Close Brothers Asset Management

Close Diversified Income Portfolio Fund

Monthly fund manager update

JULY 2020

STEPHEN HAYDE
Managing Director

PERFORMANCE

Close Diversified Income Portfolio Fund rose 0.8% in July, which compares favourably to a 0.4% rise for the IA 20-60% sector. Stock markets were mixed over the month as a whole, though generally down in sterling terms. Therefore, the fund's hedged FX position aided performance in sterling terms this month. UK large caps were down -4.4% in the month (-22% year-to-date), UK mid-caps were -1.1% (- 23% year-to-date) whilst European stocks were down -1.9% (-2.5% in sterling terms). In the US, the S&P index was up +4% (but down -1.3% in sterling terms).

Bonds continued their recovery with the 10-year Gilt yield falling from 0.17% to 0.10%. Gilts from 0-7 years are now negative yielding, which is challenging for investors looking forward for two reasons: 1) They will receive lower returns from Gilts in future, 2) The low risk-free rate drives up valuations in other areas of the investment universe, as relative valuation or discounted cash flow methodologies use the risk-free rate to work out the discount rate, which thereby theoretically justifies paying ever higher prices for riskier assets. This leads to investors choosing to increase risk when prospective returns are arguably at their worst, rather than the other way round. Within the Fund, we try to invest more significantly into risk assets when valuations are low; as we did in March and April when we sold Gilts to fund riskier purchases.

Elsewhere in bond-land, BBB spreads also continued to drop, falling to 200bps from 219bps, which means they are now back below the long term average of 213bps. This again would imply that people are fairly positive on the outlook for credit, despite the unknown length or severity of the recession.

In the alternatives space, gold surpassed its previous all-time high of $1,921 set back in 2011, while REITs, property debt and infrastructure were all mixed.

PORTFOLIO ACTIVITY

Fixed income

The main move over the month was an increase in the cash balance of the fund, from 5.3% to 9.3%. This was a result of two bonds successfully maturing in July (the Balfour Beatty Preference share and the Sainsbury Perpetual bond), while the Shawbrook 2025 bond was called early. Although cash is yielding nothing, we currently feel it is now a better risk/reward option for short-term liquidity than Gilts (our previously preferred option), so a higher cash balance is to be expected for the time being as short dated Gilts are not currently offering the required returns. However, we will of course continue to seek out good risk/reward ideas in the short dated corporate bond market to keep generating returns and yield. As an example, we have recently added to Sainsbury's only remaining bond, at a yield of 3.1% with circa 1-year to maturity.

Beazley 2029 was also added to further, at yields of up to 4.8%, with the firm re-iterating their initial Covid-19 impact assessment in the June interim results. This top up takes it into the top 10 bond holding list.

Alternatives

The renewable infrastructure holdings were further reduced, as they are trading with lower expected returns than the Private Finance Initiative (PFI) funds, and some of the cash was used to start a new position in John Laing Group, which is a mixture of global renewables and PFI exposure. John Laing recently announced that they expected to report a fall in their Net Asset Value (NAV), as a result of Covid-19 and the fall in electricity prices, which saw the shares heavily sold off and John Laing become the only infrastructure related firm on the market to currently be trading at a discount to NAV. The firm are looking to divest their renewable assets which will leave them as a PFI focused business.

Given the disappointing performance of a number of the investment trust holdings, which continue to languish at large discounts to NAV, we have continued the active engagement with management teams and boards. We were pleased to see both AEW UK REIT and Starwood European Real Estate Finance put in writing that they are looking at share buybacks and have the permissions in place. It was also pleasing to see buy notes issued by sell-side analysts on Starwood European, Real Estate Credit Investments and Honeycomb during the month – this should help to generate interest in the names. Finally, it was noteworthy that two specialist lending investment trusts, Hadrian's Wall and UK Mortgages, received bid approaches in July, made feasible by the discounts to NAV they are trading at.

YIELD AND NAV

AJ Bell's Dividend Dashboard shows that, as at the start of August, 426 UK companies have cut or deferred their dividends to the tune of £37bn this year.

In the Fund, 4.3% of equity exposure has cut or deferred their dividends, reducing the fund yield by c. 17bps (this assumes zero dividends all year for those deferring which could prove to be overly conservative). CVS Group, the veterinary services provider, was the latest fund holding to halt its dividend, following its use of the furlough scheme – as far as we can tell, no company that has used the furlough scheme has maintained their dividend. CVS Group's shares were actually strong performers in the month, as they announced that monthly revenues were back up to pre-pandemic levels. As it is only a small holding, the dividend suspension will have very little impact on the overall yield of the fund.

GCP Student Living became the 3rd REIT to trim its dividend. It trimmed from 1.58p to 1.42p. Once again, this is immaterial on its own for the fund's yield. The REIT dividend cuts have cost Diversified Income 3bps in yield. However, the 7.5% of the fund that was invested from cash and gilts into attractive yields during the market sell-off, added 35bps to the yield. The active management at the time has more than offset the negative impacts of any dividend cuts.

The Fund's yield reduced to 3.9% from 4.2% over the month, given the rising NAV and maturing 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.

OUTLOOK

We are getting close to the end (or extension) of the furlough schemes in the US and UK, while the UK has just extended loan payment holidays to October. It will be interesting to see the impact on the economies once government support is reduced. In the US, household income has actually risen in this recession as the average person on furlough is earning more than when they were employed. This is unique and slightly bizarre at the same time.

Around the world we are seeing a pickup in Covid-19 cases, leading to a halt or a reversal of lockdown easing measures. We continue to monitor developments closely.

CLOSE DIVERSIFIED INCOME PORTFOLIO FUND PERFORMANCE AS AT 31 JULY 2020

	YTD	2019	2018	2017	2016	2015
Close Diversified Income Portfolio Fund	**-3.7%**	**9.8%**	**-1.8%**	**5.4%**	**7.8%**	**2.4%**
IA Mixed Investment 20-60% shares	-3.7%	11.8%	-5.1%	7.2%	10.3%	1.2%

SOURCE:

FE Analytics 04.08.2020; YTD data as at 31.07.2020. Performance is total return, net income reinvested after fees, X Acc share class.