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Andrew Metcalf
Investment Director

Close Select Fixed Income Fund

Monthly fund manager update

May 2019

Performance

The Close Select Fixed Income Fund returned 0.3% in May, and 4.2% YTD. In comparison, the IA sterling strategic bond sector returned 0.3% in May, and 4.7% YTD. The fund remains very conservatively positioned versus the strategic bond sector (i.e. low duration and strong average credit rating).

Macro backdrop

In May, macroeconomic data once again took a backseat to geopolitics. In the UK, Theresa May resigned as Prime Minister following a miserable performance in the European parliamentary elections for her ruling Conservative Party; and in the US, President Trump expanded the scope of his trade war rhetoric to a host of new countries. The net result was a general 'risk-off' tone across major markets and significant flows into 'risk-free' government bonds – with 10 year government bonds now yielding sub-1% in the UK; sub 2.2% in the US; and a record-low negative -0.21% in Germany.

On the UK macro side, data remained volatile and difficult to evaluate given ongoing political uncertainty. Q1 2019 quarter-on-quarter GDP growth was +0.5% (versus +0.2% in Q4 2018), though the improved data was likely stoked by stockpiling ahead of the potential 'no deal' Brexit on 31st March 2019. Stronger economic growth also led to a fall in the unemployment rate to 3.8% (from 3.9%), while inflation also ticked-up to 2.1% - though chiefly caused by rising energy prices and an Easter-holidays related surge in air fares. PMI survey data remained weak, reflecting ongoing global trade concerns, and underscoring concerns amongst investors that the stronger Q1 2019 data was an aberration – with stockpiling masking a general slowdown in the wider UK economy.

In the US, macro data remained relatively strong. Q1 2019 Annualised GDP growth was revised down slightly to +3.1% (though still a significant improvement on the Q4 2018 reading of +2.2%); inflation increased slightly to +2.0% (versus March 2019 figure of +1.9%); unemployment reduced to 3.6%; and average employee earnings remained stable at a still strong +3.2%. PMI survey data was generally weaker however – reflecting ongoing concerns around President Trump's increasingly aggressive trade policies.

In the Eurozone, data was broadly stable versus the previous month, though remains weak. Q1 2019 GDP growth improved to +0.4% (versus Q4 2018 reading of +0.2%); inflation increased to 1.7% (versus March 2019 figure of 1.4%); and unemployment improved to 7.7%. PMI survey data remained weak however – with the manufacturing sector especially weak as a (likely) result of global trade tensions.

Portfolio activity

Turning to portfolio activity, there were 2 major developments in May. Firstly, the Balfour Beatty 2020 preference share – one of the fund's largest holdings - went ex-dividend. This debt instrument effectively delivers performance twice per year, in May and November, as the instrument pays a 5.375p preference share, but the instrument price only falls by c.3.0p. This proved true again in May – contributing c.0.10% to portfolio performance for the month. In addition, we completed our research coverage on Co-op Group – and immediately

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Asset Management

added a 2.6% portfolio position across the 2024 and 2026 bonds (yielding 4.7% – 5.4%). Co-op Group has spent the last 4 years selling non-core assets (including operations in banking; insurance and pharmacies) and is now a much leaner organisation focused on the defensive food sector – with a smaller funerals business. The disposals have raised plenty of cash and clarified a more defensive strategy – which we think could lead to a rating upgrade and return to investment grade over the next 12-24 months.

On the portfolio construction side, duration was held broadly stable at 3.4 years (0.6 years of which is a single Gilt holding), while the yield on the fund was maintained at 4.1%. We continue to believe that the combination of short duration and a 4% + yield de-risks the fund from future volatility.

Outlook and strategy

While the first 4-months of 2019 saw corporate bonds reverse all of the losses accumulated Q4 2018 – May was a slightly different story. Indeed, corporate bonds still delivered positive returns in May, but these were driven by falling Gilt yields rather than tightening corporate bond spreads. Despite the fact that corporate bond valuations cheapened in May, we still believe that spreads are trading slightly rich to fair value (sterling BBB credit spreads are now 201bps, versus 5yr average of 183bps; 10yr average of 235bps; and 20yr average of 216bps). In order to ensure capital preservation and deliver a high level of monthly income, we continue to seek out the best risk:reward ideas across investment grade, unrated and high yield bond sectors. We maintain our focus on stock selection reinforced by in-depth credit research, and continue to favour shorter duration corporate bonds in GBP and USD.

Close Select Fixed Income Fund discrete performance as at 31 May 2019

	YTD	2018	2017	2016	2015	2014
Close Select Fixed Income Fund	4.2%	-2.0%	7.4%	8.0%	1.7%	9.0%
IA £ Strategic Bond	4.7%	-2.5%	5.3%	7.3%	-0.2%	6.1%
IA £ Corporate Bond	4.9%	-2.2%	5.1%	9.1%	-0.3%	9.8%
IA £ High Yield	5.7%	-3.2%	6.1%	10.1%	-0.7%	1.3%

Source: FE Analytics 31.05.2019; all are X Acc share classes; performance is total returns, net of fees with dividends reinvested.