Price to book values too are not stretched. Depending on which market you look at, they are now anywhere between 8 and 30% below historic averages. Valuations will not tell you how far markets will fall in the near term – that will be determined by when the panic stops – but they should provide a guide as to what to expect in the way of returns over the medium term.

As for economic fundamentals, it is certainly true that China has been slowing down and will continue to do so. That there was a material slowdown underway was abundantly clear in declining commodities prices, Chinese electricity consumption and Chinese exports, if not in China's GDP growth numbers which have declined only slightly from 8% a couple of years ago to 7% currently. China needs to shift away from its one-dimensional investment driven economic growth model to something more balanced. This will certainly be challenging but I suspect will be easier for a command economy like China to engineer than would be the case for a more market-oriented one.

In the developed world, final aggregate demand is still weak, but this should if anything be a cause for optimism. Equity bear markets often coincide with declines in the business cycle which themselves occur when economies are operating above capacity i.e. when aggregate demand is strong. Inflationary pressures are also still very subdued which bodes well for central bank policy remaining supportive. Although Yellen and Carney have both talked about raising interest rates soon, I suspect the likelihood of this happening has declined sharply as a result of the China growth concerns and equity market declines. Furthermore, although unemployment rates have fallen, they remain above (or well above in the case of Europe) levels at which inflation generally starts to rise and central banks tend to act.

So that leaves the two other options: markets falling because they'd gone up too much or a positive feedback loop in which the market falls precipitate an economic slowdown.

As to the former, it is certainly true that the global equity bull market that began in early 2009 was well advanced. Furthermore, and more importantly, equity market volatility had noticeably declined.

The VIX index, a measure of equity market volatility had until the last few days averaged 15 since the beginning of 2013 compared with 22 from 2010-2012. Low volatility is analogous to a volcano that has been dormant for a while. The lack of activity is not a sign that the likelihood of an eruption has decreased but that pressure is building up underneath. Furthermore, the longer the period of inactivity the bigger the eruption when it eventually happens.

As for the third option – that turmoil in equity markets causes an economic slowdown – this is much harder to predict. The global economy is a complex system which can often behave non-linearly. Although there will be positive feedback loops that cause household and business confidence to be impacted by the recent equity market falls, there are also negative feedback loops that can cause equity markets to bounce back. Examples of this would be government or central bank stimulus measures or people buying because prices are cheaper.

In summary, it is impossible to say with certainty that we are not about to enter a bear market but from a business cycle and valuation perspective, economies and markets are to varying degrees some way from the point at which bear markets generally begin.

Strategic Asset Allocation

As is the case with many things in the financial world, there is no one clear definition of the term ‘strategic asset allocation’. While this may not have been the case when the term was first used in or around the 1970s, in the decades since its meaning has become increasingly ambiguous.

The term ‘Strategic Asset Allocation’ (SAA) was essentially a product of Modern Portfolio Theory and the idea that a client’s asset allocation with respect to equities, bonds and cash should be determined by real long-term expected returns from each, as well as volatilities and correlations. Since long-term expected returns would by definition not change, the SAA for a particular client would not change (volatilities and correlations measured over the longer terms are also very stable).

‘Tactical asset allocation’ (TAA) quickly became associated with SAA and referred to the process by which actual asset class weights would deviate from the SAA to take account of expectations that returns from one or more asset classes would in the shorter term be different to the aforementioned long-term expected returns. In practice, TAA deviations from SAA were never more than a few percentage points. Thus the value added from TAA has been generally either low (if the manager’s views were correct) or negative (if they weren’t).

At Seneca, we like the use of the terms SAA and TAA but we have a very different view of what they mean and how they should be applied with respect to management of investors’ portfolios.

For starters, real long-term expected returns from asset classes should not be considered stable and indeed can vary substantially from decade to decade - or even from generation to generation.

Take bonds.

Using the US as an example – it has the best data history – the table below shows annualised real returns from long bonds over certain periods.

Period	No. Years	Annualised Real Return
Jan 1866 - Oct 1901	35.8	+5.9%
Oct 1901 - Jun 1920	18.7	-4.2%
Jun 1920 - Nov 1940	20.4	+8.9%
Nov 1940 - Sep 1981	40.8	-2.7%
Sep 1981 - Oct 2015	33.1	+7.5%

These periods or phases can be seen in the following chart, which depicts the actual real long bond index.

Long Bond Real Index



Source: Credit Suisse

The point that I would make is that it would be foolish to have a high strategic allocation to bonds during multi-decade periods in which they produce substantially and consistently negative real returns.

Interestingly, equities in the US haven't exhibited the same long-term cycles as bonds. While bond bull and bear markets average 30 years, the average for equities is 6 years. The reason for this is that bonds follow inflation cycles which are long while equities are more synchronised with business cycles which

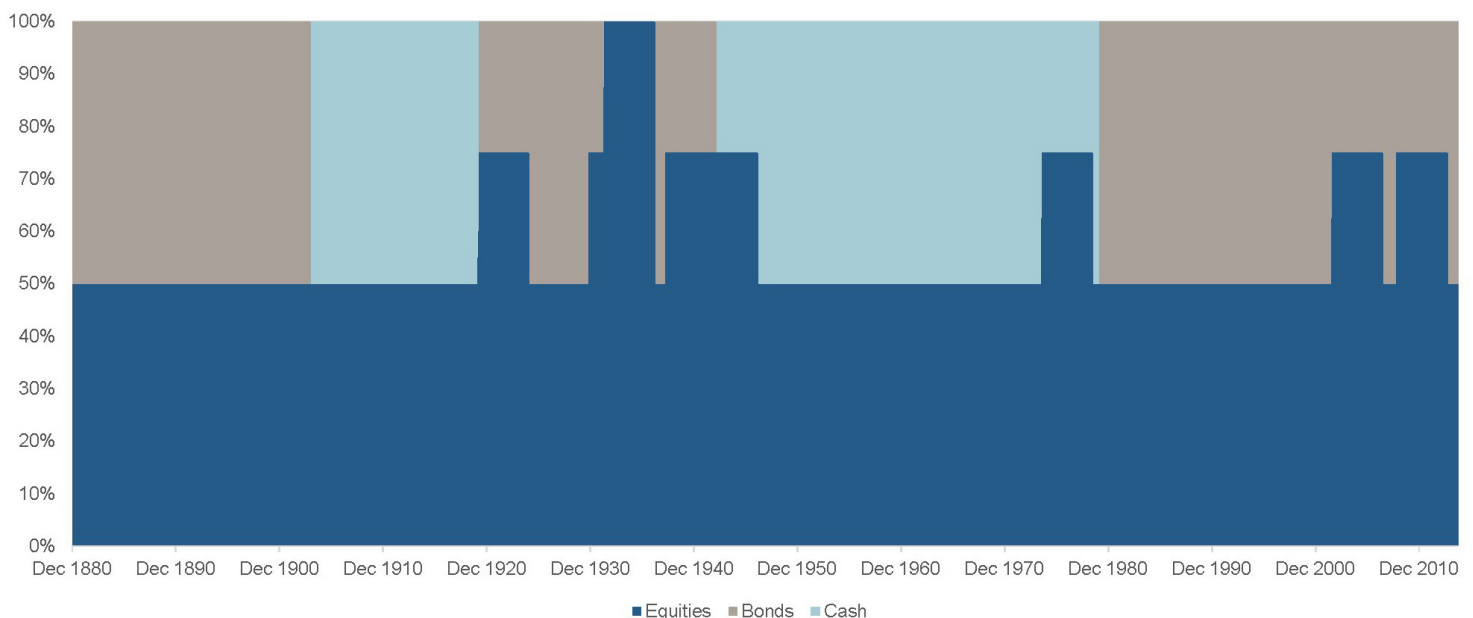
are much shorter. In other words, equity market bull and bear markets can occur within long-term bond bear and bull markets. For example, the last two equity bear markets (2000-2002 and 2007-2009) both occurred within the bond bull market that began in the early 80s. Conversely, the two equity bull markets of the 1970s happened during a period of poor real bond returns. Go back further and you'll find other examples.

To demonstrate how these findings can be used to build a more effective SAA (i.e. one that is not static but at the same time one that does not change frequently) I apply some very simple rules as follows:

- SAA starting point is 50% equities/50% bonds
- Move the equities allocation to 75% if the real equities index falls to 40% below its all-time high
- Move the equities allocation to 100% if the real equities index falls to 75% below its all-time high (very rare!)
- Move the equities allocation back to 50% five years after previous increase
- Move the bonds allocation to 0% if the real bonds index falls to 60% above its 30 year moving average
- Move the bonds allocation back to 50% if the real bonds index rises to 40% below its 30 year moving average
- The cash weighting is the residual of the above changes and cannot be negative.

The impact these rules would have had on the SAA can be seen in the chart below.

Rules-based Strategic Asset Allocation



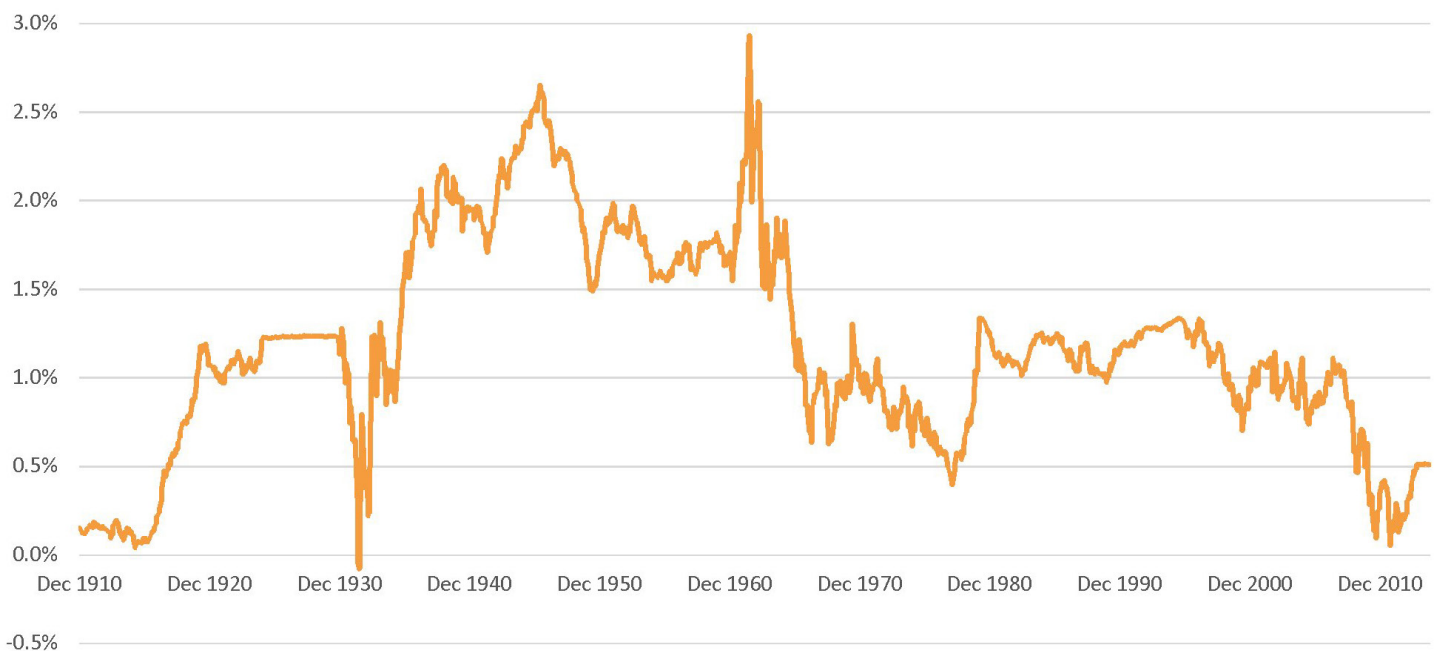
Source: Seneca Investment Managers

The main point to note is that very few changes are made. There are 14 triggers to change the equity allocation, which equates to one every ten or so years. As for bonds, there are even fewer triggers to reduce or increase its weighting: four to be precise, or once every 34 or so years (it should be noted that the bond allocation may get reduced because equities are increased, but such reductions are not 'active' ones). In total, therefore, there are 18 active decisions to change the SAA over the 135 or so years under consideration, equating to one every 7.5 years.

The big question of course is what impact these changes would have had on the performance of the rules-based SAA in relation to the static 50/50 SAA.

The answer is that they would have added 1 percentage point per annum (remember, this relates only to SAA and thus takes no account of value that can be added from TAA or security selection). Furthermore, there were only two months (out of 1260) when the rolling 30 year annualised return was lower for the rules-based SAA than for the static version. These findings can be seen in the chart below.

Value Added from Rules-based SAA in Relation to Static SAA (annualised over 30 year rolling periods)



Source: Credit Suisse

While the value added varied between 0% and 3% per annum, it is important to note that it was never negative (other than in the case of the aforementioned two months which indeed were only very slightly negative.)

To be clear, the rules-based SAA outlined above is for demonstration purposes only. The message I am seeking to communicate is that fixed SAA weights are a bad idea and that with a small number of simple rules, a substantial amount of value can be added. Furthermore, those SAA frameworks that are more flexible with respect to weighting changes tend to reduce equities at the wrong time. This is because optimisation models incorporate volatility as an input. When equity markets fall, volatility generally rises and as a result recommended SAA weights get reduced. This is in stark contrast to the rules-based SAA outlined above in which when equity markets fall, the SAA recommended weight is increased not decreased. In fact, the rules-based SAA never seeks to anticipate equity bear markets, only to respond sensibly when they happen by raising targets. Indeed this approach is endorsed by investment adviser William Bengen in his 1994 paper, [Determining Withdrawal Rates Using Historical Data](#). In it, he wrote:

“Admittedly, increasing stock allocation to 100 percent after a long period of miserable returns requires unusual foresight and fortitude on the part of the advisor, as well as the client. If you can convince your client just to maintain the 75-percent allocation under such conditions, you have won a major battle. However, the client is still faced with a shorter than-average portfolio longevity, and with much less wealth to pass on to heirs than originally hoped for.”

Bengen’s point was that although severe bear markets will always damage portfolios, the damage will be even worse if you do not take advantage of them, or, heaven forbid, reduce positions during them.

Our Response to FT Adviser Article

My attention was drawn during the month to an article in FT Adviser, [Multi-asset pledge ‘should set off alarm bells](#). *“Investors should be wary of multi-asset funds promising 5 per cent income that could be taking a “gamble” with capital”, experts warn”* says the piece. Sensationalist tosh in my humble opinion. Any fund that is investing outside of risk free assets could be said to be taking a gamble with capital, not just those targeting a high yield. What matters is whether any loss of capital that will *always* occur when investing in risky assets is temporary (tolerable) or permanent (not tolerable).

I can’t speak for all funds seeking to deliver a 5% yield but I can speak for ours. We have done extensive modelling on our CF Seneca Diversified Income Fund and we believe we can deliver this yield without putting real capital at risk over the longer term (I would agree that one cannot seek to protect capital over the short term, markets don’t work that way).

In order to achieve our investment performance objective, we need to deliver a gross total real return of just shy of 7% per annum over the longer term. After costs, this would come down to closer to 5%, which would be split between income of 5% and real capital of 0%.

So, the question then becomes, how do we deliver a gross total real return of 7%? The answer is that it comes from a combination of strategic asset allocation plus value added from tactical asset allocation and security/fund selection.

We think we will get around 4.5% from strategic asset allocation without taking undue risk. Our strategic asset allocation to equities is fairly low at 40% (our fund sits in the IA 20-60% Shares sector) and we think equities will deliver us around 6% real, in line with long-term historic averages.

Adding in bonds and alternatives, which we think will provide 2% and 5% real over the long term, and you get to a total of around 4.5% (our strategic asset allocations to bonds and alternatives are 35% and 25% respectively).

As for value added, we are looking to add 2.5 percentage points per annum from tactical asset allocation and security/fund selection. Whether we can do this depends on two things.

First, is the ex ante tracking error of our fund in relation to its strategic asset allocation giving it the potential to produce 2.5 percentage points of value added? Our risk models tell us that the answer to this question is ‘yes’.

Second, do we have an investment process that is able to deliver this potential? Again, the work we have done tells us that the answer to this question too is ‘yes’. Our tactical asset allocation process draws on well-regarded academic work that finds strong links between yields of equities and bonds and future returns.

Within UK equities, where we invest directly, we focus on mid-caps where there are higher systematic returns as well as greater stock picking opportunities that exist because of thinner broker research coverage. We also think that we're able to spot third party managers of overseas equities funds who have strong, value oriented approaches that produce good returns over time.

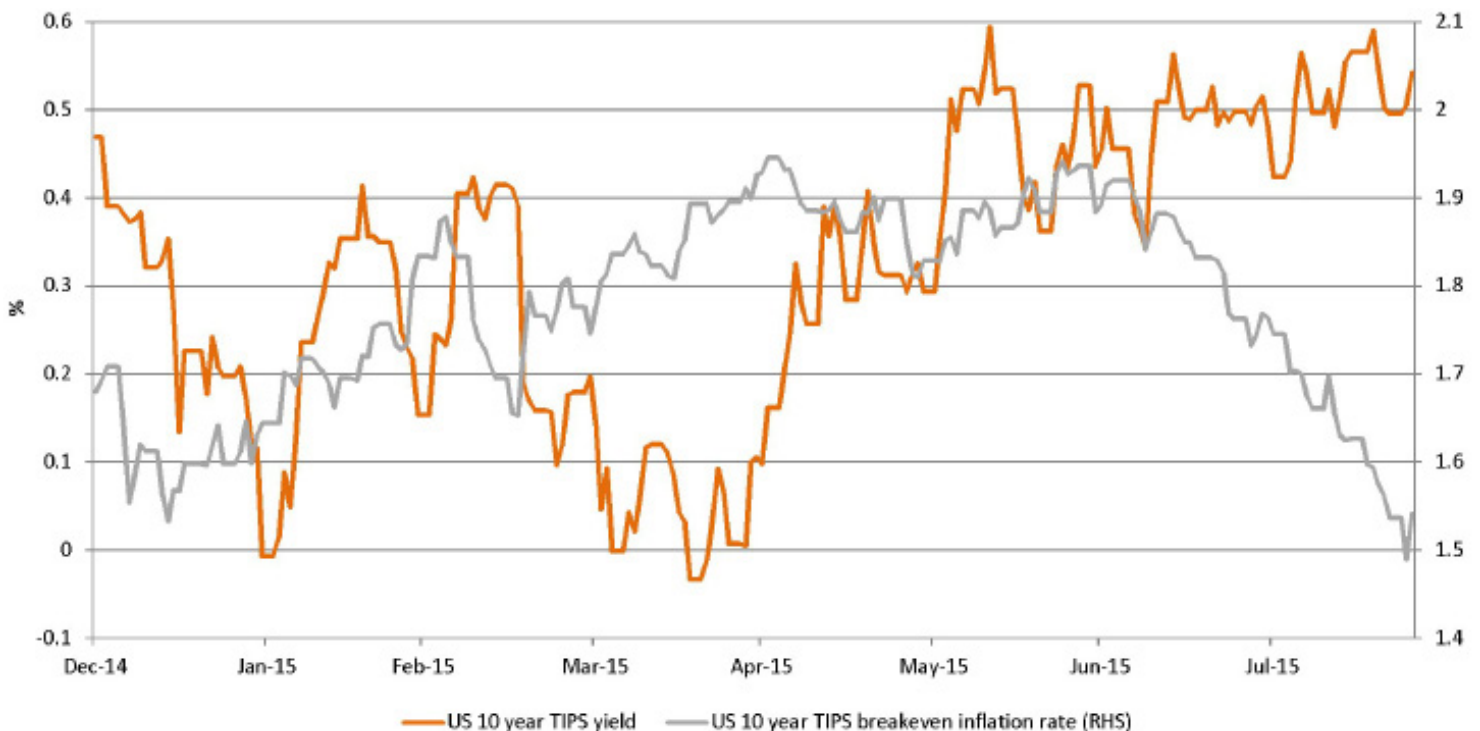
So, while we would agree there may be funds out there promising 5% that don't know what they're doing, ours does.

Inflation Watch

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

The 10 year US Treasury yield has fallen from 2.5% on 27 June to 2.1% currently (as at 25.08.2015), a very substantial change. Normally, changes in nominal yields are due to changes in the expected inflation rate over the life of a bond as well as changes in the real yield (in the corporate bond sector yields are also a function of credit spreads). However, it is interesting to note that the recent fall is due entirely to a fall in the expected rate of inflation. The 10 year breakeven inflation rate, as it is known, has fallen from 1.9% to 1.5% over the period in question, while the real yield has stayed around +0.5%.

Real Yield and Inflation: The Two Determinants of Nominal Yields



Source: Credit Suisse

My point is that I find it hard to understand how the Federal Reserve could now justify a rise in interest rates any time soon. As I wrote on our blog recently:

"I'm angry with Fed chair Janet Yellen and Bank of England Governor Mark Carney. Why did they have to be so eager to raise interest rates, talking them up in the way they did? Yellen's trigger happiness has

caused the Dollar to rise, oil prices to fall, China to devalue its currency, other emerging markets to devalue theirs, inflation pressures (to the extent there were any) to subside and, guess what, the case for raising rates to be booted into touch.

Actually, it's worse than that. By calling for rates to be raised too soon, Yellen has lost a lot of credibility. Central banks have been virtually single-handedly propping up the global financial system, so their credibility is paramount. I remember five years ago wondering which would come first; a global economy returning to "normal" or loss of faith in central banks. The last few days and weeks have seen me shifting my views firmly in favour of the latter.

My main bone of contention is that the end of QE in both the UK and the US constituted an effective tightening of monetary policy. As I noted in my last investment letter, it is estimated that the tapering of asset purchases in the US was the equivalent of an interest rate rise of 4 percentage points. This is the same as the entire tightening cycle of 2003 to 2006, which saw the Fed Funds rate go from 1% to 5%, and which arguably triggered the financial crisis. Why oh why couldn't Yellen or Carney communicate the message that having had a substantial effective tightening, they would leave interest rates where they were for at least 2 years in order to gauge its effects? It's not as if we were coming out of a normal recession in which inflation pressures were going to rebound quickly. Far from it. Inflation still needs propping up not suppressing.

I'm not an economist – thankfully! – but it seems to me that the world is prone to deflation not inflation. We humans seem to be able to find cheaper ways each year of making something or providing a service. Furthermore, while credit creation is inflationary, the reverse is deflationary. Throw in other sources of deflation like the internet or China and you have a world in need of central bankers not competing to be the first out of the blocks."

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.

Emerging markets are proving yet again that they can be a horrible place to invest. Currencies across the emerging world have been falling of late and even the strongest emerging currency of them all, the Chinese yuan, has succumbed to weakness, albeit government-induced. Is it possible that another Asian financial crisis or Russian debt crisis is lurking in the wings?

It is very hard to say where or when a similar crisis might start, but countries that have borrowed dollars and export oil must be hurting right now. One such country is Kazakhstan and as I write its currency has just plummeted 23% against the dollar, having previously been pegged to it. The likes of Russia, Nigeria and Venezuela must also be under severe pressure.

One issue that gets misunderstood is the difference between the nominal value of currencies and their real value which takes relative inflation rates into account. Even renowned publications like the FT get it wrong. A recent article in the paper was titled "[Emerging currencies hit 15-year lows](#)". In it, the authors cite the JPMorgan Emerging Market Currency index as having fallen to its "lowest level since it was created in 1999". Unfortunately the index in question consists of nominal exchange rates against the US

dollar, not real ones. This means that it does not take account of the fact that consumer prices across the emerging world have risen much more than in the US, so emerging market currencies are not (yet) as competitive as the FT suggests.

Barclays Capital runs a series of real effective exchange rate (REER) indices. Their emerging markets REER index rose by 50% from lows in early 2004 to a recent high attained earlier this year. True, much of this was attributable to the strength of the Chinese yuan but this in itself is instructive: the yuan could have much further to fall.

Current Fund Targets

The table below sets out our funds target weights. Actual positions may deviate slightly from these target weights as a result of market movements or ongoing trades, for example.

Target Weights (%)		OEICs		Investment Trust
		CF Seneca Diversified Income Fund	CF Seneca Diversified Growth Fund	Seneca Global Income & Growth Trust plc
Equities	UK	22.5	20.0	28.0
	North America	0.0	4.0	2.5
	Europe ex UK	10.0	13.0	12.0
	Japan	0.0	8.5	4.5
	Asia Pacific ex Japan	5.5	10.0	9.0
	Emerging Markets	1.2	4.5	3.0
	Global Funds	0.8	0.0	0.0
	Equities Subtotal	40.0	60.0	60.0
Fixed Interest	DM Government	0.0	0.0	0.0
	EM Debt	5.1	2.0	0.0
	Corporate	27.9	11.0	11.0
	Fixed Interest Subtotal	33.0	13.0	11.0
Alternatives	Property	8.6	5.0	9.0
	Private Equity	2.8	4.2	5.6
	Specialist Financial	10.2	13.5	8.9
	Infrastructure	4.4	1.8	4.5
	Commodities	0.0	1.5	0.0
	Alternatives Subtotal	26.0	26.0	28.0
Cash		1.0	1.0	1.0
Total		100.0	100.0	100.0

- Our broad equity target weights are in line with our strategic asset allocation – a neutral position – reflecting the view that while dividend yields are not low, nor are they high
- Within equities, we are lightly positioned in North America and Japan, where we think valuations are somewhat high
- Our big equity overweight is in Europe ex UK, a region which we think is at a much earlier stage of economic expansion than other developed economies, as evidenced by unemployment rates now falling but still being well above historic averages
- We have zero targets in developed market government bonds, reflecting the view that real long-term yields that are below 1% and in many cases negative are not good value
- There is still good value in corporate bonds where although spreads are not particularly high in relation to history, default rates should remain low
- Our alternatives exposure seeks to target investments that offer something interesting in relation to equities and bonds; in the case of equities this is more stable income streams and in the case of bonds it is income streams that are index-linked
- Our private equity exposure in each of the three funds is largely in AJ Bell, a private company in which we are one of three outside shareholders
- Elsewhere in alternatives, we like non-core REITs, asset leasing and renewable energy
- Commodities we think generally add volatility but not much in the way of return

Macro and Market Data

		Macro									
		UK	Asia ex. Japan	Emerging Markets	US	Japan	Europe ex. UK	World			
GDP (%)	Latest	3.0	6.3	3.3	2.4	-0.1	1.4	2.4			
	2015	2.6	6.0	2.3	2.3	0.9	1.7	2.8			
	2016	2.4	6.2	3.4	2.7	1.4	1.9	3.2			
CPI (%)	Latest	1.5	2.8	5.6	1.6	2.7	0.7	2.0			
	2015	0.2	1.7	7.1	0.3	0.8	0.2	1.6			
	2016	1.5	2.7	6.8	2.1	1.1	1.3	2.6			
Unemployment Rate (%)	Current	5.6	3.9	5.1	5.3	3.4	11.1	-			
	Historical Average	6.1	4.0	6.4	6.3	4.5	9.5	-			
	Current Rel. to Average (%)	-9%	-2%	-20%	-16%	-25%	+17%	-			
	Years of History	16y	13y	13y	16y	16y	16y	-			
		Equities									
		UK	Asia ex. Japan	Emerging Markets	US	Japan	Europe ex. UK	World			
Dividend Yield (%)	Current	4.5	3.6	3.2	2.3	1.9	3.6	2.8			
	Historical Average	3.5	3.0	2.5	1.9	1.5	3.0	2.3			
	Current Rel. to Average (%)	+27%	+20%	+30%	+20%	+26%	+18%	+18%			
	Years of History	15y	15y	15y	15y	15y	15y	15y			
Return on Equity (%)	Current	8.2	12.2	11.0	12.6	9.0	10.1	11.1			
	Historical Average	11.9	12.9	13.9	12.7	5.4	11.7	11.5			
	Current Rel. to Average (%)	-31%	-5%	-21%	-1%	+67%	-14%	-4%			
	Years of History	16y	16y	16y	16y	16y	16y	16y			
		Fixed Interest									
		G7 Sov Real Yield	G7 Sov. BE Inflation	G7 Sov.	UK	EMHC	IG	HY			
Yield (%)	Current	-0.3	2.0	1.0	2.3	6.4	2.6	7.2			
	Historical Average	1.5	3.9	1.5	4.2	5.4	2.8	6.6			
	Current Rel. to Average (%)	-117%	-49%	-34%	-44%	+19%	-8%	+10%			
	Years of History	15y	15y	5y	15y	5y	5y	5y			
Spread (basis points)	Current	-	-	-	-	390	107	287			
	Historical Average	-	-	-	-	378	110	382			
	Current Rel. to Average (%)	-	-	-	-	+3%	-3%	-25%			
	Years of History	-	-	-	-	6y	15y	15y			
		Alternatives									
		UK Listed PE		UK REITs		UK Infra					
Price/NAV (%)	Current	75%		109%		107%					
	Historical Average	72%		91%		93%					
	Current Rel. to Average (%)	+4%		+20%		+15%					
	Years of History	8y		9y		7y					
		Currencies									
		GBP		USD		EUR		JPY		EM	
Current Real Effective Relative to Historical Average (%)		+4%		+4%		-9%		-28%		+14%	
Years of History		29		29		29		29		19	
		Prices									
		UK Equities	World Equities	EM Equities	G7 Sov.	HY	Enviro Opps	Commodities			
Trend Growth in Real Price (%)		+2.4%	+3.1%	+3.4%	+5.4%	+6.6%	+4.5%	+8.9%			
Current Real Price Rel. to Trend (%)		+12%	+19%	+29%	-20%	-5%	+16%	-46%			
Years of History		20	20	20	30	5	16	18			
Volatility (a)		14%	16%	15%	4%	7%	20%	15%			
Long-term expected Real Return (b)		6%	6%	6%	2%	5%	5%	2%			
(b)/(a)		0.4	0.4	0.4	0.5	0.7	0.3	0.1			

