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Close Select Fixed Income Fund

Monthly fund manager update

AUGUST 2020

ANDREW METCALF
Investment Director

FUND PERFORMANCE

The Close Select Fixed Income Fund returned +1.76% in August, bringing the year-to-date (YTD) return to -0.40%. In comparison, the IA Sterling Strategic Bond sector returned +0.16% in August, and is up +2.72% YTD.

Fund performance was slightly flattered in August given the reversal of the technical “swing price” on 3rd August. The YTD performance is unaffected by the “swing price”, as its negative impact was felt in July, but even excluding the positive impact in August, the fund returned a still strong +1.11%. (Swing prices occur when the Fund has an inflow / outflow greater than 1% of assets under management).

MACRO BACKDROP

In the UK, forward-looking data points improved, with August composite Purchasing Manager Index (PMI) data rising to a very strong 60.3, from 57.0 in July and April’s record low of 13.8. The backward-looking data, however, fully reflects the ‘new normal’ of materially reduced economic activity, with Q2 UK GDP growth falling -21.7% year-on-year (YoY). Nevertheless, consensus forecasts have changed and now paint a picture of a rapidly improving outlook. UK GDP growth is forecast to rebound sharply in Q3 ‘20, but it may still be – 9.7% by year-end; inflation looks set to remain below 2% until 2023; and unemployment may increase to c. 8% in Q4 2020.

In the US, forward-looking data also improved, with August composite PMI data rising to 54.7 (versus an April nadir of 27.0). While Q2 2020 quarter-on-quarter (QoQ) annualised GDP growth was a very weak -31.7%, consensus forecasts continue to indicate a strong rebound in Q3 2020 of +21% (and further positive growth over the next three quarters), as well as inflation remaining below 2% until 2023. While US unemployment data has positively surprised markets over the past three months, this data should be treated with caution, as there are anomalies within it which we believe have yet to be rectified by US statistical agencies.

In the Eurozone, the data is broadly aligned with the UK and US, albeit August composite PMI data was a relatively weak 51.6 (versus 31.9 in May and 13.5 in April), while Q2 2020 QoQ GDP growth was -12.1% (-40% on an annualised basis). Consensus forecasts indicate improving data from here – including a strong rebound in Q3 GDP growth; inflation below 1.3% until 2023; and unemployment peaking at 9.6% in Q4 2020.

PORTFOLIO ACTIVITY

Turning to portfolio activity, there was one key theme driving fund activity during August: de-risking.

Our current market assessment is that:

1. All major fixed income markets are trading at either ‘Rich’ or ‘Fair Value’ levels; and
2. We do not believe current valuations fully reflect potential risks emerging in Q4 2020 (Covid-19 second wave concerns; Brexit cliff-edge risk; US elections)

As a result, we increased credit quality within the portfolio while simultaneously maintaining a relatively high cash balance of c. 9%. Indeed, we sold a 2.5% position in our BHP Hybrid bond (which we bought at a yield of over 5% just three months ago, and sold at a yield of 1.7% in August); as well as reducing our position in Raifessen Bank, Volkswagen Hybrid bond, and further paring back our holdings in Real Estate debt funds to below 1%. The proceeds of these trades were reinvested into short duration non-cyclical bonds (Sainsbury’s 2021 and Tesco 2020) and high quality insurance bonds (Beazley 2026 and Rothesay Life 2025).

On the portfolio construction side, duration was maintained at 3.4 years, while the fund’s yield-to-expected-call reduced to 3.3% (its Yield-to-Maturity is 3.7%, but we believe the lower figure is a more accurate measure). The average rating on the rated portion of the portfolio is BBB+. The unrated portion of the fund has reduced to just 16%, and cash will likely be deployed into new issue markets (which re-opened in September 2020).

OUTLOOK AND STRATEGY

The general market weakness in March and strong rally between April and August initially led to a valuation distinction between Sovereign, Investment Grade, and High Yield bonds – yet all sub-asset classes now appear to trade at ‘Rich’ or ‘Fair Value’:

- **Sovereign bond yields** remain at (or near) record lows across the US, UK and Eurozone given weakening macro data, Central Bank intervention, and Covid-19 concerns;

- **Sterling Investment Grade** bonds are 'Slightly Rich' versus all historical timeframes, with sterling 'BBB' credit spreads at 185bps, versus their 5yr average of 189bps; 10yr average of 225bps; and 20yr average of 217bps.
- **Sterling High Yield** spreads are 'Fair Value' versus history given a current spread of 580bps (5yr average = 452bps; 10yr average = 516bps; 20yr average = 601bps). High Yield spreads in USD and EUR debt however - which are significantly larger and more liquid markets - are both 'Rich' versus historical timeframes.

In an effort to preserve capital and generate a good 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 31 AUGUST 2020

	YTD	2019	2018	2017	2016	2015
Close Select Fixed Income Fund	**-0.4%**	**9.4%**	**-2.0%**	**7.4%**	**8.0%**	**1.7%**
IA £ Strategic Bond	2.72%	9.3%	-2.5%	5.3%	7.3%	-0.2%

SOURCE:
FE Analytics 04.09.2020; YTD data as at 31.08.2020; all figures are for the X Acc share class; performance is total return, net of fees with dividends reinvested.