Close Diversified Income Portfolio Fund

Monthly fund manager update

MARCH 2021

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PERFORMANCE

The Close Diversified Income Portfolio Fund rose +0.99% in March, which compared to a +1.27% rise for the IA 20-60% Shares sector.

Stock markets were in positive territory for the month of March. US equities rose +4.6% (+5.5% in GBP terms), European equities rose +7.8% (+6% in GBP terms) and the UK index was up +3.6%. These positive moves came in spite of the potential corporate tax rises on the horizon in the US, France heading for a renewed national lockdown and the 10-year US Treasury yield continuing its march north (from 1.4% to 1.73%). The 10-year gilt yield rose very slightly over the month to reach 0.85%.

Corporate bond spreads were little changed in March, with BBB spreads widening a touch to 1.38% from 1.35%, while riskier BB bonds saw their spreads tighten slightly to 2.69% from 2.71%. Bond spreads remain well below the long-term averages of 2.13% for BBB and 4.32% for BB.

In the alternatives space gold sold off further (-1.4% in USD terms and -0.4% in GBP terms), while the PFI Infrastructure, renewables and property trusts put in a mixed performance and lagged equity markets overall. Last month we highlighted the difference in valuations in the property space between private and public markets. This month we would highlight the difference in opinion among US property investors and those in the UK. We have three property debt funds, all trading at discounts to Net Asset Value (NAV). Starwood European Real Estate trades on a material 18.4% discount to NAV, yet its sister company Starwood Property Trust, listed in the US (and with which it shares some of the same investments) has recouped all of its Covid-19 share price fall and is trading on a 23% premium to NAV. Greencoat UK Wind, unusually, failed to bounce following its recent share placing, where we had materially up-weighted the holding. The two lead fund managers there took the opportunity to buy GBP 400,000 worth of shares.

PORTFOLIO ACTIVITY

March was the most interesting month in the fixed income space for some time. On the 11th March Verizon conducted the sixth largest corporate debt raise on record, raising USD25bn across nine new bond issues. The Verizon 2031 bond was issued at a yield of 2.55%, and is rated BBB+ by S&P.

However, what caught our eye on that day was the inaugural bond issue from the lesser known Lancashire Holdings. Whilst the company was new to the fixed income market, it was not new to the Close Diversified Income Fund, which already owns the equity. This is one of the benefits of having multi-asset experience – as knowledge of one area can help in another. Because it was new to the market, issuing a USD bond in the UK and became somewhat lost in the Verizon news, the yield ended up coming at a very attractive 5.625% (a spread of 4.12% over the US Treasury yield). Despite this bond being rated as investment grade (BBB- by Moody's) the spread of 4.12% is much wider than you can currently get for American BB sub-investment grade rated bonds (current spread 2.44%) and also bigger than one can currently achieve for American B rated bonds (current spread 3.69%), which is all extremely anomalous. The fund bought a significant position in this bond, resulting in it immediately ranking among the top 10 holdings. The purchase was funded by selling some lower yielding USD bond names which had an average yield of 2.85%. If held over the next 10 years, the Lancashire issue should make a compound return of 72.8%. This compares to 32.5% for the bonds sold and 28.6% for the new Verizon 2031 deal which attracted so much attention.

Another new bond issue caught the eye too. Paragon tendered for its 2026 (callable in 2021) bond and issued a replacement 2031 (callable in 2026) bond. The 2026 bond was already owned in the Fund and the tender price equated to selling it back to the company at a yield of just 1.25%, while the new issue came at a yield of 4.375%. We have not seen yields like this for a long time in the new issue market, so the decision was taken to make this a top 10 holding in the Fund as well. At that yield the spread equated to a sizeable 3.96% over that available from Gilts. The bond is rated BB+, yet today the average spread on BB (lower rating) bonds in the UK is just 2.69% and the notable pick up versus similarly rated bonds is clear to see. This trade was financed by selling some shorter dated bonds in the portfolio with an average yield of 1.7%. Looking ahead 5 years, the Paragon bond should give a compounded return of 23.9% versus 8.9% for the bonds sold.

And just like buses, a third new issue of interest came along too. Burford Capital, celebrated its ratings upgrade from Moody's by issuing its first ever institutional bond (the Burford bonds the Fund has purchased to date are retail bonds which can be bought in smaller denominations). Demand was high for the issue, in part because of the extremely high yield. The 2028 bond (rated BB by Moody's) came at a yield of 6.25% - a spread of 5% over the US Treasury yield, which compares favourably to the average BB spread in the US of just 2.44% and B spread of just 3.69%. There are just not many bonds with Burford's credit rating which offer such a yield. We were heavily scaled back on this issue, as many US and UK fund managers were trying to get involved in the issue, but we still managed to get a 0.5% position for the Fund. The price of the bond rose 3% once dealings commenced in the new issue. We expect that institutional demand will keep driving up prices (and driving down spreads) on all the Burford issues we own (we also own the 2022, 2024, 2025 and 2026 bonds).

Outside of the fixed income space, the Fund continued to increase its new positions in Unilever and Philip Morris (see last month's commentary for more information on those) and we took part in the discounted placing of the Supermarket Income REIT.

YIELD

Diversified Income's yield (based on end of month prices) rose to 3.8% (from 3.6% at the end of February) as lower yielding positions were reduced/exited and higher yielding positions were added to/initiated. The Fund is still sitting on a large cash weighting (10.8%). Whilst cash has no yield, this still has a better forward looking return than short dated gilts (negative yielding) which used to be the first port of call for spare cash when our outlook was 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 positions. In this tough environment the hard work continues to find attractive risk / reward ideas across the spectrum of asset classes which the Fund is able to invest in.

OUTLOOK

As the activity this month showed, despite higher than average valuations across asset classes, we are still able to find individual ideas that we think offer attractive risk adjusted returns. The new positions added 0.2% to the Fund's forward looking yield, despite the fact that we sold a number of existing holdings to finance them, and the fact that Fund's NAV rose 1% over the month (a rising NAV reduces yield of the fund).

The Fund remains well diversified by asset class, geography and sector, and generating attractive risk-adjusted returns for clients remains the key objective.

CLOSE DIVERSIFIED INCOME PORTFOLIO FUND PERFORMANCE AS AT 31 MARCH 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	0.9%	3.5%	11.8%	-5.1%	7.2%	10.3%

SOURCE: FE Analytics 06.04.2021; YTD data as at 31.03.2021. Performance is total return, net income reinvested after fees, X Acc share class.