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Close Portfolio Funds

Monthly fund manager update

APRIL 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 'cheap durables' – direct interests in predictable and sustainable businesses purchased at attractive cash-based valuations – is complemented by allocations across fixed income and alternatives as appropriate.

MONTHLY PERFORMANCE

Each Fund delivered negative returns in April and under-performed their respective Investment Association peer groups (in brackets): Conservative fell -2.6% (-1.8%), Balanced -3.3% (-2.1%) and Growth -4.0% (-2%). The currency overlay detracted significantly by -0.6%, -0.9% and -1.2% respectively, principally because sterling weakened by -4.3% against the US dollar over the month.

Since inception the Funds have delivered annualised returns of 4.7% (4.7%), 6.3% (6.5%), 7.5% (6.7%) with capture ratios of 102%, 101% and 106% across Conservative, Balanced and Growth respectively.

MONTH IN REVIEW

UK government gilts fell -2.9% in April as fixed income markets continued to price for higher interest rates. Our positioning in cash and other short-dated gilts protected on a relative basis. After rebounding in March, stock markets declined by -2.8% in April. Our equities underperformed on a stock selection basis, but an underweight allocation to equities relative to the IA peer groups was beneficial. The top three contributors were Relx (trimmed in the month), Suncor Energy (purchased in March), and Cenovus Energy (also purchased in March). The bottom detractors were Alphabet (added in the month), Applied Materials, and Oriental Land (trimmed the previous month).

APRIL THOUGHTS: WHY BONDS?

Bonds have had a torrid start to 2022 with yields rising substantially in most markets. The ICE BofA Sterling Broad Market Index has declined by -10%. Not only are investors nursing losses on their fixed income holdings, but these losses have been registered during a period of equity market weakness. The MSCI All Countries World Index is down -6% so far this year. Bonds have seemingly lost their diversifying properties, provided poor recent returns, and – according to the prevailing market narrative - face a bleak future. Why would anyone want to hold bonds?

First, rising yields should mean higher returns, because a bond which doesn't default will return the yield at purchase if held to maturity. An asset class offering a 2% risk-free return today must, by definition, be more attractive than when if offered a lower return of 0.5% - as UK Gilts did as recently as last summer. Moreover, the chance of losing money in any given year has now reduced because these higher starting yields mathematically give increased protection against further rises in interest rates. A five year bond yielding zero suffers a 10% capital loss if yields rise 2%. But that five year bond now yielding 2% will only suffer a further 10% loss if yields rise an *additional* 2.6% over a year (assuming a flat yield curve). Behaviourally, investors tend to attach greater significance to the recent past, and feel their remembered losses particularly acutely; rationally, bonds are safer now that yields are higher. Of course, the reason that yields are higher is due to rising inflation and central banks increasing interest rates – what has changed is that investors now receive some compensation for these risks, whereas once there was little or none.

From a portfolio perspective it is crucial to focus not just on the expected return of an asset, but also consider how it behaves in relation to other positions in that portfolio. No asset class works in all backdrops and entering the current environment, where inflation is rising and growth is slowing, bonds have performed particularly poorly and not diversified against equity weakness. But that is just a single specific scenario. Year-to-date we have mitigated the declines to some extent through keeping our fixed income as cash-like as possible by remaining 'short duration'. But the current environment is unstable in that the US Federal Reserve has made clear that it will bring inflation down by raising interest rates even if this incurs a recession – jumping over the stagflationary 1970s to get straight to the inflation-busting 1980s. In a more typical equity market selloff triggered by a recession, it is reasonable to expect that high quality sovereign bonds would once again become an effective portfolio component, making profits which not only lowers the drawdown but provides opportunities to rebalance back into equities and harness the volatility.

For the time being, the increases to short-term rates from central banks are pushing up long-term rates in parallel. It continues to pay to remain short duration. But we stand ready to buy longer-dated bonds if it becomes apparent that central banks have over-tightened monetary policy and the interest rate increases are stifling already slowing economies into recession.

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 the current slowdown 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 recommend that unitholders judge our performance over a period of five years or more.

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