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Close Portfolio Funds

Monthly fund manager update

MARCH 2022

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STRATEGY OVERVIEW

The Close Portfolio Funds seek to achieve resilient returns over the long term through an equity-led approach to investing in a multi-asset context. Our strategy of acquiring companies we consider 'cheap durables' – direct interests in predictable and sustainable businesses purchased at attractive cash-based valuations – is complimented by allocations across fixed income and alternatives as appropriate.

MONTHLY PERFORMANCE

Each Fund delivered positive returns in March but under-performed its respective Investment Association peer group (in brackets): Conservative rose 1.1% (1.5%), Balanced 1.8% (2.8%) and Growth 2.5% (3.0%).

Since inception the Funds have increased by an annualised 4.9% (4.8%), 6.7% (6.7%), 7.9% (6.9%) with capture ratios of 103%, 101% and 105% across Conservative, Balanced and Growth respectively.

MONTH IN REVIEW

Bonds fell -2% in March (ICE Bank of America Sterling Broad Market Index) as markets continued to price for higher interest rates. Our positioning in cash and other short-dated Gilt securities protected on a relative basis. After a weak start to the year, stock markets rebounded by ca. 4%. Our equities performed roughly in-line. The top three contributors were Accenture, Oriental Land (trimmed late in the month) and UnitedHealth Group (also trimmed). The bottom detractors were Admiral (trimmed early in the month), Partners Group (added late in the month), and Ally Financial.

MARCH THOUGHTS: THE SORTING HAT

Applying words 'Growth' and 'Value' to describe the nature of stocks is common in investing nomenclature, but we eschew these terms. Growth is a component of value, and a business that adds to their capital base at rates of return below their cost of capital is actually destroying value, not creating it. Instead, our fundamental unifying belief is that the worth of any asset – be that equity, bond, an alternative – is the present value of their future cashflows discounted back to today at an appropriate rate. For bonds this is straightforward. The size and timing of the coupons and final maturity date are explicit. All that remains is to handicap the credit risk either through outright default or more insidiously via inflation.

For equities this exercise is simple, but not easy. Shareholders have a claim on the residual cashflows of the business in which they are part-owners. But the free cash flows are not contractual. The starting 'coupon' is the free cash flow yield upon entry at the current share price. But unlike the coupons on bonds, there are no guarantees about future payments. Hopefully they will grow, but they may fall. What happens is subject to the economic environment and the evolution of the company's competitive advantage within their industry. We are particularly attracted to equity coupons that are virtually assured to grow for many years, even decades, in a predictable fashion. Once our business analysis is complete all that remains is to wait patiently for an appropriate entry price such that the starting 'yield' encompassing the future cashflow direction calculates to an appropriate return. In our case we use a hurdle rate of 8%, chosen as a reasonable proxy for the historical long-run real return from equities of 6% plus 2% for inflation.

Today the equity component of our portfolio is comprised of 'cheap durables'. These stocks are sold in the market on a starting free cash flow yield of 5% compared to the market average of 4.4%. But, if we have done our homework correctly, these companies are expected to grow this starting yield at a faster rate than the market average, at above-market rates of return on capital, and with less leveraged balance sheets: above-average businesses at below-average prices. We own Kobe steak priced like brisket. The missing ingredient is the unpredictable amount of time in which the long-run weighing machine of the market overcomes the short-run voting mechanism on stocks. Whilst we wait, our conviction in analysis of business fundamentals prevents us from being pushed out of positions when share prices move against us.

So, instead of seeing the investing landscape through a lens of 'Growth' versus 'Value' and attempting to time the fluctuating vicissitudes between the two camps, our constant belief is that there are only two sets of stocks: 'cheap' and 'expensive', with the former defined as those which go on to outperform the latter once the deliberations of the market sorting hat are concluded.

LOOKING AHEAD

With substantial holdings in cash and short-term Gilts we are looking for opportunities to become more constructive on the lower valuations for equities and corporate bonds. In particular, we are watching for the Federal Reserve to become less 'hawkish' with respect to interest rate increases, and also following the unfolding business cycle, to see whether it stabilises and turns up. Conversely, should a recession be confirmed we would reduce equities further and look to buy longer-duration Gilts in order to protect portfolios.

As a long-term strategy with low turnover we fully expect and recommend that unitholders judge our performance over a period of five years or more.