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Weixu Yan
Investment Manager

Close Tactical Select Passive Funds

Monthly fund manager update

May 2019

Review

While May saw equity markets reverse course and decline across the board, Fixed Income and most of the Alternative assets provided some diversification. Thus within the Close Tactical Select Passive (TSP) fund range, conservative was the only one to outperform its respective IA sector, while Balanced and Growth underperformed theirs. Year-to-date both Conservative and Growth remain ahead of their peer groups with only Balanced slightly lagging.

In GBP terms, Japanese equities were the most resilient falling -0.8% whilst other developed market equities fell around -3.0% and Emerging Market equities declined nearer to -4.0%. The best performing equity holding in the range was HSBC Japan Index Fund at -1.4%.

Fixed Income investments with longer duration like Lyxor FTSE Actuaries UK Gilts (+2.7%) and HSBC UK Corporate Bond Index (+1.2%) outperformed shorter duration ETFs like iShares GBP Corporate Bond 0-5 year (+0.1%) and Lyxor FTSE Actuaries UK Gilts 0-5 year (+0.5%). However, the best performer was Lyxor FTSE Actuaries UK Inflation Linked Gilts at +4.2%.

Alternatives mostly fared as expected in a falling equity market with Invesco Physical Gold ETC being the second best holding returning +4.6% and outperforming the broad commodity benchmark by almost 4.0%. Infrastructure was more mixed, with the iShares Global infrastructure ETF returning +2.5% while HICL and GCP returned -2.2% and +1.3% respectively. The JPM Managed Futures UCITS ETF, which is a momentum strategy, was the best performing holding across the TSP range returning +4.9%.

General positioning

During May we trimmed our UK exposure given increased political risk around a possible general election and weaker relative growth and added this to our risk budget in the US where the outlook for earnings is better and there are more opportunities. Otherwise at a regional level, we remain overweight Europe and Asia-Pacific, neutral in US and Japan, and underweight in UK.

Overall we lowered our Fixed Income allocation and increased our weight to Alternatives. We are adding to Property and Infrastructure within Alternatives for diversification while we lowered our exposure to UK corporate bonds to reflect a less attractive outlook for bonds. Within Fixed Income however, we still prefer shorter to longer duration.

Bi-monthly article

ETF myth buster: the fallacy of illiquidity

Imagine this fiction not too far from reality. Towards the end of an economic cycle investors fear that ETFs become illiquid. A credit crisis might trigger it: in response to ultra-low rates, borrowers gorge and lever up against property and autos; clever investment bankers securitise and package up debt of variable quality, and in turn lever up to buy it from each other; a crisis in the real economy sparks foreclosures and bankruptcies; debtors default, credit dries up and market volatility spikes. ETF managers (not being discerning folk) become forced sellers at distressed prices because they "buy the whole market" and only have one market to trade in. Worse still, several managers trading the same index at scale compound the squeeze and suffocate more orderly trading by chasing the same deals.

Whilst these events actually happened*, the assertion about liquidity is not true for several reasons. Low exchange trading levels do not mean low levels of market liquidity. There are effectively three pools of liquidity which an ETF investor can tap into: on-exchange, over-the-counter (OTC) and the underlying market itself. This is true whether an ETF is physical or synthetic, because an investment bank using swaps may ultimately trade physical assets in an underlying basket too.

Before tapping the underlying markets, though, ETFs can be traded on-exchange or OTC, where buyers and sellers can be matched to trade the units of ETFs between them - without needing to create or redeem units and enter the market. However, this is only the case if the ratio of buyers to sellers is the same; if it is not then ETFs will have exactly the same creation and redemption process as index tracking funds: if there were more buyers than sellers then the ETF provider would need to create new units to satisfy buyers' demand.

Three ways in, three out

How much does an ETF trade within these pockets of liquidity? Like the tip of an iceberg, only around 20-30% of an ETF's Average Daily Volume (ADV) is traded visibly on exchanges via direct market participants. But the majority of ETF turnover is satisfied OTC - off-exchange - by specialist market-makers such as Jane Street and Flow Traders who broker institutional size deals, representing the remaining 70-80%. Since the advent of MiFID II it is mandatory to report all OTC trading, even that of so-called Dark Pools which facilitate often larger and private trading between counterparties, so they are ultimately transparent and well regulated. Typically, OTC liquidity may be three or more times greater than on-exchange.

It is likely that an ETF's ADV will be satisfied by one of these first two pools. If not, managers can access the entire implied liquidity of the underlying market which dwarfs on-exchange and OTC operations. You can think of the first two tiers as the apex and middle of a pyramid, underpinned by a broad base of trading which may offer many hundreds of times the liquidity of the others. Put another way, the liquidity of an ETF cannot be worse than the index itself. And if we even loosely say that no more than 20% of all equity trading is by ETF managers rather than other investors, the liquidity demands of any one ETF are dwarfed by the liquidity of the market itself.

Institutional clout

The logical conclusion is that whatever the ADV of an ETF, whether £3m or £30m, its size does not restrict investors' ability to execute a trade. The broader market may be relatively and temporarily illiquid, but this challenges all investors of the same scale equally.

ETFs and Index Trackers have democratised investing for millions by making it cheaper and accessible. However, many investors can only access markets on-exchange, with the other options out of reach. At Close Brothers, our Tactical Select Passive range combines expertise with institutional scale to ensure our clients' liquidity needs are not affected when politics or anything else inflames the markets.

**A crude and simple explanation of the GFC of 2008.*

Close Tactical Select Passive Funds discrete performance as at 31 May 2019

	YTD	2018	2017	2016	2015	2014
Close TSP Conservative Fund	**5.9%**	**-4.2%**	**6.5%**	**14.3%**	**1.9%**	**8.2%**
IA £ 20-60% Equity	5.8%	-5.1%	7.2%	10.3%	1.2%	4.9%
Close TSP Balanced Fund	**7.0%**	**-5.3%**	**9.1%**	**17.6%**	**2.5%**	**7.3%**
IA £ 40-85% Equity	7.8%	-6.1%	10.0%	12.9%	2.7%	4.9%
Close TSP Growth Fund	**7.8%**	**-5.5%**	**11.8%**	**16.4%**	**1.8%**	**7.0%**
IA £ Flexible Investment	7.3%	-6.7%	11.2%	13.8%	2.0%	4.9%

Source: FE Analytics 10.06.2019; all are X Acc share classes; performance is total returns, net of fees with dividends reinvested.

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10 Crown Place, London EC2A 4FT. VAT registration number: 245 5013

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