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Close Select Fixed Income Fund

Monthly fund manager update

August 2019

Performance

The Close Select Fixed Income Fund returned -0.27% in August, and 5.88% YTD. In comparison, the IA Sterling Strategic Bond sector returned +0.91% in August, and 8.29% YTD. We remain very conservatively positioned versus the strategic bond sector (i.e. low duration and strong BBB+ average credit rating).

The underperformance in August was driven almost entirely by our holdings in Burford Capital bonds – which had a very volatile month following a negative report from Muddy Waters - a US hedge fund. We discuss our Burford holdings in more detail below.

Macro backdrop

On the UK macro side, politics continued to be the main driver of fixed income markets. Prime Minister Boris Johnson announced that he would prorogue (suspend) Parliament for c. 5 weeks ahead of the current Brexit deadline of 31st October 2019. The strategy has been widely condemned as a 'constitutional outrage'. At the time of writing, this may significantly increase the probability that the UK will either: 1) leave the EU with 'no-deal' in October 2019; or 2) precipitate a Parliamentary revolt that will lead to another Brexit extension and a General Election in Q4 2019. Naturally, markets have taken fright at both potential outcomes - sending sterling to multi-year lows, and the UK 10 year Gilt yield to a record low yield of 0.40%.

Looking at the data, it is clear that the backward-looking numbers are weakening. Q2 2019 GDP growth was -0.2% (Q1 2019 = +0.5%) dragging down GDP growth for the 12-months to 30th June 2019 to +1.2%; unemployment increased to 3.9% (from 3.8%); and inflation actually increased to 2.1%. Forward-looking data points remain volatile and closely linked to Brexit headlines. Indeed, PMI data strengthened to a (still anaemic) 50.7 in August (versus 49.7 in July), albeit manufacturing and construction sectors continue to weaken.

In the US, macro data remained relatively robust, albeit increasingly volatile. Q2 2019 Annualised GDP growth was downgraded to +2.0% (versus +3.1% in Q1 2019, and +2.2% in Q4 2018); inflation increased to +1.8% (from +1.6%); unemployment increased slightly to (a still very strong) 3.7%; and average employee earnings increased slightly to 3.2% (from +3.1%). PMI survey data on the other hand weakened to 50.9, and manufacturing PMIs fell into negative territory for the first time since the financial crisis – largely reflecting ongoing concerns around President Trump's increasingly aggressive trade policies, which are causing manufacturing weakness across the world.

In the Eurozone, data was generally weaker versus the previous month. GDP growth for 12-months ending in Q2 2019 was confirmed at 1.1% (versus 1.2% in Q1 2019); inflation decreased to 1.0%; and unemployment was stable at 7.5%. PMI survey data was slightly stronger however (at 51.8) – with continued weak manufacturing figures partially offset by a stronger Services sector.

Portfolio activity

Turning to portfolio activity, the major development in August was the volatility of Burford Capital bonds, which accounted for virtually all of the fund's underperformance. In early August, Muddy Waters (a short selling boutique hedge fund) published a report which primarily argued that Burford's profits are inflated given a sizeable portion of them are 'non-cash'. The report surprised the market, but after thoroughly evaluating each of Muddy Waters' allegations, we concluded that we fundamentally disagree with their claims. We will continue to evaluate the situation as new information becomes available.

On the portfolio construction side, duration increased slightly to 3.7 years (0.6 years of which is a single Gilt holding), while the yield on the fund was boosted to 4.1% given Burford bond underperformance (yields moved from c. 5%, to an average of 8.6%) as well as our strong research efforts over the period. We continue to believe that the combination of short duration and a c. 4% yield de-risks the fund from any future volatility.

Outlook and strategy

Bond markets have performed very strongly over the first 8-months of 2019, but we do not expect this 'Goldilocks' environment to continue. Indeed, sovereign bond yields are trading at, or near, historic lows, and we also believe that spreads are trading slightly rich-to-fair value (sterling BBB credit spreads are now 184bps, versus 5yr average of 184bps; 10yr average of 228bps; and 20yr average of 217bps). 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.

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

	YTD	2018	2017	2016	2015	2014
Close Select Fixed Income Fund	6.0%	-2.0%	7.4%	8.0%	1.7%	9.0%
IA £ Strategic Bond	8.3%	-2.5%	5.3%	7.3%	-0.2%	6.1%
IA £ Corporate Bond	9.7%	-2.2%	5.1%	9.1%	-0.3%	9.8%
IA £ High Yield	8.8%	-3.2%	6.1%	10.1%	-0.7%	1.3%

Source: FE Analytics 03.09.2019; all are X Acc share classes; performance is total returns, net of fees with dividends reinvested.