Stephen Hayde
Managing Director

Close Diversified Income Portfolio Fund

Monthly fund manager update

August 2019

Performance

The Close Diversified Income Fund fell 0.5% in August, this compared to -1% for the IA 20-60% sector. This takes the year to date return for Diversified Income to 6.2%. More broadly, over the course of the month, UK large cap equities were -5%, UK mid-caps -1.4%, US -1.7% (-1.8% in GBP terms), Europe -1.2% (-1.6% in GBP terms) and Japan -3.8% (-1.7% in GBP terms).

Market roundup

Brexit continues to dominate the headlines. At the time of writing, the Prime Minister remains determined to leave on October 31st. We expect to see significant political wrangling as Remainers and Brexiteers both dive deeply into nuances of the UK's uncodified constitution to help their cause. Uncertainty remains.

Away from the Brexit saga in the UK, the main economic story of the month was the ongoing trade war between the US and China. There was plenty of toing and froing between the nations, but despite all of Trump's positive tweets suggesting China was keen to agree a deal (most likely in a bid to stop the stock market from falling), we ended up with both the US and China raising tariffs on 1st September.

One of Trump's tweets demanded that all US companies, "are hereby ordered to immediately start looking for an alternative to China." On this topic Google is reportedly moving production out of China, into Vietnam. I also heard anecdotally from one excited South American businessman that they can now manufacture goods and get them into the US for 30% less than China. Other companies the Close Diversified Income fund owns, like Diploma, have said that their manufacturing clients are looking at moving their supply chains out of China – so this could become a reasonable headwind to China's growth going forward.

JPMorgan has estimated that the latest round of tariffs will increase average costs per U.S. household by $1,000 a year - up from $600. That estimate is in the low range because it was based on a duty rate of 10%, before Trump increased it to 15%. All eyes will be on the September meeting between the two nations.

More broadly, as global economic growth continues to slow, there was a noticeable pick up in the mention of "recession" in the press. Data from Google Trends shows an increase in people searching for the term "recession" around the world. Though not an indicator of its own, it's a worthy consideration as the market relies on confidence.

In the US, the manufacturing PMI fell below 50 for the first time since September 2009, whilst the German manufacturing PMI posted a 7th straight month of contraction. The UK and Germany also posted negative Q2 GDP growth – putting them half way to a technical recession.

As ever, Central Bankers remain accommodative with the incoming ECB chief Christine Lagarde insisting the ECB has the tools to tackle any downturn, and that interest rates could go lower, whilst Jay Powell (head of the Federal Reserve), said that, "we will act as appropriate to sustain the expansion." He also added that they were looking at expanding their toolkit. Elsewhere, a third Chinese bank was bailed out by the government, and the month also saw a number of diplomatic relations tested across the globe.

Close Brothers
Asset Management

Fixed income

Turning to bonds, it was a positive month for returns, with the price rises in the 10 year gilt pushing yields down to 0.48% from 0.61%. Government bonds outperformed corporates, as BBB corporate spreads rose to 1.84% from 1.76%. The average yield of the bond market today is 1.46%, with a duration of 7.05 years (source: TwentyFour AM). Due to its stock picking nature, the Close Diversified Income Fund's bond allocation currently has a yield of 3% with a duration of 2.8 years. We continue to actively maintain our shorter duration stance.

Equities

The big stock news of the month was a third short seller launching an attack on Burford Capital. US hedge fund Muddy Waters (MW) released a series of reports over a two week period in an attempt to drive the share price down (they had taken a short position previous to their release). The first report was very detailed in its accusations, but the Burford management team gave an equally detailed rebuttal; with the board pointing out the gaps in MW's knowledge of cases that they had cited.

Burford is still a significant holding in Neil Woodford's Equity Income fund, and given his need to raise capital a number of his holdings are currently under short seller attack. MW's comments on corporate governance were true, but nothing new, and after consulting with shareholders Burford have now decided to address some of these by; 1) having a secondary listing in the US or moving to the UK main market from the perceived riskier AIM market, 2) introducing two new non-executive directors to the Board, as the current ones have been in situ beyond the recommended time, 3) appointing in a new CFO and 4) moving the current CEO up to the main board. Given the severity of the accusations and the share price fall, myself and our financials analyst worked morning, noon and night for two weeks to investigate the reports- trying where we could to independently verify the data. We also engaged with a litigation finance expert and a lawyer through our GLG Expert Network to ensure we had outsiders' opinions on the company.

One key accusation was that Burford overstates its Net Asset Value. Within our calculations, we can attribute almost all the fair value gains Burford has on its balance sheet to two cases – Petersen and Eton Park. Regula readers of my monthly update will recall that Burford recently sold 10% of their interest in the Petersen Energia lawsuit for $100m, after a meaningful court decision in the case. This means that logically they could be valuing their remaining 61.25% stake at $612.5m. Eton Park is an almost identical case to Petersen (same claim – different client) and thus its value will have also risen on that same court decision. Using the same valuation metrics, the Eton Park stake could be valued at $126m. MW said that Burford should use cash accounting – so the Petersen and Eton Park cases should be included in the Net Asset Value calculation at cost ($18m for Petersen and $26m for Eton Park), despite having just sold 10% of the Petersen case for $100m. So with $720m of fair value gains on their balance sheet, I calculate that up to $700m of these could be from these two cases (where we have an external valuation data point) which suggests a prudent approach to writing up the value of the remaining cases. Sell-side analysts have also gone through the MW research and come up with some interesting points, for example Numis show that the valuation of a different case involving Napo Pharmaceuticals was actually quite conservative. Far from the "loss" that MW suggested. Burford Capital shares and the bonds sold off in the month, and whilst the mud may stick for some time, we continue to hold the company for its non-cyclical, USD earning, uncorrelated returns. We will, of course, continue to monitor developments and have a further meeting with the company later in the month.

Alternatives

In the Alternatives space it was pleasing to see all of the PFI funds, 5 of the 6 renewable funds and most of the REITs post a positive return. Gold was the big winner though; up 7.5% (gold thrives on political turmoil and/or weak currencies). Property debt funds were flat overall.

Yield and NAV

The Close Diversified Income fund's yield was static at 3.7%. The overall yield is the result of all the individually picked attractive risk:reward ideas. In this tough environment the hard work continues to find attractive risk:reward ideas across the whole spectrum of asset classes that the Fund is able to invest in.

Close Diversified Income Portfolio Fund discrete performance as at 31 August 2019

	YTD	2018	2017	2016	2015	2014
Close Diversified Income Portfolio Fund	**6.2%**	**-1.8%**	**5.4%**	**7.8%**	**2.4%**	**5.0%**
IA Mixed Investment 20-60% shares	9.2%	-5.1%	7.2%	10.3%	1.2%	4.9%

Source: FE Analytics 02.09.2019; all are X Acc share classes; performance is total returns, net of fees with dividends reinvested.