Close Brothers Asset Management

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Close Diversified Income Portfolio Fund

Monthly fund manager update

JUNE 2020

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Managing Director

PERFORMANCE

The Close Diversified Income Portfolio Fund rose 0.9% in June; this compared to a 1.4% rise for the IA 20-60% Shares sector. Stock markets continued their recovery, with the S&P 500 now in positive territory year-to-date (YTD) in sterling terms, and outperforming bond markets. This is not what I would have expected in a year of deep recession which has seen over 20 million Americans unemployed. The UK stock market remains a laggard amongst developed market equity indices, with the blue chip index down c.18% YTD and the mid-cap index down c.22% YTD.

The structural currency hedge the fund has in place reduces downside risks for sterling investors holding international assets; however it does also mean that the upside is reduced when sterling is weak. Given recent sterling weakness, the position has detracted from performance YTD by c. -0.5%. Both the Euro and US dollar have strengthened c.7% against sterling this year, but the fund has only enjoyed half the performance benefit of this.

PORTFOLIO ACTIVITY

Equities

In addition to the trade placed last month, we added further to Lancashire Holdings in its placing of new shares at 700p. The placing announcement was accompanied by a positive trading update, highlighting that the prices they can charge for insurance were up 20-30% at the June renewals, which should help them make improved future returns. The shares finished the month at 809p. Lancashire is also an example of when a dividend cut can be a positive for shareholders. They elected not to pay a special dividend for the year ending 2019, but to retain the capital instead, as they could see the prospect for better returns ahead. Lancashire is now among the fund's top 10 equity holdings.

Given the sharp recovery in equity valuations, 3rd party fund exposure was further reduced to take the equity weighting back towards 20%. On a Price-to-Earnings basis, the UK market valuation is now above that of 19 December (at a time when COVID-19 and a recession were far from investors' thoughts). This is a quick about turn from our more bullish behaviour of March and April, but the cheaper prices were only briefly available, and valuation dictates the risk appetite of the fund.

Fixed income

Over the month, the 10-year gilt yield fell from 0.18% to 0.17%, while the 0-6 year part of the UK gilt curve is now negative yielding. Corporate bonds outperformed again, as BBB credit spreads fell from 243bps to 219bps, which is close to the long term average. This is a place which we've termed "no man's land" as there is no clear valuation signal as to whether bond markets are cheap or expensive now.

On the back of the positive Lancashire news on industry pricing (mentioned above) I further up-weighted the Beazley USD 2029 bond at a yield of 4.8%. Elsewhere, the William Hill 2020 bond also successfully matured over the course of the month.

Long-time followers of the fund will know that the investment process has remained consistent throughout; add to risk when it is cheap (often during market sell-offs) and reduce risk when it is more expensive. The chart of bond spreads (overleaf) demonstrates this approach in action. In both large sell-offs of the past 10 years we have used it as an opportunity to sell all gilts and add risk; increasing risk and duration on both occasions.

Alternatives

Given the disappointing performance of a number of the investment trust holdings which continue to languish at large discounts to Net Asset Value NAV, we have had a number of meetings with management teams and Boards (just as we did in the aftermath of the Corbyn nationalisation threat hit to the Private Finance Initiative funds) to encourage a pro-active strategy towards closing the gap. To this end it is pleasing to see a whole host of management teams and directors buying shares in their trusts (ICG Longbow, Starwood European Real Estate Finance, Ediston REIT, Honeycomb, GCP Asset Backed Income, Hibernia REIT, Warehouse REIT) and two holdings beginning share buy backs (Honeycomb and GCP Asset Backed Income). These latter two make up c.5% of the Fund, while the three property debt funds (ICG Longbow, Starwood European Real Estate Finance & Real Estate Credit Finance) make up a further 7%. Honeycomb's share price was dragged down markedly during the March sell-off, yet it is still to recover meaningfully despite positive NAV movements in March, April and May, on top of a rallying stock market. This pro-active approach to engaging with investee company management is an important exercise, and one which hopefully demonstrates a commitment to maximising value and returns for investors in the fund.

OUTLOOK

In the UK, the furlough and Self-Employment Income Support schemes starts to taper off in August, meaning we could well start to see a pick-up in job losses as companies decide they do not want to partially pay for some of their employees.

Over in the US, two polls in the last week suggested that Joe Biden has now taken a >10% lead in the Presidential polls against Donald Trump. Goldman Sachs wrote that if Biden's tax proposals are enacted, this would reduce their S&P 500 earnings estimate for 2021 by 12%. China continues to forge ahead with its own political agenda, arresting the first person in Hong Kong under the new security laws, for carrying a Hong Kong independence flag. China also continues to under deliver on its phase 1 trade deal with the US. Both issues call into question China's future global relationships.

In the latest revision to the IMF's economic outlook, they warn that the world is facing, "*a crisis like no other*", and now expects global growth to shrink -4.9% in 2020, 1.9% below the April 2020 forecast of -3.0%.

With all this to consider 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

According to AJ Bell's Dividend Dashboard, 385 UK companies have cut or deferred their dividends as at 1 July this year – meaning the sum paid out has been c. £32bn less than that which was forecast at the start of the year. (https://www.ajbell.co.uk/dividend-dashboard)

Within the fund, holdings amounting to just 4.06% of the equity exposure have cut or deferred their dividends this year, reducing the fund's yield by c.17bps (although this assumes zero dividends all year for those companies deferring payouts, so could even prove to be overly conservative). However, given the 7.5% of the fund that was invested (from cash and gilts) into attractive yielding securities in the sell-off, we have more than offset this negative impact to the yield through active management. The duration on the bond portion of the fund rose from 3 years to 3.1 years over the month.

The fund's yield reduced to 4.2% from 4.5%, given the strong rise in NAV coupled with the minor impact of dividend deferrals. The yield on the fund 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.

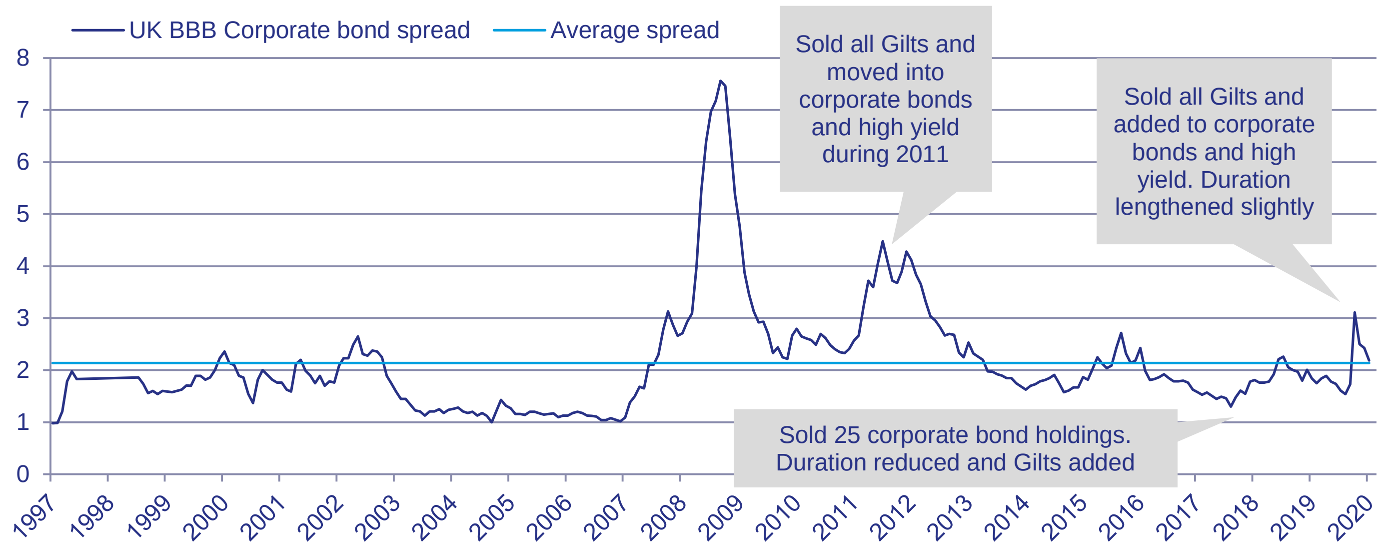
ARTICLE: THE HUNT FOR INCOME

Crises, such as the Global Financial Crisis and the COVID-19 pandemic, inevitably throw up challenges for companies and investors alike. Generating and sustaining investment income is one such challenge. As corporate revenues fall, the potential for dividend cuts and credit defaults increases.

Despite being an ever present potential risk to investors, dividend cuts were catapulted to the forefront of the investor psyche in Q1 2020, as an unprecedented number of companies announced they were cutting or suspending dividend payments.

How does this situation impact investors and how is the Close Diversified Income Portfolio Fund continuing its hunt for income?

Read more >



SOURCE: Close Brothers Asset Management and Bloomberg Finance L.P. as at 30 June 2020.

CLOSE DIVERSIFIED INCOME PORTFOLIO FUND PERFORMANCE AS AT 30 JUNE 2020

	YTD	2019	2018	2017	2016	2015
Close Diversified Income Portfolio Fund	**-4.5%**	**9.8%**	**-1.8%**	**5.4%**	**7.8%**	**2.4%**
IA Mixed Investment 20-60% shares	-4.1%	11.8%	-5.1%	7.2%	10.3%	1.2%

SOURCE:

FE Analytics 03.07.2020; YTD data as at 30.06.2020. Performance is total return, net income reinvested after fees, X Acc share class.