Close Brothers
Asset Management

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Close Diversified Income Portfolio Fund

Monthly fund manager update

MAY 2020

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PERFORMANCE

The Close Diversified Income Portfolio Fund rose 1.7% in May, compared to a 2.8% rise for the IA 20-60% sector. Stock markets continued their recovery with the US returning 4.7%, pushing the S&P 500 back into positive territory for 2020 in GBP terms. The UK was also up (3.1%), but the UK stock market remains significantly underwater at -18.9% on a year to date basis. Europe also had a positive month, up 4.2%.

The positive moves were likely driven by hopes that the COVID-19 enforced government lockdowns were coming to an end, along with the announcement of further central bank stimulus plans. Over the past 8 weeks, central banks have been buying $2.4 billion per hour of financial assets – increasing their balance sheets from $16trn, where they have been for two years, to $20trn (Source: Bank of America). However, despite this, Jerome Powell, the head of the US Federal Reserve, has stated that "*there's a lot more we can do. I will say that we're not out of ammunition by a long shot.*"

Gilt yields fell from 0.23% to 0.18%. Part of the UK gilt curve is now negative, and the UK government issued £3.8bn worth of gilts at a negative yield for the first time. Over the month, corporate bonds outperformed sovereign debt again, as BBB credit spreads fell from 250bps to 243bps, although these remain above the longer term average of 213bps.

PORTFOLIO ACTIVITY

The big theme of the month centred on Lloyds insurers, where we placed a number of trades. Within the equity space, we added to our Lancashire Holdings position as it was felt that the market had oversold the shares given the relatively low losses they are expected to endure due to COVID-19, coupled with the positive opportunity for firmer pricing of policies, which should mean they are able to make higher returns going forward. We were able to add to the position at prices as low as 608p, so it was heartening to see the stock finish the month at 680p.

On the fixed income side of the portfolio we added to two other insurers; Beazley and Hiscox, both of which have had higher COVID-19 loss forecasts than Lancashire, but we had been seeing persistent market rumours from equity brokers that they would raise extra cash from shareholders. As a bondholder, it is always good news to hear that shareholders are dipping their hands into their pockets to bolster the balance sheet. Hiscox was first to announce their fund raising and within 18 minutes the Fund's position had been added to at a 6.3% yield, having added earlier in the day at 6.7% on the rumours. Those bonds finished the month at a yield of 5.3%, as others in the market digested the good news. The Hiscox 2045 positon is now the largest bond holding in the Fund.

A second opportunity arose late in the month when Beazley followed suit, announcing a placing after hours. As a bond already held and well researched, we were able to act at the earliest possible opportunity, adding to the Beazley 2029 bond at a yield to maturity of 5.26% first thing the next morning. Once again, the yield continued to fall as the market digested the news, ending the month a few days later at a 5% yield.

These trades highlight how quickly the Fund is able to react to news flow. Both companies are now better financed than before the COVID-19 pandemic (on the assumption that their loss forecasts are correct). Furthermore, they are now operating in an environment where they can charge higher prices for policies (thereby generating higher future returns) and with more restrictive policy wording (lowering risk). Yet we were able to purchase the bonds at historically high spreads and yields.

Over the month, the Fund also took part in the Pension Insurance Corp 2031 new issue at 4.625% and Direct Line 2032 at 4%. Elsewhere, the Pennon Perpetual bond successfully matured at its first call date, as expected.

ALTERNATIVES

In the alternatives space, the Fund participated in the Renewables Infrastructure Group placing at a below screen price of 120p, which was then sold immediately for a small profit.

We also switched part of our holding in the Wisdomtree Physical Gold ETF into the Invesco Physical Gold ETF. This was for two reasons; firstly it is a cheaper solution and secondly, with the gold position becoming larger it makes sense to diversify the counterparty risk.

EQUITY

Given the sharp recovery in equities, some of the equity risk was reduced over the month via a sale of Booking Holdings and some of the 3rd party fund exposure. My Quant Model calculates that on a Price to Earnings (P/E) basis, using 2021 earnings (rather than 2020 earnings) the UK market P/E is 16.2x, up from 15.3x in December 2019. There was a brief period in March where the market looked like it was starting to get cheap again, but P/E multiples have since rebounded fairly sharply.

OUTLOOK

Equity markets have been buoyed by lockdown easing and central bank support, but when we see one banking CEO say that the Q1 write-off will be all for this recession it does make us wonder if market participants are getting a bit ahead of themselves. Whilst we have seen plenty of profit warnings from companies, we are yet to see the human impact of the recession. In the US, 40m people have lost their jobs in the past 10 weeks, but are temporarily financially comfortable due to the Federal Pandemic Unemployment Compensation (FPUC) scheme. Similarly, in the UK, the Government continues to pay the salaries of some 8m furloughed workers. But the key question now is how many of these furlough scheme recipients will actually have a job to go back to. Longer term unemployment could impact consumer sentiment, spending and their ability to repay loans.

Furthermore, we continue to keep a close eye on developments in China as relationships sour not only in Hong Kong and the US, but also with Taiwan, India and Australia but to name a few. As ever, we will continue to do our 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

As at 20th May, 247 companies have cut or deferred their dividends (£39.3bn of dividends) (Source: Numis). Within the Fund holdings amounting to just 3.03% of our equity exposure have announced a cut or deferral to their dividends. Diploma and UDG decided to defer their dividends as they are both utilising the government's furlough scheme and felt obliged to limit rewards to shareholders whilst in receipt of government support. Both companies have very strong balance sheets. Another holding, Imperial Brands, cut its dividend by 33%. This has long been touted as a possibility by the market, and the cash saving will be used to accelerate the deleveraging of the company – which should help the rating of the company if successfully achieved. A total of 11.65% of the Fund's equity exposure is now confirmed to be paying dividends as usual. We wait to hear from the rest.

In the alternative spaces, the PFI and renewables funds have reiterated their 2020 dividends and guided for 2021. The commodity positions are unaffected as they do not pay dividends. One of the smaller REIT positions, Ediston, trimmed its monthly dividend payment by 30% for April to reflect lower rent collections for the month. The largest REIT holding, Residential Secure Income, reported that rent collections were at 99% and maintained dividend guidance. Urban Logistics, a final mile warehousing REIT, reported 100% rent collection, whilst Hibernia, which has largely technology and government tenants, reported 94% rent collection.

The Fund's yield reduced to 4.5% from 5% over the month as a result of the strongly rising NAV and a higher cash level following the Pennon bond maturity. A combination of the Pennon bond maturing and adding to the previously mentioned longer dated insurance names has increased the Fund's fixed income duration from 2.7 to 3 years, but locking in strong yields on the holdings in the process.

In the period since the sell-off started in March, 7.5% of the Fund has now been reinvested (out of cash,gilts and maturing bonds) into more attractive and higher yielding opportunities. This has offset any dividend cuts and deferrals so far several times over.

CLOSE DIVERSIFIED INCOME PORTFOLIO FUND PERFORMANCE AS AT 31 MAY 2020

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

Source: FE Analytics 03.06.2020; YTD data as at 31.05.2020. Performance is total return, net income reinvested after fees, X Acc share class.