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Close Select Fixed Income Fund

Monthly fund manager update

SEPTEMBER 2020

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FUND PERFORMANCE

The Close Select Fixed Income Fund returned +0.4% in September, and 0.0% year-to-date (YTD). In comparison, the IA Sterling Strategic Bond sector returned +0.1% in September, and is up +2.8% YTD.

Fund performance for Q3 2020 was therefore +2.8%, while the IA Sterling Strategic bond sector returned +1.8%.

MACRO BACKDROP

The macro-economic data is following a broadly similar Covid-19-related trend across all 3 major markets. Backward-looking GDP growth data is improving as lockdowns are lifted; dire unemployment rate forecasts for Q4 2020 are being gently eased (from c. 9% to closer to 7% in the UK for example); and forward-looking survey data remains strong - albeit more cautious than August data given renewed fears over additional lockdown restrictions over the next six months.

In the UK, forward-looking data points weakened versus a very optimistic August, with September composite PMI data falling to, a still strong, 55.7 (versus 59.1 in August and April's record low of 13.8). The backward-looking data now fully reflects the Q2 2020 Covid-19 lockdown and materially reduced economic activity this led to - with Q2 UK GDP growth falling -21.5% year-on-year (YoY). Despite fears over a second lockdown over the next 6 months, consensus forecasts continue to indicate an improving outlook. Indeed, GDP growth is forecast to have rebounded sharply in Q3 2020, albeit overall 2020 GDP growth is still expected to be -9.9%; inflation is forecast to remain below 2% until 2023; and unemployment expected to peak at c. 7.4% in Q4 2020.

In the US, forward-looking data was broadly stable, with September composite PMI data of 54.4 (August 2020 = 54.6). While Q2 2020 quarter-on-quarter (QoQ) annualised GDP growth was a very weak -31.4%, consensus forecasts continue to indicate a strong rebound in Q3 2020 (and a more modest full year 2020 GDP growth decline of -4.4%). Inflation is forecast to remain below 2% until 2023; and US unemployment data is expected to improve steadily from the August unemployment figure of 8.4%.

In the Eurozone, the data is broadly aligned with the UK and US, albeit September composite PMI data was a relatively weak 50.1 (versus 51.9 in August and 13.5 in April), while Q2 2020 YoY GDP growth was -14.7%, consensus forecasts indicate improving data from here – suggesting a strong rebound in Q3 GDP growth; inflation below 1.3% until 2023; and unemployment peaking at 9.3% in Q4 2020.

PORTFOLIO ACTIVITY

Turning to portfolio activity, three key themes dominated September:

1) De-risking: We do not believe current rich / fair value valuations fully reflect the potential risks emerging in Q4 2020 (Covid-19 second wave concerns; Brexit cliff-edge risk; US election). As such, we reduced exposure to a series of UK-domiciled insurers (selling c. 5% of the fund) and increased cash levels to 16%.

2) Bond buybacks and redemptions: In September, c. 9% of the fund matured or was redeemed early (at attractive valuations). Indeed, Enel offered to buy back their 2021 Hybrid bond from us at a yield of just 0.90% - which we gladly accepted.

3) Selective buying: Against a backdrop of de-risking, our deep dive credit research continues apace. As such, we added to a series of attractive opportunities, including a new Virgin Money 2025 bond (yield = 5.1%); Commerzbank Perpetual bond (yield = 6.5%); and Perenti 2025 bond (yield = 6.5%).

On the portfolio construction side, cash levels are at a record high of 16%; duration was reduced to 3.1 years; and the fund's yield to expected call was maintained at 3.3% (Yield to Maturity is 3.7%, but we believe the lower figure is a more accurate measure of yield). The average credit rating on the rated portion of the portfolio is A-, and the unrated portion of the fund is just 16%. We expect to deploy cash and boost yield in a cautious and selective manner, targeting only those bonds which offer very attractive valuations.

OUTLOOK AND STRATEGY

The general market weakness in March and strong rally in April - August led to a clear valuation distinction between Sovereign, Investment Grade, and High Yield bonds. However, all sub-asset classes now appear 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 193bps, versus their 5yr average of 184bps; 10yr average of 225bps; and 20yr average of 217bps.
- **Sterling High Yield** spreads are fair value versus history given current spread of 607bps (5yr average = 452bps; 10yr average = 516bps; 20yr average = 601bps). High Yield spreads in USD and EUR – which are significantly larger and more liquid markets – are also trading at fair value versus historical timeframes.

In an effort to preserve capital and deliver 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 30 SEPTEMBER 2020

	YTD	2019	2018	2017	2016	2015
Close Select Fixed Income Fund	**0.0%**	**9.4%**	**-2.0%**	**7.4%**	**8.0%**	**1.7%**
IA £ Strategic Bond	2.8%	9.3%	-2.5%	5.3%	7.3%	-0.2%

SOURCE:

FE Analytics 02.10.2020; YTD data as at 30.09.2020; all figures are for the X Acc share class; performance is total return, net of fees with dividends reinvested.