Close Brothers Asset Management

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Close Diversified Income Portfolio Fund

Monthly fund manager update

MARCH 2022

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PERFORMANCE

The Close Diversified Income fund returned +1.5% in March, matching the return of the IA 20-60 Shares Sector. This brings the year-to-date return of the fund to -0.5%, which compares very favourably with a fall of -3.4% for the IA peer group over the same period.

Russia's invasion of Ukraine continued to drive volatility at the start of the month, although financial markets rebounded quickly in the main. Despite the negative impacts the conflict may have on the global economy, the Bank of England raised interest rates by +0.25% to 0.75%, while the US Federal Reserve implemented their first rate rise (also +0.25%) and guided to further increases at each of the remaining meetings in 2022. The problem Central Bankers have to navigate is that interest rates take time to take effect, meaning policy makers may keep raising rates before they know the full impact of those increases already implemented. Historically, this has often seen Central Bankers tightening monetary policy until a recession ensues. Nevertheless, the equity market has taken all this in its stride for the time being.

The US equity market advanced +3.6% (+5.7% in GBP terms) over the month, UK equities were up +0.8% while European markets declined -0.6% (+0.1% in GBP terms). The 10-year gilt yield rose from 1.41% to 1.61% in March. Corporate bonds outperformed sovereign bonds as BBB spreads fell to 1.72% from 1.86% (after initially selling off close to the long term average of 2.10%). Riskier BB spreads fell to 3.45% from 3.54%. The Fund still has no Gilt holdings, with the fixed income exposure all in corporate bonds.

The yield of the fund's bond holdings continued to rise, increasing from 4.9% to 5.3%. This is now not too far away from the 30-year high CPI inflation prints witnessed recently (a rate of 6.2% was announced in the month). The bond allocation has 3.8 years of duration, down from 3.9 years last month. We remain short duration within the fixed income allocation and the fund still maintains a high cash weighting of c.12% (essentially zero duration). The weighting to bonds is now 35.6%, back up from the historical lows after we took advantage of the early March spike in yields (see portfolio activity section below).

After outperforming as markets fell in recent months, it was pleasing to keep up with the IA sector peer group as markets rebounded, despite the underweight equity position. This was in part down to the investment process – which involves embracing risk when we are being adequately compensated to do so. During the early March market sell-off a number of interesting opportunities across all three major asset classes presented themselves, and we were able to exploit some of these to make good returns in just a matter of weeks. A further boost to performance came from a takeover offer for Hibernia REIT. The shares rose 38%, to within a whisker of the offer price, and were promptly sold. This is the fourth quarter in a row the fund has had a takeover approach for one of its holdings. Interestingly all the offers have come from private equity buyers. Elsewhere in March, we also saw Paragon Banking Group bonds upgraded to investment grade from high yield, taking the fund's high yield exposure down to 5.1% from 7.2%.

PORTFOLIO ACTIVITY

It was an exceptionally active month as we invested a total of 5.4% of the fund's assets in the early March sell-off.

As noted, we increased the bond weighting by nearly 3% from the all-time lows. We added materially to a positon in Nationwide Perpetual bonds at yields as high as 6.25%. These bonds yielded just 2.6% as recently as two quarters ago in September 2021. This trade took the weighting from 0.4% to 2.6% in the fund, making the holding a top 10 bond position. These bonds have already bounced 3 pence and there are now 11 brokers advertising on the dealing screens that they are willing buyers of 34.5 million of these bonds. We were able to buy millions of these bonds during the sell-off from investors de-risking, but fast forward just three weeks and no investors want to sell despite the higher price. We also materially added to Co-Op 2026 bonds at a yield of 5.44%. This is almost double the 2.8% yield they traded at in September 2021. Elsewhere, we added to Abrdn Perpetual bonds at yields as high as 6.03% (this bond came to the market in December last year at a yield of 5.25%), while we also added to Trafigura Perpetual bonds at yields as high as 8.66% (these bonds yielded 5.875% in September 2021), and Travis Perkins 2026 bonds at a 4% yield (double the yield they were trading at in September 2021).

It has been a difficult period for bonds in general since we slashed exposure within the fund in early 2021 on valuation grounds but falling prices equal more attractive future returns and we believe that now is an opportune time to turn a little more positive on the asset class.

In the equity space, we added to the position in Schroders Non-Voting shares. These were trading at a record high 40% discount to the price of the Voting shares, and given the stock market falls at the start of the month, the shares fell to 1710p (a 7.3% dividend yield that is two times covered by earnings). The shares have recently gone ex-dividend 85p, representing a 5% income already on this month's purchase. Despite going ex-dividend the shares have now recovered to 1920p, leading to a 17.25% total return on the purchase this month.

Elsewhere, we added to insurance services group Phoenix Group Holdings at 575p (an 8.55% dividend yield). Following good results and an increase in the dividend of 3% the shares have bounced to 614.2p, again despite already going ex-dividend with a dividend of 24.8p. Therefore, the fund has already benefitted from a 4.3% yield from those shares and is sitting on a total return of 11.1% on the purchase this month.

Within the European equity allocation, we added to chemical distribution company Brenntag at 66 Euros. The shares have since bounced to 73.5 Euros – a total return of 11.3% on the purchase this month.

Within the alternatives space, we added to 3i Infrastructure at 314p. The share price is now up to 348p, representing a return of 10.8%.

Despite investing a relatively large amount, fund inflows and a number of sales meant the cash weight only reduced by 0.4% over the course of the month. It currently sits at c.12%.

In terms of disposals in the fund during March, the holding in Nestle was completely sold at a relative all-time high valuation. Nestle is seen as a defensive stock and has held up well through the equity market sell-off. We also sold a 0.75% weighting in silver and gold (zero yielding assets), as we booked the profit from the recent rally in the gold price during the current geopolitical crisis. After selling gold at above USD 2,000 / ounce it fell through the rest of March as the equity markets rallied and ended the month at USD 1,937.

Elsewhere, we continued to reduce our weighting in infrastructure assets which rallied strongly over the month, lowering the future expected return.

YIELD

The Fund's yield (based on end of month prices) rose to 4.3% from 4.2%. The trades described above more than offset the impact of the strong rise in the Net Asset Value (NAV) in the month (rising prices = lower yields). The yield on the Fund is the result of all the individually picked attractive risk / reward ideas.

OUTLOOK

The Fund remains diversified by asset class, geography and sector with the purpose of generating attractive risk adjusted returns for clients. We will continue to tilt the portfolio away from areas and ideas that are more expensive (lower forward-looking returns) and continue to use the Quant Model to focus research efforts on those areas and ideas with better value. Volatile markets will increase the likelihood of finding more investments at valuations we consider good risk / reward.