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Close Select Fixed Income Fund

Monthly fund manager update

MAY 2020

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FUND PERFORMANCE

The Close Select Fixed Income Fund returned +1.9% in May, taking the year to date performance to -4.2%. In comparison, the IA Sterling Strategic Bond sector returned +2.2% in May, and is down -0.5% year to date.

MACRO BACKDROP

Financial markets posted another month of positive performance in May following a strong showing in April – largely in response to the large and co-ordinated policy response from central banks and governments following the COVID-19 outbreak. While macro data remained very weak across the UK, US and Eurozone given the impact of COVID-19, data generally improved from the nadir in April as ‘lockdown’ measures were tentatively eased across most developed markets.

In the UK, forward-looking macro-economic data points improved from a very low base, with May composite Purchasing Managers’ Index (PMI) data rising to a still very weak 28.9 (versus April’s record low of 13.8). While the backward-looking data has yet to fully reflect the impact of materially reduced economic activity, consensus forecasts indicate that UK GDP growth will fall -15% in Q2 2020 on an annualised basis (and remain negative until at least Q2 2021), while inflation is expected to remain below 0.7% for the next 12 months, and unemployment will increase to c. 8% in Q2 2020.

In the US, macro data also improved versus April, but remained very weak. Composite PMI data improved to 36.4 from April’s reading of 27.0, and Q1 2020 annualised GDP growth was -5.0%. Consensus forecasts indicate a much gloomier outlook however, revising expectations to include a -34% fall in Q2 2020 GDP growth, followed by a strong rebound over the subsequent three quarters. Inflation is expected to remain below 1.0% over the next 12 months, with and unemployment increasing to c. 16% in Q2 2020.

In the Eurozone, the data is broadly aligned with the UK and US. May composite PMI data improved to 30.5 versus record low of 13.5 in April, while Q1 2020 GDP growth was -3.2%, equating to -14.2% on an annualised basis. Consensus forecasts indicate further weakening in macro data from here, including a -14% fall in Q2 2020 GDP growth, with GDP data remaining negative until at least Q1 2021. Inflation is expected to remain below 0.5% over the next 12 months, while unemployment is expected to rise to c.10% until at least Q2 2021.

PORTFOLIO ACTIVITY

Turning to portfolio activity, there were two key developments within the portfolio during May 2020.

Firstly, we added to several existing bonds at attractive levels in the insurance sector, including Rothesay 2025 (BBB+) and Beazley 2029 (BBB+). The month of May also provided an example of our ability to respond quickly to emerging investment opportunities. On the afternoon of 5th May 2020, Hiscox announced an equity raise to boost credit metrics – a major positive catalyst for Hiscox bonds. Within 20 minutes of the announcement, we had added an additional 1% portfolio position in the Hiscox 2025 bond, taking our total holding size to 2.4%. By the 29th May, the Hiscox 2025 bond was priced at c. 105; 5pts higher than when we purchased it on 5th May.

Secondly, we were again heavily involved in buoyant new issue markets, adding to several high quality bonds via this route. We added a c. 7% portfolio position across 6 bonds, including Phoenix Group 2031 (BBB rated with a yield of 4.8%); Aviva Group (A- rated with a yield of 4.0%); and Direct Line (BBB+ rated with a yield of 4.0%).

On the portfolio construction side, duration increased to 3.1 years, while the fund’s yield to expected call reduced to 5.0% (the yield to maturity is 5.4%, but we believe the lower figure is a more accurate measure of yield). The average rating on the rated portion of the portfolio is BBB. The fund now has c. 2% in cash, with a further 9% due to mature over the next 9 weeks.

OUTLOOK AND STRATEGY

The general market weakness in March and strong rally in April and May has led to a clear valuation distinction between sovereign; investment grade; and high yield bonds.

- **Sovereign bond yields** are at (or near) record lows across the US, UK and Eurozone given weakening macro data and wider concerns related to COVID-19.
- **Sterling Investment Grade** bonds are relatively cheap versus all historic timeframes, with sterling ‘BBB’ credit spreads at 243bps, versus their 5yr average of 188bps; 10yr average of 223bps; and 20yr average of 217bps.

- **Sterling High Yield** spreads appear very cheap relative to historic averages given current spreads of 828bps (5yr average is 478bps; 10yr average is 517bps; 20yr averages 603bps). However, current spreads are naturally reflecting expectations of rising default rates over the next 6-12 months.

Aiming to preserve capital and deliver a high level of monthly income, we continue to seek out what we believe are 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.

CLOSE SELECT FIXED INCOME FUND PERFORMANCE AS AT 31 MAY 2020

	YTD	2019	2018	2017	2016	2015
Close Select Fixed Income Fund	**-4.2%**	**9.4%**	**-2.0%**	**7.4%**	**8.0%**	**1.7%**
IA £ Strategic Bond	-0.5%	9.3%	-2.5%	5.3%	7.3%	-0.2%

SOURCE:

FE Analytics 03.06.2020; YTD data as at 31.05.2020; all figures are for the X Acc share class; performance is total return, net of fees with dividends reinvested.