Close Diversified Income Portfolio Fund

Monthly fund manager update

MAY 2022

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PERFORMANCE

The Close Diversified Income fund was down -1.1% in May, which compares to -0.5% for the Investment Association (IA) 20-60% Shares Sector. This takes the year-to-date (YTD) return for the Fund to -0.8% in 2022, which compares favourably to the -5.6% fall for the IA 20-60% peer group.

Equity markets were weak in the first half of May; the S&P 500 in the US briefly entered bear market territory (defined as a 20% decline), but rebounded towards the end of the month as the minuets from a recent Federal Reserve meeting hinted at pausing interest rate rises in the autumn. Elsewhere, markets also took some comfort from hopes of an economic rebound in China as the government started to ease Covid-19 lockdown measures and announced a wide-ranging aid package.

Over the month as a whole, the US equity market was flat (also flat in GBP terms), but the tech-heavy NASDAQ fell a further -2% (also -2% in GBP terms). The UK equity market advanced +0.8%, but European equities fell -0.4% (although they were up +1% in GBP terms). Within fixed income markets, the 10-year gilt yield rose from 1.91% to 2.10%, while corporate bonds underperformed sovereign bonds as BBB spreads rose from 1.94% to 2.02% (bringing them closer to their long-term average of 2.1%). Riskier BB spreads went from 3.89% to 4.44% (now above the long-term average 4.25%). The yield of the bond holdings we own continued to rise, from 5.7% to 6.1%. The Fund remains short duration within its fixed income allocation, and we still maintain an elevated cash weighting (essentially zero duration) of 10%. The overall weighting to bonds has been increased again, to 39.2% from 36.9% at the end of April.

News flow wise, the main detractor was UK Chancellor Rishi Sunak's introduction of a windfall tax on oil and gas companies, which he is considering extending to electricity production companies, including renewables. As a result, Greencoat UK Wind fell 6% and GCP Infrastructure was off 5% over the month. On a positive note, two of the three logistics REITS reported updated Net Asset Values (NAVs). Warehouse REIT delivered a NAV total return of 16.1% over the 6 months to March, whilst Tritax EuroBox delivered a NAV total return of 9.5%. Despite these large NAV gains the share price reactions were muted and both REITs ended the month at significant discounts to their new NAVs. Urban Logistics will report its NAV in June. Cordiant Digital Infrastructure announced a 6.1% NAV total return for 6 months to March (also ahead of the expected run rate). In the equity space, Philip Morris rose 6% after making an approach for Swedish Match. As well as boosting its non-cigarette business it will also give them a US manufacturing, distribution and sales network from which to sell its IQOS range (currently done via a joint venture).

WHY A SELL-OFF IN BOND MARKETS CAN BE GOOD FOR ACTIVE INVESTORS

I am often asked a lot of questions on bonds and whether this is a good time to be invested in them or not. Recently bond yields have been rising, which means bond prices have been falling, so the lowest risk asset class has been losing investors' money. However, one could argue that this is a positive for those with a long-term investing horizon. The low point for yields came in 2021, and regular readers will know that we had heavily reduced the fixed income allocation within the Fund at this point, taking its weighting down to an all-time low. At that time the fixed income portion of the Fund had a yield of 3.3%. Now, if you were going to be invested for the next decade, what would you prefer: just to make a steady 3.3% per annum, or to have a sell-off in year 1, and then have the ability to make a higher yield for the remaining 9 years?

Let's look at the maths. If you invested £100,000 at a 3.3% yield you could theoretically have £138,358 at maturity after 10 years, if one assumes coupons were reinvested, an annual compound return of 3.3%. However, if bonds markets fell 6.8% in year 1 (the capital decline which would see yields rise from 3.3% to the current 6.1% yield on the Fund's bond allocation), then one's prospective future returns improve markedly. In this example, one could then theoretically achieve a much higher annualised return of 4.7% overall if you were able to secure a compounding return of 6.1% for the remaining 9 years of the period. The reality will never quite match the theory for numerous reasons, but the fact remains that the higher bond yields we are now seeing provide active investors with significantly better and more plentiful opportunities. We are hopeful that the active approach we take in the Fund will ultimately provide investors with good outcomes, given that we sold a number of bonds in 2021 and are only now re-investing the proceeds (avoiding some of those year 1 losses).

Close Brothers Asset Management

Given that the 10-year expected inflation rate is 4.2%, the sell-off in fixed income can actually be seen as a welcome development from another perspective as well, as it not only means higher returns in the long-run, but also offers the prospect of a real return from fixed income.

PORTFOLIO ACTIVITY

May was another active month. We have now increased the bond weighting by 6.3% since February following a string of further purchases in May:

- We added to Nationwide Perpetual bonds again, at yields as high as 6.6% for bonds which yielded 2.6% in September 2021

- We added a new position in Pershing Square Holdings 2031 at a yield of 5.5%

- We added to Trafigura Perp bonds again, at yields as high as 9.4% for bonds which yielded 5.9% in September 2021

- We added to Co-Op 2026 bonds again, at a yield of 8.2% for bonds which yielded 2.8% in September 2021

- We added to Travis Perkins 2026 bonds again at yields as high as 5.5% for bonds which yielded 2% in September 2021

- We added to Pension Insurance Corp Perp at yields as high as 6.8% for bonds which yielded 3.9% in September 2021

- We added to Marks and Spencer 2037 bonds at a yield of 7.1% after their results showed a continued improvement in their credit metrics. Their metrics are investment grade now, though it is doubtful that the rating agencies will upgrade them yet given the uncertain consumer backdrop / high inflation

- We added to Just Group 2026 at a yield of 5.2% for bonds which yielded 2.3% back in September 2021

- We added to Abrdn Perp bonds at yields as high as 6.4%. This bond came to the market in December last year at a yield of 5.25%

Within equities we added to Phoenix Holdings at 574p (8.6% yield). The shares bounced to finish the month at 637p. We also top-sliced the Schroders position locking in a 40%+ profit in two months. In the alternatives space Greencoat UK Wind was top-sliced after a strong run (and before the windfall tax news hit the shares), while ICG Longbow returned a further 10% of its capital as it continues to wind down.

The cash weighting fell very marginally overall, to 10% from 10.1%.

YIELD

The Fund's yield (based on end of month prices) rose to 4.8% from 4.5%. This was driven by the sell-off in the bond market and our recycling cash into higher yielding investments. 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 attempting to generate 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 our proprietary Quant Model to focus research efforts on those areas and ideas offering better value. Volatile markets should increase the likelihood of finding more investments at valuations we consider good risk / reward.