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Close Select Fixed Income Fund

Monthly fund manager update

JUNE 2020

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FUND PERFORMANCE

The Close Select Fixed Income Fund returned +1.56% in June, and -2.73% year-to-date (YTD). In comparison, the IA Sterling Strategic Bond sector returned +1.52% in June, and +0.97% YTD.

MACRO BACKDROP

Fixed income markets posted positive returns in June, as governments and central banks continued to reassure markets with a co-ordinated “whatever it takes” policy position. While backward-looking macro-economic data remained very weak across the UK, US and Eurozone given the impact of COVID-19, forward-looking survey data continued to improve from the nadir in April as ‘lockdown’ measures were eased across most developed markets.

In the UK, forward-looking data points improved, with June composite PMI data rising to 47.6 (from 30.0 in May and April’s record low of 13.8). While the backward-looking data has yet to fully reflect the ‘new normal’ of materially reduced economic activity, consensus forecasts indicate that: UK GDP growth will fall -18% in Q2 2020 on an annualised basis (and remain negative until at least Q2 2021); inflation will remain below 0.7% for the next 12 months; and unemployment will increase to c. 8% in Q3 2020.

In the US, forward-looking data also improved, with June composite PMI data rising to 46.8 versus its April nadir of 27.0. Consensus forecasts indicate that macro data will continue to weaken, however, before any potential improvements – with Q2 2020 GDP growth expected at –34.5% (followed by a strong rebound over the following three quarters); as well as inflation remaining below 0.8% over the next 12 months. While US unemployment data has positively surprised markets over the past 6 weeks, it should be treated with caution; it is possible that it contains statistical errors, while rising COVID-19 infections in many states could lead to a reversal of any lockdown easing measures.

In the Eurozone, the data is broadly aligned with the UK and US. June composite PMI data improved to 47.5 (versus 31.9 in May and 13.5 in April), while Q1 2020 GDP growth was -3.1% (-13.6% on annualised basis). Consensus forecasts indicate further weakening in macro data from here, including a -14.7% fall in Q2 2020 GDP growth (and remaining negative until at least Q1 2021); inflation below 0.5% over the next 12 months; and unemployment rising to c.10% until at least Q2 2021.

PORTFOLIO ACTIVITY

Turning to portfolio activity, there were two key developments within the portfolio in June 2020.

Firstly, we have reduced our exposure to the Real Estate sector. For the past three years, the fund has held a c. 9.5% portfolio position across three Real Estate debt funds (the only third-party funds we own in the portfolio). Given the market volatility in March, these funds have underperformed significantly – and account for the majority of portfolio underperformance versus the sector on a YTD basis. While we appreciate the positive contribution these funds have made to our strong and consistent historical performance (the Select Fixed Income fund has generated 1st or 2nd quartile performance every year for the past 5 years), we have now reduced our real estate debt fund holdings to c. 1%.

Secondly, we were once again active in buoyant new issue markets, and added to several high quality bonds in June via this route. Indeed, we added a c. 5% portfolio position across 7 bonds, including Nationwide Building Society (BBB-: Yield = 5.8%); Legal & General 2030 (A-: Yield = 4.0%); and Bupa 2035 (BBB+: Yield = 4.1%).

On the portfolio construction side, duration increased to 3.3 years, while the fund’s yield-to-expected-call reduced to 4.0% (Yield to Maturity = 4.3%, but we believe the lower figure is a more accurate measure). The average credit rating on the rated portion of the portfolio is BBB+. Given significant maturities over the past 6 weeks, coupled with a myriad of attractive new issues, the unrated portion of the fund has reduced to just 24%. The fund has c. 7% in cash and 11% of the fund will mature in the next 12 weeks.

OUTLOOK AND STRATEGY

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

- **Sovereign bond yields** remain 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 near fair value versus all historical timeframes, with sterling 'BBB' credit spreads at 217bps, versus their 5yr average of 189bps; 10yr average of 223bps; and 20yr average of 217bps.
- **Sterling high yield** spreads appear relatively cheap versus history given current spread of 713bps (5yr average = 484bps; 10yr average = 518bps; 20yr average = 603bps), though this is reflecting expectations of (yet to emerge) rising default rates over the next 6-12 months.

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.

CLOSE SELECT FIXED INCOME FUND PERFORMANCE AS AT 30 JUNE 2020

	YTD	2019	2018	2017	2016	2015
Close Select Fixed Income Fund	**-2.73%**	**9.4%**	**-2.0%**	**7.4%**	**8.0%**	**1.7%**
IA £ Strategic Bond	0.97%	9.3%	-2.5%	5.3%	7.3%	-0.2%

SOURCE:

FE Analytics 03.07.2020; YTD data as at 30.06.2020; all figures are for the X Acc share class; performance is total return, net of fees with dividends reinvested.