MARTEN & CO

Update | Investment companies

16 January 2018

Seneca Global Income & Growth

Walking the walk

In mid-2017, Seneca Global Income & Growth Trust's (SIGT's) manager set out a clear road map of how it would reduce gradually the trust's equity weighting over the next couple of years. The manager has been sticking to this plan and, in this report, we update on the changes it has been making to SIGT's portfolio. The manager expects to see a global recession in 2020 with a global bear market in equities commencing in 2019. The aim is that SIGT will be meaningfully underweight equities as developed markets and economies reach their peak phase (during which equities traditionally show their poorest performance).

Multi-asset, low volatility, with yield focus

Over a typical investment cycle, SIGT seeks to achieve a total return of at least the consumer price index (CPI) plus six per cent per annum, after costs, with low volatility, and with the aim of growing aggregate annual dividends at least in line with inflation. To achieve this, SIGT invests in a multi-asset portfolio that includes both direct investments (mainly UK equities) and commitments to open-and-closed-end funds (overseas equities, fixed income and specialist assets). SIGT's manager uses yield as the principal determinant of value when deciding on its tactical asset allocation and holding selection.

Year ended	Share price total return (%)	NAV total return (%)	Bench-mark* (%)	MSCI World total return (%)	MSCI UK total return (%)
31/12/13	25.4	17.4	3.5	21.1	18.5
31/12/14	6.1	2.7	3.5	11.2	0.5
31/12/15	11.0	7.8	3.6	3.8	(2.2)
31/12/16	14.3	12.4	3.5	29.4	19.2
31/12/17	15.2	15.0	6.0	13.8	11.8

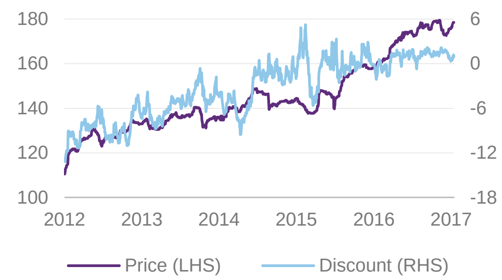
Source: Morningstar, Marten & Co. *Note: SIGT's benchmark is Libor + 3% from 18 January 2012 changing to CPI + 6% with effect from 7 July 2017.

Sector	Flexible investment
Ticker	SIGT LN
Base currency	GBP
Price	178.50p
NAV	177.03p
Premium/(discount)	0.8%
Yield (prospective)*	3.5%

*Note: yield assumes dividend is paid at SIGT's minimum rate of 1.58p per quarter for the remainder of the year ending 30 April 2018.

Share price and discount

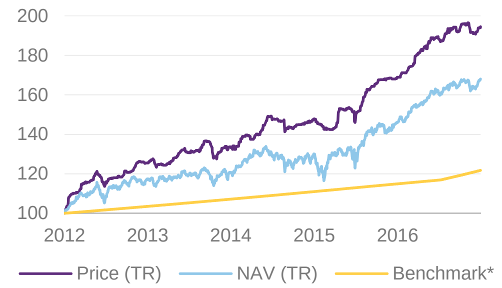
Time period 31/12/2012 to 12/01/2018



Source: Morningstar, Marten & Co

Performance over five years

Time period 31/12/2012 to 31/12/2017



Source: Morningstar, Marten & Co

Domicile	United Kingdom
Inception date	19 August 2005
Manager	Team managed
Market cap	80.6m
Shares outstanding	45.2m
Daily vol. (1-yr. avg.)	116.0k shares
Net gearing	6.1%

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Click here for our most recent update note

Manager's view – reducing equity exposure in anticipation of a global recession in 2020

Equity exposure is reducing by 1% every couple of months.

As discussed in our notes of June and September 2017, Seneca Investment Managers (Seneca IM) has set out a clear road map for SIGT's equity weighting and how this will be reduced over the next couple of years. Specifically, SIGT's equity exposure is being decreased by 1% every couple of months (give or take, depending on market conditions) in advance of a global recession that Peter Elston (the research specialist for asset allocation) anticipates in 2020. He expects to see a global equity bear market commencing in advance of this, starting at some point in 2019, and aims for SIGT to be meaningfully underweight equities at this time, as it is during the peak phase that equities provide the worst performance. As discussed in the asset allocation section (see page 3), since setting out its intentions, Seneca IM has been sticking to its plan.

Read Peter Elston's investment letters at: senecaim.com

For professional investors, a detailed discussion is provided in Peter Elston's investment letters of July 2017 (Issue 26: Preparing for the next downturn) and November 2017 (Issue 30: Keeping it simple – how to add value effectively through tactical asset allocation). We recommend reading both.

Developed markets and economies are in an expansion phase

During the expansion phase inflation starts to take hold. This causes central banks to shift into tightening mode.

Peter believes that developed economies are, on average, in an expansion phase. Theory suggests that it is during this phase that inflation starts to take hold and inflation rates rise above central bank targets, which causes central banks to shift into tightening mode. The US has been tightening for two years and, while US inflation reduced in the early part of 2017, it is now on the rise again and so the US Federal Reserve will continue to tighten.

The US has been tightening for two years and the UK has now seen its first rate rise since the financial crisis.

The UK has now seen its first rate rise since the financial crisis, on the back of rising inflation and, while the economy is close to full employment and continues to grow, this uptick has been driven primarily by the 'cost push' effects of sterling weakness in the aftermath of the Brexit vote. There are concerns that this inflation is becoming entrenched, which has led to the Bank of England taking action on interest rates, with the potential for further adjustments in due course.

UK consumer facing industries are experiencing weakness but UK exporters and UK industries that compete with imports are doing well.

Peter takes the view that, looking at the UK economy overall, the outlook is sufficiently positive but within this the picture is mixed. The UK consumer is clearly coming under pressure and UK consumer facing industries are experiencing weakness as a result. However, UK exporters aided by weak sterling and UK industries that compete with imports are generally doing well. For example, the UK housebuilding sector has traditionally imported a lot of its raw materials from continental Europe but, following sterling depreciation, more of its materials are now being sourced from within the UK, which is benefiting these suppliers. In summary, Peter thinks that the weak consumer is balanced by a strong external sector, and the current adjustments are just part of the normal cycle of creative destruction. Government finances are also in much better shape than they have been. Peter thinks that the government might consider easing up on austerity, which could come from allowing public-sector wages to increase or increasing government spending directly.

Europe and Japan's economic recoveries are lagging that of the UK, which is behind that of the US.

On balance, the developed world is now well into the expansion phase.

Looking at Europe and Japan, their economic recoveries are lagging that of the UK, which is behind that of the US. Unemployment rates in Europe and Japan are well above historic averages and well above all-time lows, suggesting these economies have some way to go before reaching full capacity. In contrast, unemployment rates in the UK and the US are very close to all-time lows. As such, Peter thinks that Europe and Japan can continue to see their unemployment rates fall as their economies move from the recovery phase towards the expansion phase. Taking the balance of all of the above, Peter thinks that, on average, the developed world has now moved into the expansion phase.

Tightening monetary policy is a warning sign

A simple yet effective way to keep track of the cycle, and therefore add value through tactical asset allocation, is to keep a close on eye on monetary policy.

It is during the expansion phase that returns from equity markets start to fall (equity returns are best in recession phase, second best in recovery phase, then slightly lower, but still positive in the expansion phase). Peter says that a simple yet effective way to keep track of the cycle, and therefore add value through tactical asset allocation, is to keep a close on eye on monetary policy. Specifically, a key warning sign for equity markets is when monetary policy has been tightening for a prolonged period, and the yield curve inverts. This arguably signifies the end of the expansion phase.

An inverted yield curves means that monetary policy is tight and so there is likely to be some sort of decline in economic activity.

Inverted yield curves mean that monetary policy is tight and so there is likely to be some sort of decline in economic activity. Peter says that, in the US, the last five recessions have been presaged by an inverted yield curve and that an inverted yield curve (in the US) has always lead to a recession. As such, Peter values this as a strong leading indicator. Peter wants SIGT to be heavily underweight equities by the time we move to the peak phase, which he thinks will be in about two years from now.

Asset allocation

One percent reduction in equity exposure every couple of months

During H2 2017, Seneca IM has continued to reduce SIGT's equity exposure, by 1% every couple of months, as promised.

The team at Seneca IM set out its intention, in mid-2017, to reduce SIGT's allocation to equities during the next few years with the aim of being significantly underweight by 2020 (we first commented on this in our update note of 13 June 2017). The manager had already been reducing the previous equity overweight (SIGT is now underweight equities) prior to making this statement and, during H2 2017, has continued to reduce SIGT's equity exposure, by 1% every couple of months, as promised. The key changes are summarised as follows:

- A 1% reduction in SIGT's equity weighting at the end of June (discussed in our September 2017 note) taking the equity exposure from 61% to 60%
- A 1% reduction in SIGT's equity weighting at the end of August, taking the equity exposure from 60% to 59%. All the reduction came from North American equities. 0.5% was invested in corporate bonds while the other 0.5% was invested in specialist assets
- A 1% reduction in SIGT's equity weighting during October, taking the equity exposure from 59% to 58%. All the reduction came from reducing SIGT's exposure to Japanese equities. 0.5% was invested in corporate bonds while the other 0.5% was invested in specialist assets
- A 1% reduction in SIGT's equity weighting at the beginning of November (brought forward from a planned reduction intended for the beginning of December), taking the equity weighting from 58% to 57%. All the reduction came from the disposal of

Conviviality (UK equities). This rationale behind this sale is discussed in greater detail below.

Figure 1: Comparison of end November 2017 asset allocation, end June 2017 asset allocation and end November 2017 income generation

Source: Seneca IM, Marten & Co

Conviviality sold in its entirety

Figure 2: Conviviality share price

Source: Bloomberg

Conviviality (**www.conviviality.co.uk**) has been a somewhat irregular investment for SIGT as its holding period has been less than a year (SIGT's managers are longer-term, low-turnover investors whose investment horizon is usually three to five years) but the investment thesis came through far more quickly than was expected. At the beginning of November, Mark Wright (research specialist for UK equities) was becoming more cautious on the stock. The holding had done extremely well (it had gone up 60% or thereabouts since purchase) and so its valuation metrics were not so attractive. However, Mark was also concerned when the company's finance director left October and he had some concerns regarding two financial misstatements that had been disclosed since SIGT initially invested.

Mark felt that there was a risk that some more serious issues could emerge and, given Conviviality's relatively high valuation, felt it prudent to dispose of the holding. At the time, Mark did not want to reallocate the proceeds across the remaining holdings and so SIGT's cash balance was increased.

Intermediate Capital sold in its entirety

Figure 3: Intermediate Capital share price

Source: Bloomberg

Purchased in 2011 on a contrarian view, Intermediate Capital (**www.icgam.com**) has provided close to a 30% annualised return for SIGT over its holding period. At the time of purchase, the company was moving from being quite a capital-intensive business, that was relatively highly debt financed, to becoming more of a conventional fund manager. SIGT's managers felt the market did not fully appreciate this change. The thesis has worked out very well. Intermediate Capital was purchased on a yield greater than 6% and sold on a yield of 3%. The dividend has been increased every year since purchase and Intermediate Capital has also paid significant special dividends. The proceeds from the sale of Intermediate Capital were used to finance the purchase of a position in Babcock International (discussed on the next page).

Babcock International – sole new addition to the UK equities portfolio

Figure 4: Babcock International Equity share price

Source: Bloomberg

Babcock International (**www.babcockinternational.com**) provides highly skilled engineering support and specialist training for infrastructure assets across four main business segments: marine, land, aviation and nuclear. It sits within the support services sector and its biggest client is the UK government (80% of its work is for the public sector while 75% of its work is in the UK).

Profit warnings from other support services companies such as Capita, Interserve, Mitie and Serco over the last few years, have also weighed heavily on Babcock. However, Babcock's business model is fundamentally different to those of its struggling peers. The services provided by these companies are often relatively low skilled, in the public eye and relatively low margin (a few years back, intense competition saw many support service companies bidding aggressively for work on the assumption that there would be considerable add-on work, at higher margins, but this did not materialise). Babcock's work, in comparison, uses highly skilled labour and considerable technological knowledge. This is usually applied in heavily regulated and often secretive industries (for example nuclear and defence). Such expertise is often in short supply and as a result, barriers to entry are relatively high, with better-quality earnings the result. Following a material derating, Seneca IM took the view that Babcock was too cheap given its quality. It believes that Babcock has high potential to rerate over the next few years.

Specialist assets increased

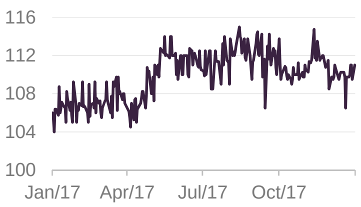
Figure 5: International Public Partnerships share price

Source: Bloomberg

The manager says it was happy to top up SIGT's position in Greencoat UK Wind (**www.greencoat-ukwind.com**) during that company's fundraising in October. The manager has also added to SIGT's holding in International Public Partnerships (INPP) and reintroduced Ediston Property (EPIC) to the portfolio.

INPP (**www.internationalpublicpartnerships.com**) has been held in SIGT's portfolio since July 2016 and we have discussed the investment rationale in our previous notes. INPP's share price suffered following negative media coverage relating to talk by the Labour Party of renationalising utilities and infrastructure assets. However, Seneca IM says that INPP is invested in fairly uncontentious areas and it is not particularly exposed to a buy in by the UK government in the event that Labour is elected. As such, it took the view that the price decline presented a buying opportunity.

Figure 6: Ediston Property share price



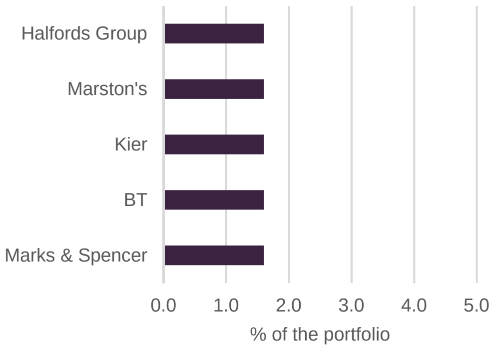
Source: Bloomberg

EPIC (**www.epic-reit.com**) was removed from SIGT's portfolio when it went through its own rationalisation and consolidation process 12-18 months ago. At that time, EPIC was smaller and SIGT's managers felt that it would be difficult to have the size of position they would like for SIGT without owning around 8% of EPIC. This was not feasible for SIGT, given the liquidity of EPIC's shares at that time, and so the position was sold. However, EPIC has since completed a very successful fundraising meaning that it is once again suitable for SIGT's portfolio. Seneca IM likes EPIC's management team and has been impressed by the latter's ability to 'work the assets' in EPIC's portfolio. Seneca IM thinks that this will be very important in the late part of the property cycle.

Largest investments

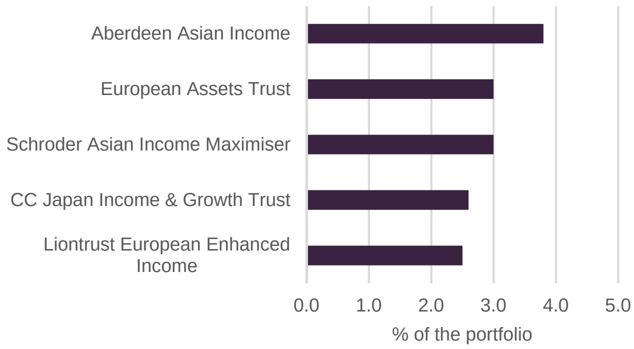
Figures 7, 8, 9 and 10 show the largest positions in each part of the portfolio as at 30 November 2017. Details of the rationale underlying some of these and other positions can be found in our previous research notes. Some of the more recent changes are also discussed in detail above.

Figure 7: Top UK equity positions as at 30 November 2017



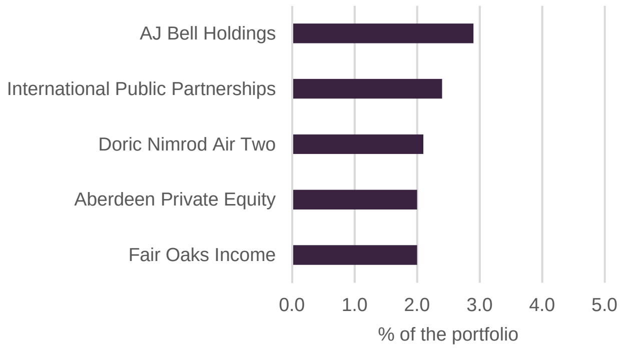
Source: Seneca IM

Figure 8: Top five overseas equity positions as at 30 November 2017



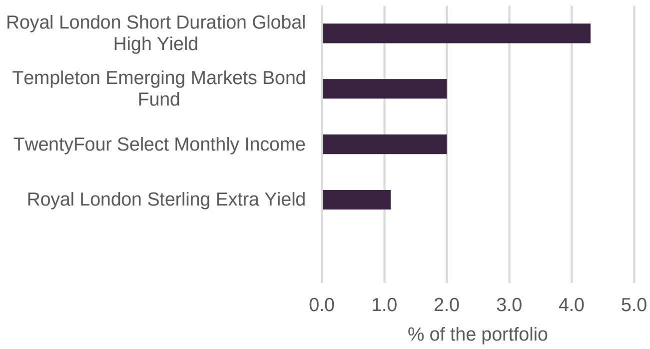
Source: Seneca IM

Figure 9: Top five specialist asset positions as at 30 November 2017



Source: Seneca IM

Figure 10: All fixed income positions as at 30 November 2017



Source: Seneca IM

Aberdeen Private Equity, a top-five specialist asset position, has announced recently that its entire portfolio has been sold at a modest premium to its last NAV. The proceeds will be returned to shareholders. Its share price rose sharply on the news.

Performance

Figure 11: Cumulative total return performance to 31 December 2017

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	Strategy change*
SIGT NAV	2.6	1.2	4.9	15.0	39.3	68.0	88.8
SIGT share price	1.7	0.7	3.4	15.2	46.1	94.6	118.8
Flexible Investment NAV	1.4	2.4	4.3	10.5	32.0	50.6	59.3
Flexible Investment share price	2.0	3.9	6.6	15.9	43.5	62.5	74.5
Blended benchmark**	0.7	2.2	4.3	6.0	13.7	21.8	23.8
MSCI UK	5.0	4.9	6.8	11.8	30.4	55.3	67.3
MSCI World	1.5	4.7	6.5	12.4	52.9	114.2	128.8

Source: Morningstar, Marten & Co. *Note: strategy change was approved by shareholders on 18 January 2012. Please see our November 2015 initiation note for more details. **Note: SIGT's benchmark is Libor + 3% from 18 January 2012 changing to CPI + 6% with effect from 7 July 2017.

Peer group and benchmark-beating returns with lower volatility – **click here** to see the QuotedData website for up-to-date figures.

Figure 11 illustrates SIGT's share price and NAV total return performances in comparison with those of its peer group, its blended benchmark, the MCSI UK and MSCI World indices. Looking at Figure 11, SIGT has overwhelmingly beaten its peers and the indices provided. SIGT's long-term performance record is very strong (it is ahead of the peer group and various indices over five years and since the strategy change in 2012 and, for the three-year period, is only beaten by the MSCI World). In our view, it is over longer-term horizons that SIGT's performance is best assessed.

Looking at Figure 12, SIGT has achieved these returns, with lower volatility than the average of its peer group, over all of the time periods provided. Its return volatility has also been lower than that of both the MSCI UK and MSCI World indices.

Figure 12: Annualised standard deviation of NAV returns to 31 December 2017

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	Strategy change*
SIGT NAV	5.40	6.12	5.95	6.02	10.85	9.85	9.53
SIGT share price	3.72	4.44	4.58	4.48	6.12	6.04	6.16
Flexible Investment NAV	6.11	8.08	8.25	8.28	10.90	10.96	11.06
Flexible Investment share price	12.28	10.52	11.27	11.78	13.67	13.89	13.99
MSCI UK	9.50	9.28	10.21	10.16	17.79	16.35	16.37
MSCI World	9.35	12.06	11.30	11.75	15.50	14.43	14.11

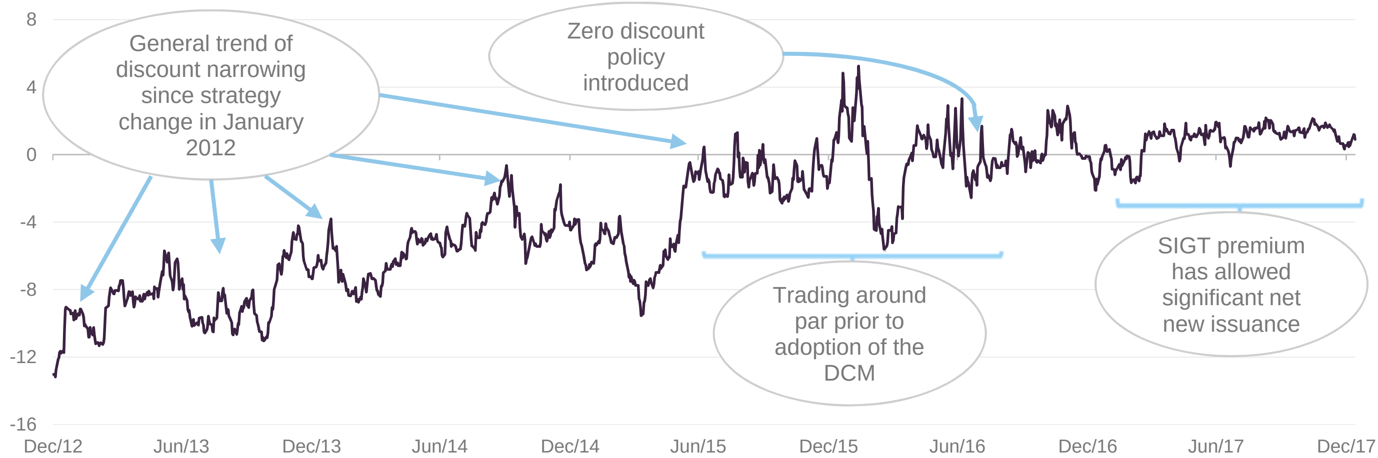
Source: Morningstar, Marten & Co. *Note: strategy change was approved by shareholders on 18 January 2012. Please see our November 2015 initiation note for more details.

Stock issuance continues apace

SIGT's number of shares in issue has grown by 10.4% during the last six months, raising £7.76m for the trust.

As illustrated in Figure 13, SIGT's discount control mechanism (DCM), which went live on 1 August 2016, continues to keep the trust trading close to asset value. We have previously said that, by giving investors confidence that they can enter and exit SIGT at close to NAV, the DCM should allow SIGT to attract new shareholders and grow its asset base over time, if it continues to provide low-volatility returns that are attractive to investors. Figure 14 illustrates that this appears to have been the case.

Figure 13: Premium/(discount) over five years



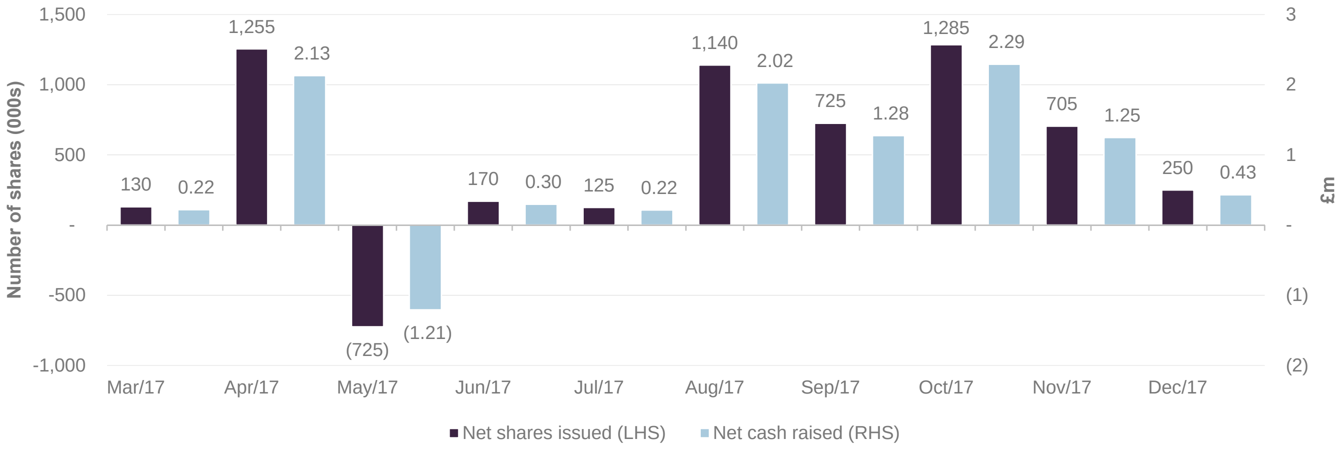
Source: Morningstar, Marten & Co.

SIGT's number of shares in issue has grown by 10.4% during the last six months, raising £7.76m for the trust. Net issuance of this scale illustrates that there is demand for SIGT's strategy. There has been a growing recognition of what the trust has achieved. Seneca IM ascribe this to the adoption of a new investment process three years ago, SIGT's subsequent investment performance and the additional resource that Seneca IM has added to its sales and marketing efforts, reflecting its willingness to invest in its business.

DCM is proven for both issuance and repurchases

While the overwhelming trend, since the introduction of SIGT's DCM, has been one of share issuance, SIGT has made one share repurchase. As illustrated in Figure 14, on 8 May 2017, SIGT repurchased one million shares at a price of 168.25p per share. With a closing NAV of 170.51p per share, this suggests the shares were repurchased at a discount of around 1.3% and so the transaction was NAV accretive for remaining shareholders. The repurchase represented 2.4% of SIGT's issued share capital at the time of repurchase, which is clearly significant, and demonstrates the board's commitment to the DCM for repurchases as well as issuance.

Figure 14: Net stock issuance and net amount raised, by month, since the DCM went live on 1 August 2016



Source: Morningstar, Marten & Co.

New three-year £14m borrowing facility

The new facility charges interest at a rate of Libor + 1.1% and has terms that are very similar to the outgoing facility.

On 1 November 2017, SIGT announced that it has replaced its previous two-year £11m rolling debt facility, which expired on 31 October 2017, with a new three-year £14m facility. Seneca IM says that the new facility, which charges interest at a rate of Libor + 1.1%, is also provided by RBS, has terms that are very similar to the outgoing facility, is very flexible and there has been no increase in the facility's covenants.

There is no plan to increase the level of gearing.

The manager advises that there is no plan to increase the level of gearing in the trust at this time, but the facility gives SIGT the flexibility to finance any share buybacks that might be required, or to maintain the existing level of gearing, assuming that SIGT continues to be able to issue ordinary shares.

Fund profile

Further information regarding SIGT can be found at Seneca IM's website: senecaim.com

SIGT's aim is to grow both income and capital through investment in a multi-asset portfolio and to have low volatility of returns. Its portfolio includes allocations to UK equities, overseas equities, fixed income and specialist assets.

SIGT is designed for investors who are looking for income, want that income to grow, want the capital of the investment to grow and are seeking consistency, or lower volatility, in total returns. A pure bond fund could meet the first of those needs, a pure equity fund could meet the first three. SIGT invests across a number of different asset classes with the aim of achieving all four objectives.

Seneca Investment Managers – a multi-asset value investor

Seneca IM is a multi-asset value investor. It takes a team approach

SIGT's portfolio has been managed by Seneca Investment Managers (Seneca IM), and its forerunners, since 2005. Seneca IM describes itself as a multi-asset value investor. We think the combination of multi-asset investing with an explicit value-oriented approach may be unique to Seneca IM. The idea is that Seneca IM can allocate between different asset classes and investments, emphasising those that offer the most attractive opportunities and yields, making asset allocation, direct UK equity and fund selection (for access to other overseas equities and other asset classes) following a value-based approach.

Team approach – broadening responsibilities

A number two has been introduced for each research area.

Seneca IM takes a team approach to managing its portfolios. In recent years, there has been one research specialist focused on: asset allocation (Peter Elston), fixed income (Alan Borrows), UK equities (Mark Wright), specialist assets (Richard Parfect) and overseas equities (Tom Delic). However, in October 2017, and in advance of Alan Borrows' retirement, the team decided to 1) introduce a number two for each research area and 2) amalgamate the overseas equities and fixed income research responsibilities. Seneca IM is also looking to add extra resource to the investment management team and expects to make an announcement shortly. In the meantime, Tom Delic has taken over responsibility for fixed income research.

Overseas equities and fixed income, both exposures gained via funds, have been combined into one research area.

Within SIGT's portfolio, exposure to both overseas equities and fixed income is gained via funds. The research for these areas focuses primarily on assessing the fund manager, and its investment process, rather than the asset class itself. As such, the team has determined that it is more relevant to split research responsibility for these third-party funds, along geographic lines. Figure 15 provides a summary of the new responsibilities.

Figure 15: Research responsibility summary

Research responsibility	Lead	Support
Asset allocation	Peter Elston	TBA
UK equities	Mark Wright	Tom Delic
Third-party funds – overall process and framework	Tom Delic and TBA*	
Third-party funds – developed (North American equities, European equities, corporate bonds)	TBA*	Tom Delic
Third-party funds – Asia/emerging (Asian equities including Japan, emerging market equities, emerging market debt)	Tom Delic	TBA*
Specialist assets (property and alternative assets)	Richard Parfect	Peter Elston
Fixed income direct (government bonds)	TBA**	Peter Elston

Source: Seneca IM *Note: Tom Delic is responsible in the interim. **Note: Peter Elston is responsible in the interim.

MiFID II ready

Seneca IM is adding to its internal resource to analyse investments.

Seneca IM's plans to add to its investment team reflect the decision, in common with many asset managers, to add to its internal resource to analyse investments as, following the implementation of MiFID II on 3 January 2018, it now has reduced access to third-party research. However, the Seneca IM team believes that because it has tended to conduct its own research internally, it is already well positioned for a post MiFID II environment.

Recent recognition

In the Investment Week Specialist Investment Awards for 2017, Seneca IM was ‘highly commended’ in the ‘Multi-Asset Group of the Year’ category. Seneca IM says that it is particularly proud of this recognition as the awards are assessed by a large independent panel of industry experts, having looked at over 400 funds across the multi-asset space, with Seneca IM coming in second to Premier Asset Management and ahead of other very credible managers. Seneca IM believes that the commendation provides strong recognition for the portfolio management team and vindicates its focus on value, strong performance in recent years and the work done to strengthen the investment process.

Seneca IM has begun 2018 with three new hires

Dawn Morris is now head of marketing for Seneca IM. Darron Pace has joined as compliance manager while Danielle Tully has been appointed as investment administrator.

Seneca IM has recently hired Dawn Morris to run its marketing operations for both the company and its products, including SIGT. Dawn has considerable marketing experience working for a range of range of financial services companies including MBNA, Santander, M&S Bank and the Universities Superannuation Scheme.

In addition, Seneca IM has hired Darron Pace as compliance manager to enhance its compliance function and Danielle Tully as investment administrator, to provide administrative support to its investment team.

Previous research publications

Readers interested in further information about SIGT, such as investment process, fees, capital structure, trust life and the board, may wish to read our annual overview note *Celebrating five years since strategy change*, published on 10 March 2017, as well as our previous update notes and our initiation note (details are provided in Figure 16 below). You can read the notes by clicking on them in Figure 16 or by visiting our website.

Figure 16: Marten & Co. previously published research on SIGT

Title	Note type	Date
Low volatility and growing income	Initiation	2 November 2015
On track for zero discount policy	Update	11 May 2016
In demand and no discount	Update	16 September 2016
Celebrating five years since strategy change	Annual overview	10 March 2017
Changing tack	Update	13 June 2017
Steady reduction in equity exposure	Update	13 September 2017

Source: Marten & Co.

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IMPORTANT INFORMATION