SENECA
INVESTMENT MANAGERS

Seneca White Paper

Specialist Assets Review

It's time to specialise

In our opinion adding specialist assets such as real estate investment trusts, infrastructure and specialist financials to an investment portfolio makes sense. These assets can provide strong returns and a haven at a time of growing geo-political uncertainty and worries about the next recession.

Investing in these specialist areas can be rewarding but it is not without risk. At Seneca IM, we have almost two decades experience investing in this area and believe our edge is in our internal research and expertise, both of which are crucial when exploring the specialist assets arena.

Executive summary

Economic context; why now could be a good time to invest more of a portfolio into specialist assets.

Ten years after the financial crisis that rocked the global banking system and the global economy, we are overdue an economic downturn, or recession. As most investors are aware, economies are cyclical. Economic growth usually lasts for about five to seven years before a correction – a downturn or fall in growth.

Should investors be factoring a potential downturn into their investment strategy?

The International Monetary Fund (IMF) has recently revised and reduced its predicted global growth to 3.5% in 2019; growth could be slowed by increasing risks, including a possible increase in tariffs by the United States and other governments, and increased political uncertainty around the globe, most notably in Europe due to Brexit (quoted by the IMF in January 2019). We, along with a number of experts, believe that many of the largest companies in stock markets are over-valued, and the thinking being that the bull-run is unlikely to carry on for too much longer.

Given the landscape and potential for challenges ahead, now could be a good time for investors to review and gain exposure to specialist assets as a component in their portfolios.

Safe havens are proving harder to find so how can investors enhance returns while balancing risk?

Decreasing exposure to equities (likely to become more volatile) and bonds (expensive), could be wise, and opens up an opportunity for reasonable exposure to "specialist assets".

Access to specialist assets is done through particular investment trusts.

These vehicles that are closed-ended investments issue a fixed number of shares, which investors can then buy and sell.

A key benefit of investment trusts is that fund managers ordinarily have a fixed pot of capital to manage: hence, they do not have to deal with the flows of money in and out of the fund that can be typical of other investment structures, such as open-ended investment companies and unit trusts. Investment trusts are paying more income than ever before on a more frequent basis, according to research by Winterfloods published in 2018.

The increase in income is a response to growing demand for income-based returns via dividends, particularly from assets such as infrastructure, property and specialist financial vehicles.

With interest rates at close to historic lows, investors are becoming more interested in alternative sources of income and return.

It is our view that promising types of specialist assets, based on typical investment yields and stability of income, are:

- **Property (Real Estate) Investment Trusts (REITs)** – companies listed on stock exchanges that directly own property. Some are investing in more specialist property areas.
- **Infrastructure** - this is a broad investment category, ranging from sewers to wind farms.
- **Private equity** - accessing opportunities within privately owned businesses.
- **Specialist financials** – a range of opportunities from music royalties to aircraft leasing.

This white paper will outline and provide examples and case studies of these types of specialist assets, explaining how they work and the potential benefits of investing in them.

Typical income returns can vary between circa 4% and 8% and may be higher. Some are inflation linked, and although not without risk, can generate reliable income streams, not linked to economic cycles as part of a wider portfolio.

We will also analyse the risks of these assets - for example, if the shares of an investment trust are trading substantially higher than the value of their assets - and how to potentially minimise these.

Our investment managers build relationships with property investors, landlords and asset managers.

Specialist asset categories

Property (REITs)

REITs are property companies, listed on stock exchanges. They must distribute 90% of their income (from rent) via dividends.

An example of a smaller and therefore potentially more dynamic REIT is “Ediston Property Investment Company”, a property investment and asset management company with an emphasis on out-of-town retail centres; other sectors covered in the space include GP surgeries and private rental accommodation.

REITs involve investment in real property assets that typically produce reliable income streams in the mid-high single digits.

Our opinion is that some of the best returns in REITs may come from out-of-town retail centres. These are increasing as high street shops struggle, and retail warehouses grow due to e-commerce expansion.

Other promising areas for REIT investment include GP surgeries where funds support the provision of purpose built, multi-GP surgeries, at a time of growing demand for healthcare services. An example is “Primary Health Properties”.

The property investment market for prime office space (for example, London’s West End) has become saturated, with large investors chasing a small amount of properties in exclusive post codes. Such assets can also be prone to high cyclicality.

We prefer smaller, niche, property investment funds that have potential for growth, and where our investment managers can build strong relationships with the REIT management teams. When investing in a REIT, we focus on the nature of the lease profile. Do the leases justify the rent charged to tenants? For example, if a tenant is being charged £10 per square foot for using the building but a tenant at a similar property is paying £7 per square foot, the landlord may have to reduce their rent when the lease expires, or spend money refurbishing the property to avoid losing the tenant. Mitigating considerations would include any alternative uses for the property.

One of a REITs main investment risks is that property is an illiquid asset, combining a number of approaches alongside a diverse range of other assets can help minimise this risk.

Strong Foundations

Case study:

Strong foundations – the PRS REIT

- Private Rental REIT opportunities have previously been invested in by sovereign wealth funds. Now, however, they are becoming more mainstream for UK institutional investors. One such example is the PRS (Private Rental Sector) REIT which looks to fund affordable housing estates purpose built for the rental market.
- Growth in demand for affordable rented housing is likely to continue, given the shortage of houses in the UK market and the Government's promise to provide more affordable, long-term rented houses for tenants.
- Location focus is outside of the South East to avoid expensive land and build costs but with tenant demand under served by existing supply.
- Risks of this type of investment include lack of demand. Other risks can be minimised due to the quality and expertise of the property's management team.
- So far, the roll out of construction sites has been in line with expectations, with a pipeline of new homes including private housing estates in Liverpool, Cheshire, Telford, Shropshire, and the West Midlands.

Infrastructure

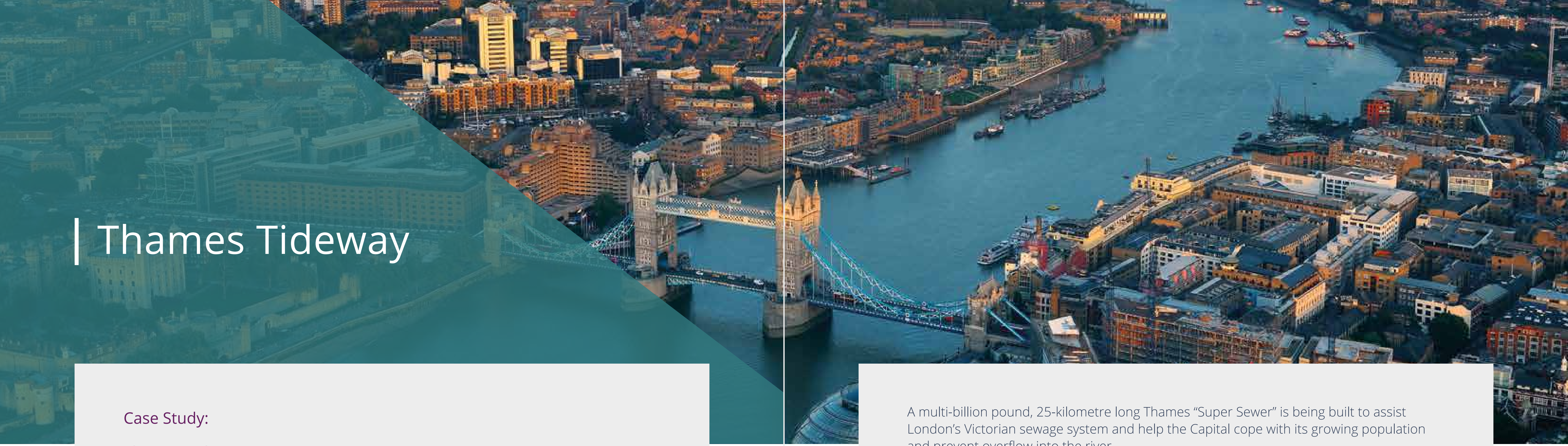
It may not be the most glamorous of financial investments, but we will always need roads, rails, bridges, schools, police and fire stations.

In 2017, infrastructure was the fourth largest investment company sector, according to the Association of Investment Companies.

Cuts in government spending on public infrastructure since 2010 has left a funding gap – and an opportunity for private capital.

Infrastructure investment opportunities, include:

- A multi-billion pound, 25-kilometer long Thames "Super Sewer", which is being financed by a consortium of investors, including INPP (International Public Partnership).
- John Laing Environmental Assets Group, which invests in assets ranging from waste and various renewable energy assets, offers exposure to a range of sustainable investment in significant growth areas.



Thames Tideway

Case Study:

Thames Tideway

The River Thames has always played a major role to London's economic, political and cultural life.

For centuries, it was a conduit for the removal of the city's waste.

However, after an unusually hot June in 1858, the nauseous and noxious gases rising from the River Thames became unbearable and action had to be taken.

The result was a 1,100-mile network of underground sewers, built by engineer Sir Joseph Bazalgette.

The sewer network, which was finished in 1868, was an extraordinary achievement of engineering. It was built to cope with a population twice the size of London's in 1858 (two million).

Today, nearly nine million people live in the capital.

A multi-billion pound, 25-kilometre long Thames "Super Sewer" is being built to assist London's Victorian sewage system and help the Capital cope with its growing population and prevent overflow into the river.

The tunnel will intercept, store and transfer sewage waste away from the River Thames.

The "Tideway" project is due to be completed in 2024.

As well as being one of the biggest and most important public infrastructure projects in the UK, in our opinion it's also a good investment opportunity.

The sewer is being financed by a consortium of investors, including INPP (International Public Partnerships).

We believe a differentiator here is that investment returns are received through the construction phase. As the pipeline is completed, its operational ownership lasts 120 years.

The Tideway project is part of a wider investment trust (INPP).

Investment trusts such as INPP give investors access to various infrastructure projects. A diversified portfolio can reduce investment risks by not being too reliant on a small number of investments.

Private equity

Listed private-equity funds generally invest in a portfolio of unquoted shares, as funds mature over time.

Potential advantages of investing in private equity (PE) specialist assets

We believe that private equity can provide some of the highest investment returns of any specialist asset.

Private companies with "Patient Capital" investors can invest and build their businesses with less concern for short-term market performance.

Risks

- Fees paid to PE investment managers are generally higher than other types of investment trust, although there has been a shift towards making fees further linked to performance.
- Directly invested; focussed portfolios can be volatile if large positions emerge due to a revaluation event.
- Discounts to Net Asset Value can open up at times of market stress, however, in our opinion these should prove temporary.

Specialist financials

We invest in a wide range of asset financing and leasing from planes, secured asset lending, through to music royalties.

Get Lucky

Case study:

Hipgnosis Songs Fund

Our investment in a fund that buys the rights to songwriters' future royalty payments aims to cash in on the boom in digital-streaming services.

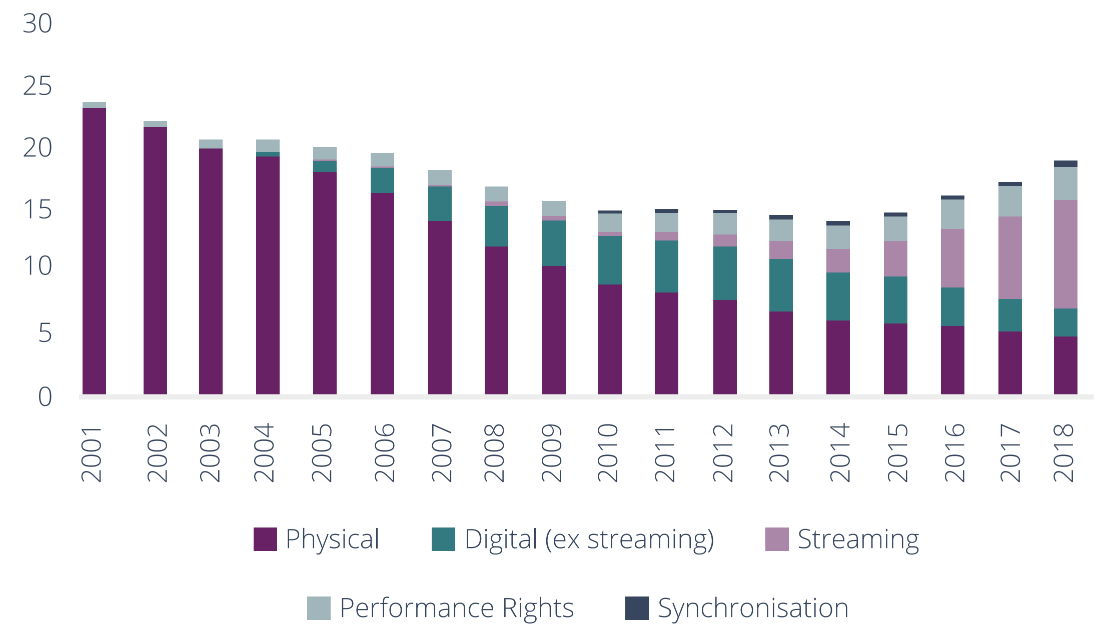
- Given valuation levels in fixed income markets we're spending more time analysing other financial instruments that will give us access to "bond like" income streams.
- One area we're exploring is music royalties.
- A recent investment in our portfolio is the Hipgnosis Songs Fund, which has raised £200 million to buy a portfolio of songwriter's catalogues.
- The fund effectively buys future royalty payments from writers of songs, calculated on historic values.
- It aims to pay investors a five per cent yield and an annual NAV return of 10% over the medium term (net of fees).
- Songwriters get a share of royalties, whenever a song in the fund's music catalogue is played on the radio or streamed on music services such as Amazon and Spotify.
- Nile Rogers, the songwriter behind some of the best-known songs of the last 40 years including co-writing "Get Lucky" by Daft Punk, is on the advisory board of the Hipgnosis Songs Fund.
- The Hipgnosis portfolio is advised by Merck Mercuriadis a former head of "The Sanctuary Group PLC". He has been in the industry for thirty-four years at Virgin Records and Sanctuary Group, having managed artists such as Elton John, Guns N Roses and Iron Maiden to name but a few.

Now that's what I call earnings

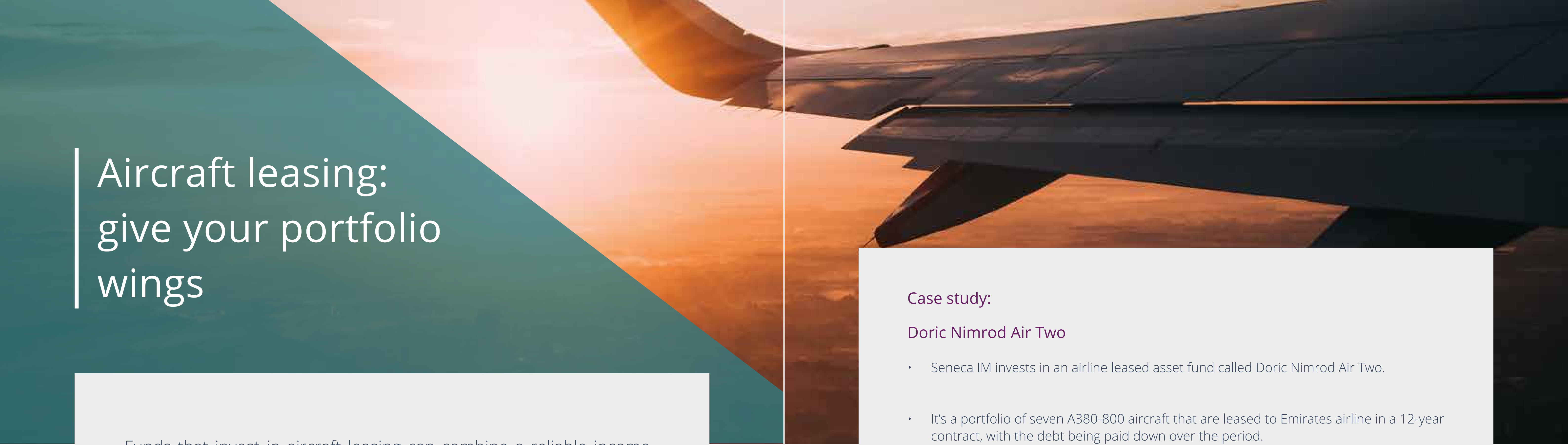
- Music industry revenue declined between 1999 and 2014.
- Music piracy ravaged earnings and physical sales were in constant decline.
- Revenue from downloads was subdued due to illegal downloading sites, however we believe that an inflection point has been reached and the music industry is returning to an era of growth.
- Life is becoming more difficult for piracy sites.
- Our research suggests online music-streaming services are set to increase significantly across the globe, due to new technology and growing geographical markets.
- Since 2015, revenue growth from streaming has outweighed the decline in physical sales and digital downloads.
- The music industry's revenue has increased in the past 4 years.
- For an increasing number of people, streaming services are the main way to listen to music. This is creating an inflexion point that has reversed the multi-year decline in revenues.
- Streaming services are being pre-installed in cars.

- The fund is supported by an advisory board that includes Nile Rodgers – the legendary songwriter, singer and music producer who co-founded Chic – and ex- CEOs and finance directors of major record labels such as EMI, Universal, Atlantic and Sony.
- The investment fund's risks include revenue not rising (although even at current levels our model predicts a five per cent annual return) and an increase in music piracy.

Global recorded music industry revenues 2001-2018 ($billions)



Source: Global Music Report 2019



Aircraft leasing: give your portfolio wings

Funds that invest in aircraft leasing can combine a reliable income stream with good returns.

These closed-end funds include Doric Nimrod Air (One to Three), which own a fleet of A380s leased to Emirates, the flag carrier for Dubai (see case study Doric Nimrod Air Two).

Aircraft are leased at a fixed rate, for a fixed time. The airline using the aircraft is responsible for the costs of the aircraft while leased, including insurance and maintenance.

At the end of the lease, the planes are sold, and the fund is wound up. Proceeds are then returned to investors.

For investors, the crucial factor is counterparty risk i.e. the financial health of the airline. In addition, an awareness of likely resale value of the aircraft needs to be appreciated.

Funds estimate the resale value of their planes and historically there have been concerns about planes' resale value, but in recent months there has been growing optimism as a secondary market begins to develop.

Case study:

Doric Nimrod Air Two

- Seneca IM invests in an airline leased asset fund called Doric Nimrod Air Two.
- It's a portfolio of seven A380-800 aircraft that are leased to Emirates airline in a 12-year contract, with the debt being paid down over the period.
- Emirates bears all aircraft costs, including maintenance, repair and insurance, during the lease.
- The aircraft undergoes a full overhaul at the end of the lease, which Emirates pays for.
- The aircraft have a working life of more than 25 years. So, after the 12-year lease the aircraft can be sold in the secondary market.
- The secondary market for these aircraft is unproven but given capacity demands in the UAE and the growth in air travel in Asia, especially China, it is likely this will be a source of demand. The planned cessation of production of the aircraft by Airbus, in our view, increases the scarcity value of these unique aircraft.
- **Typical returns:** 8% income per year, with final capital return dependant on future plane residual resale values.

Summary

The global economy may be overdue for a downturn with increased geo-political uncertainty.

Now may be a good time for investors to review their portfolios to take account of specialist assets.

Seneca IM's investment strategy is to find the right balance between quality and value, and in doing so generate stable sustainable income and returns.

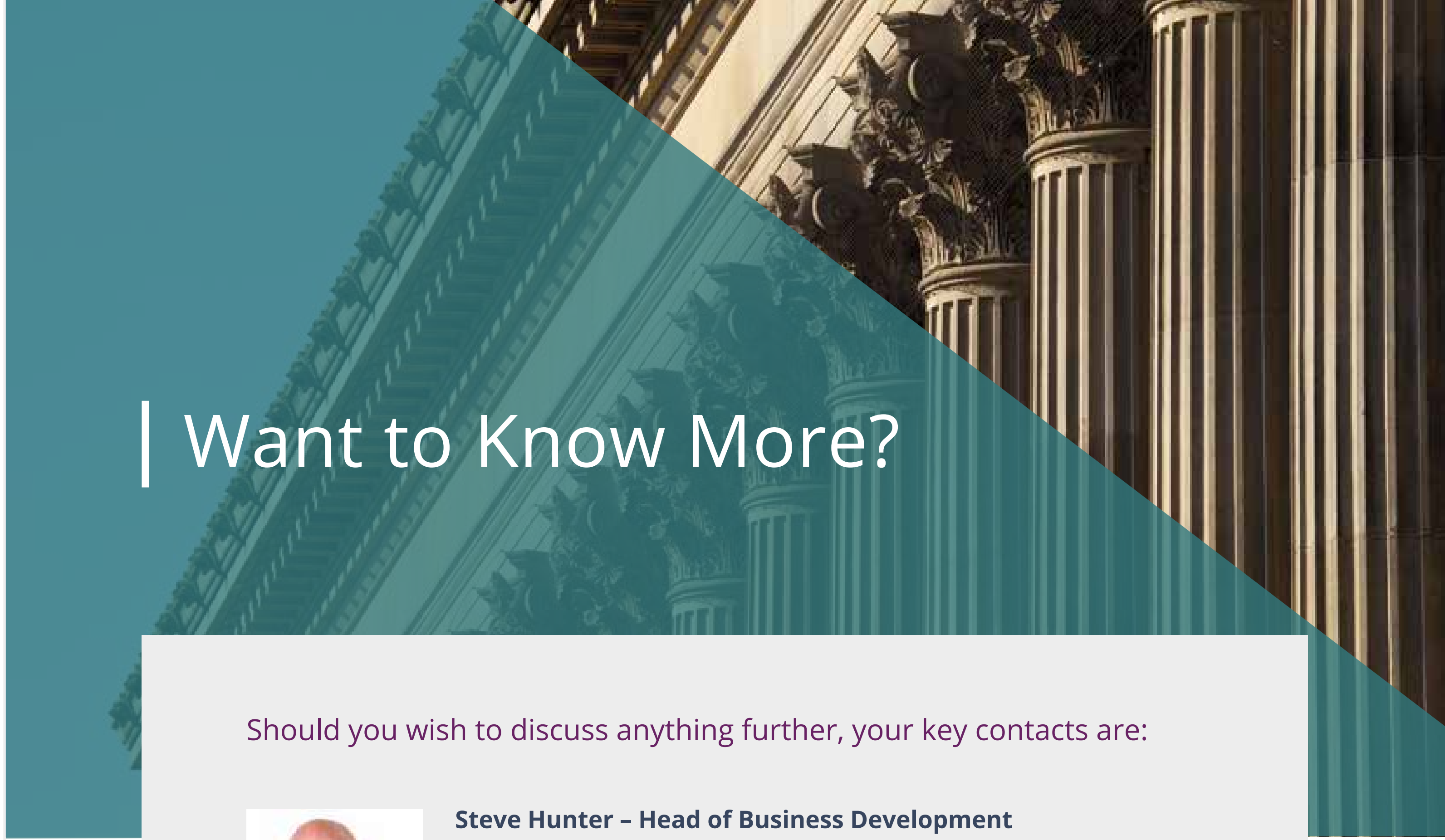
Combining specialist assets – physical assets such as property, infrastructure, private equity funds and specialist financial assets including mortgages and music royalties – alongside more traditional investments such as equities and bonds has several attractions for investors.

They can provide good investment yields with reduced volatility and are not usually linked to the stock market or economy.

Investing in these specialist areas can be rewarding but it is not without risk. At Seneca Investment Managers we have almost two decades experience investing in these areas and combining these non-traditional investments with more traditional investments such as equities and bonds.

We believe our edge is in research and expertise, both of which are crucial when exploring the specialist assets arena.

If you would like to know more about our approach to Multi-Asset investing, please get in touch.



Want to Know More?

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