Close Brothers
Asset Management

Close Diversified Income Portfolio Fund

Monthly fund manager update

MARCH 2020

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PERFORMANCE

The Close Diversified Income Portfolio Fund fell by 9.4% in March. This compared to a 10% fall for the IA 20-60% sector. This is now the largest drawdown in the fund's history, as most asset classes struggled in the coronavirus induced panic and its resultant market sell-off.

MARKET ROUNDUP

Long-time readers of my monthly updates will be familiar with my investment approach – which is more valuation-driven than macro-orientated. Going into this year, I had continued to reduce risk (though with hindsight, clearly not enough) as valuations at the time were not that favourable. The equity allocation within the fund was reduced a record low of 19.3%. Bond duration was also down to a record low of 2.7 years, 5.3% of the portfolio was put into short dated gilts and Nestle bonds, the gold weighting was increased, as was cash to 6% from 3% in November. A very small inverse ETF position in equities was also added and alternatives were sold down to 25% from nearly 30% (via a large sale of the renewables infrastructure trusts).

So after being so proactive it was, of course, very disappointing to only see a small outperformance on the bear market which ensued in March. So what happened?

Well starting with geography – international equities and bonds performed a lot better in sterling terms than in local currency terms due to sterling being very weak. The pound weakened c. 3% against USD and Euro in the month. This masked some of the poor performance of international investments. The fund has predominantly sterling denominated investments, so it does not benefit that much from sterling weakness (and what foreign exposure it does have is half-hedged for USD and Euro).

Debt did as badly as equity (and in some cases worse) – the Investment Association Sterling High Yield Bond sector underperformed the IA Global Equity Income sector in this sharp bear market. Even the IA Sterling Corporate Bond sector (which has to be a minimum of 80% Investment Grade bonds) was down -6.4% on average.

BBB bond spreads rose from 1.73% to 3.11% (above the long-term average of 2.13%) and BB spreads rose from 3.29% to 6.40% (above the long-term average of 4.32%). These are at, or above, levels last seen during the bursting of the tech bubble around 2001.

A tangible demonstration of how debt has performed like equity can be seen in Phoenix Holdings. It is worth remembering that equity needs to be wiped out before bonds are potentially impaired. However, towards the end of March, the equity of Phoenix Holdings was down 23% (the fund does not hold the equity), whilst the Phoenix 2025 bond (which the fund does hold) was down 20%. A number of the debt funds within the Close Diversified Income Portfolio Fund, be they asset backed lenders or real estate lenders, were also heavily sold off c. 30%. This was the biggest disappointment because I had bought these debt funds expecting them to be more defensive than equity in an economic downturn. However, it is worth remembering that this is only looking at how things have behaved on a one month view and markets can change quickly.

REITs underperformed – Real Estate Investment Trusts (REITS) fell sharply as the coronavirus lockdown threw up the prospect of rental holidays and tenants going out of business, as well as the prospect of falling property values. REITs are the most cyclical of our alternative holdings. One positive indicator for 11 of our alternative funds was seeing directors personally buying shares across all the sectors of PFI, Renewables, REITS and property debt. Hopefully their purchases will prove insightful.

Added to the above, small and mid-cap equities underperformed versus their large cap counterparts.

PORTFOLIO ACTIVITY

So what has been done in the month (besides setting up the home office)?

Given the huge drops in markets (and hence potentially improved valuations), the fund did what it should do and continued to look for good risk:reward ideas, which involves selling things that are now relatively expensive and buying things that are relatively cheap.

Sales

- The very small positions in the inverse ETFs were sold at a profit (short the UK, EU and US stock markets).
- A 2% position in a 2020 Gilt matured.

- A 0.9% position in Partnership 2025 was called early, maturing into cash.
- I sold the other 2% position in gilts at yields of 0.25%; their job done.
- I sold the Daily Mail 2027 bond at a 4.6% yield (its yield low versus what we were buying) and it is at risk of becoming a fallen angel (being downgraded to junk).

Reinvesting the proceeds into new ideas

- I bought a Sainsbury Perpetual bond (callable in July 2020) at yields of up to 6.1%. If they do not call this bond in July the yield will increase to 10.2%. Current trading at Sainsbury is very strong, and they will benefit from government schemes such as the removal of business rates.
- I opened a new position in a William Hill 2020 bond at yields up to 8.9%. It matures in June, and in February was trading with a yield of just 1%. Whilst trading is obviously tough for William Hill at the moment they are sitting on £760m of cash on their balance sheet.
- Small trades were done in other existing bonds such as BHP Billiton Perpetual (callable in 2022) at yields of up to 6%, Phoenix 2025 at 6.4%, Partnership 2025 at a 10% yield and ICG 2020 at yields up to 10.6%.
- In the alternatives space, I added to International Public Partnership and HICL Infrastructure, which should be relatively immune to the coronavirus as the majority of their investments are availability-based government contracts - protected against inflation. The way availability PFI projects work is that the asset, such as a school, does not need to be utilised, just available. BBGI, in their coronavirus update to the market, even gave 2021 dividend guidance; such is their confidence in their PFI projects at this time.
- In equities, two new names were added, Visa and Booking Holdings; both have net cash positions, no balance sheet concerns, are market leaders and may emerge from this period stronger. Booking
- Holdings may benefit as rivals come under financial pressure. Visa may benefit from the accelerated structural move towards a more cashless economy as many people fearing contagion are choosing card payments over cash.
- Some existing names were topped up, including Babcock. Its price fell to as low as 300p which equated to 4x earnings. To put this into context, during the Global Financial Crisis, the UK stock market bottomed at 7.6x. Sell-side analysts expect defence companies to be one of the most resilient sectors in this outbreak as and a lot of their work will be deemed critical.
- I also added to Imperial Tobacco at 5x earnings; they have since issued a statement confirming that current trading has not been impacted by the coronavirus.

The equity weighting finished the month 0.5% higher at 19.8% of the portfolio.

OUTLOOK

The coronavirus is creating extreme volatility as investors try to work out several questions: how long the lockdowns will last; whether a second wave of contagion will ensue lockdowns ending; how long companies can survive a revenue drought; which companies will cut their dividends; how many people will be laid off and how this fear may change consumer behaviour. There is plenty to mull as we enter April.

With 6.5% in cash and a whole host of bonds due to mature through 2020 (c.12% of the fund), there is plenty of cash to put to work. I will continue to do my best to find attractive risk-adjusted investments, and to be guided by valuations rather than the daily roller coaster of the markets.

YIELD AND NAV

The fund's yield rose materially to 5.3%, from 3.5%, as a result of the falling NAV and the trades outlined above. How does a 9.4% fall in the fund's NAV equate to a near 50% increase in the yield? It's down to short duration bonds.

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 PERFORMANCE AS AT 31 MARCH 2020

	YTD	2019	2018	2017	2016	2015
Close Diversified Income Portfolio Fund	**-11.3%**	**9.8%**	**-1.8%**	**5.4%**	**7.8%**	**2.4%**
IA Mixed Investment 20-60% shares	-12.9%	11.8%	-5.1%	7.2%	10.3%	1.2%

SOURCE:

FE Analytics, 03.04.2020; 2019 (YTD) data as at 31.03.2020. Performance is total return, net income reinvested after fees, X Acc share class.