Close Brothers Asset Management

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Close Diversified Income Portfolio Fund

Monthly fund manager update

JANUARY 2021

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PERFORMANCE

The Close Diversified Income Portfolio Fund fell -0.33% in January, which was in line with the IA 20-60% Shares sector. This month marks my 10th anniversary running the Fund, so I thought it might be interesting to look at how the market, and in particular the income, landscape has evolved. Over the decade, the fund has returned 62.7% on a cumulative basis, which compares favourably to a 59.9% return for the IA sector. This return has also been delivered with a much lower level of overall volatility, as the variety of assets and a shorter duration position have helped smooth the path of returns.

THE PAST DECADE

Let's start with gilts (the risk free rate). When I started running the Fund, I never imagined that we would see negative interest rates on bonds, but that is where we find ourselves today. The 5-year gilt yield has fallen from 2.46% to -0.03% over the past decade, while the 10-year gilt yield has fallen from 3.65% to 0.33%.

Gilts have featured in the Fund twice during this period: in 2011 when they performed well in the risk asset sell-off before being sold to make way for higher yielding corporate bonds, which drove returns in subsequent years; and between 2018-20, when gilts were bought as part of a de-risking exercise before being sold in the March 2020 Covid-19 sell-off, again to reinvest into higher yielding corporate bonds at more attractive levels.

As things stand, short-dated gilts are not an option for the Fund given that yields to maturity are negative, meaning they carry an expected loss. In such circumstances, cash, with its 0% expected return, has a better risk/return profile.

Moving up the risk spectrum brings us to investment grade bonds. So how have BBB-rated bond spreads changed over the past decade? Well, these too have fallen, reducing from 2.48% to 1.44% currently – meaning investors are getting less reward for shouldering corporate credit risk. The reward is currently well below the long-term average, which is a reason to be cautious.

If we add together the 10-year gilt yields and BBB-rated corporate bond spread, one can see that a 10-year BBB corporate bond has seen its yield compress from 6.13% to 1.77% over the past decade.

One way for investors to increase yield from their bond allocation is to buy longer-dated bonds – but the amount of yield investors earn for each unit of duration risk has fallen to an all-time low too (30 years of data), meaning that the risk/reward profile of such a trade has deteriorated significantly. The second way to increase yield within the fixed income asset class is to buy bonds with a lower credit rating (again taking on additional risk). However, the spreads here have also compressed. BB-rated bonds (also referred to as junk bonds) have seen their spreads fall from 4.1% to 3.06% over the past decade, and these are also well below the long-term average of 4.33%.

Looking ahead we will keep top-slicing risk and look for better entry points, whilst scouring all the sub-sectors within fixed interest (investment grade, non-rated, index-linked, junk bonds, convertible bonds, subordinated debt and perpetual bonds) for new attractive risk/reward investments. However, at present, these are increasingly hard to come by.

Inflation is also a driver of yield. Many companies will raise their prices by inflation with a consequent boost to profit and dividends, whilst some investment trusts and REITs see their incomes rise with inflation and so link their dividends to it. The rate of Retail Prices Index (RPI) inflation has fluctuated over the past decade, but it started the period at 4.8% and has finished at a recession-induced 1.2%. The government is also looking to move its benchmark of inflation away from RPI to the historically lower Consumer Prices Index (CPI) measure in 2030, which could further hamper inflationary gains in the longer-term.

The alternatives sector has continued to grow over the decade, with the variety of investments open to the fund growing notably over this time. We have seen a plethora of new renewables, royalties and battery funds. In the REIT space we have seen new specialist trusts list on the market - some of which have traded well against the recent economic backdrop - such as warehouse and supermarket REITs. Many of these alternatives continue to offer attractive yields, as they pay out the majority of their earnings as dividends.

Elsewhere within alternatives, commodities have historically provided the Fund with useful diversification benefits. Whilst precious metals such as gold and silver have no yield, we can also invest in precious metal miners. On this front, incidentally, we are close to finding out the new dividend policy for our holding in Barrick Gold, which is set to ramp up shareholder returns after spending the last 2 years improving its balance sheet to a net cash position.

The alternatives sector has not been immune to falling interest rates over the past 10 years – with some debt-related companies reducing their dividend targets (as new loans earn a lower return than yesteryear) and other sectors, like the Private Finance Initiative (PFI) funds and renewables funds, using lower discount rates to value their projects (pushing up valuations today at the expense of lower future returns). Looking ahead there will continue to be new funds launched, with those on my radar including digital infrastructure, global renewables and farmland funds.

In the equity space, valuations have also crept up over the last decade. The UK market 2-year forward-looking Price Earnings (P/E) ratio has risen from 10x to 15x.Higher valuations today mean equity yields are 33% less than they would have been if valuations had remained at 10x.

Equities are at the bottom of the pile of the corporate capital structure (hence the most risky) and are the longest duration asset class (you are buying the company's cash flows for as long as it survives). Therefore, equities are more sensitive to changes in the required level of return (be it driven by a rising risk free rate or rising risk premium). This makes them the most volatile asset class.

The Covid-19-induced recession meant that a lot of equities reduced or cancelled their dividend payments. AJ Bell calculate that the top 100 UK companies reduced their dividend payments by 20% in 2020. Looking at my Quant Model, I can see that the 2-year forward-looking (2022) dividend yield on the top 100 is forecast to be 4.2%. Interestingly, this is actually higher than the 4% figure back in January 2011, despite the current higher valuations.

Looking ahead, we will add to equities when suitable risk/reward ideas present themselves, and avoid any temptation to rush into higher risk assets just to increase the headline yield. We have recently added a position in Phoenix Group (7% yield) after taking profits in the Phoenix 2025 bond (which gave us a better return than if we had held the equity, despite its lower risk position in the capital structure).

Where does all this leave the Fund? Well, if one looks at a chart of the mark to market yield of the Close Diversified Income Portfolio Fund over time, we can see that, at 3.5%, it is currently towards the lower end of the range seen over the past 10 years. This is to be expected, especially with the current higher than usual level of cash in the fund. Lower yields and higher valuations are making income a scarce commodity – which is why active management (in both stock picking and asset allocation) is even more crucial. The Fund has never shied away from researching non-rated bonds, investing in bonds further down the capital structure (those that rank below senior bonds but still above shareholders), seeking out convertible bonds with attractive yields, and looking at new sectors in the alternatives and equity universes. And this is very much what I intend to continue doing going forward. Thank you to everyone who has supported the Fund over the past 10 years!

OUTLOOK

As I head into my 11th year running the Fund, it currently offers a forward-looking yield of 3.5% and an elevated cash level of 12.9%. Expensive markets, coupled with excitable retail investor participation, a buoyant IPO market, and record levels of investors using margin to fund purchases, have all historically been reasons to be cautious (just as all have previously been indicators of frothy markets). Interestingly, this is being reflected in record searches on Google for "stock market bubble". Make of that what you will.

Selling holdings like the BHP Billiton Perpetual bond at a yield of 1.26%, after buying at a 6% yield during the Covid-19 sell-off, and the Close Brothers 2027 bond at a yield of 1.15%, after buying when it was first issued at a yield of 4.25%, has boosted the cash levels of the Fund further recently, but gives up little in the way of future return.

However, in markets as volatile as this, that cash could prove very useful were there to be a pullback. The optionality cash affords is of great value to the Fund and it will be invested as and when attractive risk/reward ideas are found.

In the words of Jeremy Grantham, Chief Investment Strategist of GMO, an asset manager:

"*Even with hindsight, it is seldom easy to point to the pin that burst the bubble. The main reason for this lack of clarity is that the great bull markets did not break when they were presented with a major unexpected negative. Those events, like the portfolio insurance fiasco of 1987, tend to give sharp down legs and quick recoveries. They are in the larger scheme of things unique and technical and are not part of the ebb and flow of the great bubbles. The great bull markets typically turn down when the market conditions are very favourable, just subtly less favourable than they were yesterday. And that is why they are always missed.*"[1]

[1]Viewpoints: Waiting for the Last Dance: The Hazards of Asset Allocation in a Late-Stage Major Bubble, Jeremy Grantham, 5th January 2021.

Close Brothers
Asset Management

CLOSE DIVERSIFIED INCOME PORTFOLIO FUND PERFORMANCE AS AT 31 JANUARY 2021

	YTD	2020	2019	2018	2017	2016
Close Diversified Income Portfolio Fund	**-0.3%**	**1.4%**	**9.8%**	**-1.8%**	**5.4%**	**7.8%**
IA Mixed Investment 20-60% shares	-0.4%	3.5%	11.8%	-5.1%	7.2%	10.3%

SOURCE: FE Analytics 03.02.2021; YTD data as at 31.01.2021. Performance is total return, net income reinvested after fees, X Acc share class.

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