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Close Diversified Income Portfolio Fund

Monthly fund manager update

FEBRUARY 2021

STEPHEN HAYDE
Managing Director

PERFORMANCE

The Close Diversified Income Portfolio Fund fell -0.3% in February versus 0% for the IA 20-60% Shares sector.

Stock markets ended February in positive territory, although sterling appreciation meant that gains for UK investors were reduced. For example, US equities rose +3.5% in nominal terms, but only +1.8% in GBP terms, while European equities rose +4.5% in nominal terms, but just +2.4% in GBP terms. The UK equity market itself was up +1.2%.

Gilts were the big movers, especially towards the end of the month, as yields rose notably higher. A number of reasons were cited for this, including: the announcement of lockdown easing, economic growth strengthening, inflation picking up, budget deficits remaining high (meaning gilt issuance will too), and the potential for a rating agency downgrade for the UK. The 10-year gilt yield rose to 0.82% from 0.33% at the end of January, and the 2031 gilt price (which moves inversely to yields) fell -5.1% in the month. Such moves may not sound much, but when one considers that investors were holding this bond at the end of January to make just 0.33% per year then it puts the market move into perspective. We hold no gilts in the Fund as they have represented poor risk-adjusted returns for some time.

Corporate bonds outperformed gilts (though the IA Sterling Corporate Bond sector still fell -2.6% in the month) as spreads continued to narrow. BBB spreads over equivalent gilt yields fell from 1.44% to 1.35% (well below the long-term average of 2.13%).

In the alternatives space, gold sold off (down -6.7% in USD terms and -8.4% in GBP terms) giving back some of last year’s gains. One reason cited was the higher risk-free rates (as a result of higher gilt yields). However, it could be argued that the expectation that central banks are willing to continue fiscal and monetary support despite the gradual removal of lockdown restrictions (letting the economy “run hot”), increases the chance of a policy mistake, so we retain our gold position in the Fund as a hedge against unforeseen tail risks. Elsewhere, the Private Finance Initiative (PFI) and Infrastructure funds all sold off, with the property-related debt and REIT holdings mixed. In a continued sign of the difference of opinion between private markets and public markets, RDI REIT (not owned) was bid for in the month by Starwood (a large US property specialist) – sending its shares up 30% on the news. Three of the investment trust holdings we do own announced placings in February to finance future growth: Greencoat UK Wind, Tritax EuroBox and Warehouse REIT.

PORTFOLIO ACTIVITY

During the course of the month, we sold part of our position in the Greencoat UK Wind holding at 141p, in anticipation of a future equity raise after a flurry of deals left them in need of additional funding. A placing did indeed come in short order, priced at 131p (equating to an expected return of 6.9% and yield of 5.5%). We therefore took the opportunity to participate in the placing and take the Fund’s position up to a sizeable 3%. Overall, the shares fell, dragged down by this fund raise which dented February performance. However, these share price dips around fund raisings tend to be temporary, while the opportunity to buy at a level which conveys higher forward looking returns is clearly a positive.

Within alternatives, we added to a new area through the IPO of the Cordiant Digital Infrastructure Investment Trust. Cordiant will seek to invest in the nuts and bolts of the internet such as fibre, telecom towers and data centres. Additionally, we also managed to negotiate some free warrants to come with the new issue, which could be a source of free profit if the trust successfully executes its strategy. Warrants entitle the holder to buy the stock of the issuing company at a fixed price until a specified date, so getting something for free with the possibility of a return in the future could translate into an excellent risk/reward outcome. We shall endeavour to make this the new normal on IPOs we participate in to help improve the risk-adjusted returns for investors.

Within the fixed income space, the Fund’s bond exposure was further reduced, with the last of the BHP Billiton Perpetual bond sold at a yield of 1.19%, and the remainder of the Close Brothers 2027 bond sold at yields as low as 0.97%. Bonds are now down to 36% of the Fund, the lowest in a decade, with duration remaining at 3.7 years.

In the equity space, two positions were trimmed (Diploma and CVS Group). Both are smaller-caps that have re-rated strongly in the current market to trade at the top end of their historic valuation ranges and are relatively low yielders. The proceeds were reinvested into up-weighting our position in Philip Morris and to establish a new one in Unilever. Both companies issued results in February highlighting their resilient post Covid-19 performance, record cash generation, decent balance sheets and high returns profile, yet both are trading on historically low valuations.

Measured by the price to earnings (P/E) ratio relative to the stock market, Philip Morris is trading near 10-year lows, despite its market-leading reduced-risk tobacco positioning and a 5.7% dividend yield. As for Unilever, in recent months the share price has fallen from £49 to £38, just a fraction higher than the lows of March 2020. Its P/E relative to the stock market is now trading near 10-year lows, while its absolute valuation is back to the average of the past 20 years and the yield has risen back up to 4%.

YIELD

The Fund's yield (based on end-of-month prices) rose to 3.6% from 3.5% at the end of January, as lower yielding positions were reduced or exited and higher yielding positions were increased or initiated. Burford Capital was the latest fund holding to reinstate its dividend and will now pay the whole of 2020's dividend in one go in June 2021.

The Fund still maintains a sizable cash weighting of 11.3%. Whilst cash has no yield, it still has a better forward-looking return than negative yielding short-dated gilts, which used to be the first port of call to invest spare cash when cautious. Having cash gives optionality and it will be invested in new ideas as they are identified, or when any market pull back makes valuations in general more attractive.

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.

OUTLOOK

Whilst equities rose in the month they did not have everything their own way as the rise in sovereign bond yields did lead to a brief sell-off. As mentioned in numerous previous monthly updates, low risk-free rates have led to higher valuations in all asset classes (as analysts have lowered the discount rate they use to value the cash flows from an asset). Rising sovereign bond yields, if they were to persist, would impact the longest duration assets the most (loss-making tech stocks for instance where most of the value is far into the future), and cash generative mature businesses the least (where more of the value is near-term).

In the portfolio we remain fairly low duration: we have plenty of cash (no duration), our bond holdings have a duration of 3.7 years, much of the allocation to alternatives is to lower duration assets which are based on finite projects or loans (apart from gold and the REITs), and our equities tend to be cash generative mature businesses. The equities in the portfolio tend to carry low levels of leverage too – so interest costs on servicing their debt (which may rise in this scenario too) are not a major component of their costs.

The Fund remains diversified by asset class, geography and sector, with the aim of generating attractive risk-adjusted returns for clients.

CLOSE DIVERSIFIED INCOME PORTFOLIO FUND PERFORMANCE AS AT 28 FEBRUARY 2021

	YTD	2020	2019	2018	2017	2016
Close Diversified Income Portfolio Fund	**-0.7%**	**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 03.03.2021; YTD data as at 28.02.2021. Performance is total return, net income reinvested after fees, X Acc share class.

CBAM5423