Close Portfolio Funds

Monthly fund manager update

MAY 2022

GILES PARKINSON
Managing Director

STRATEGY OVERVIEW

The Close Portfolio Funds seek to achieve resilient returns over the long term through an equity-led approach whilst 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 May but they all out-performed their respective Investment Association peer groups (in brackets) on a relative basis: The Conservative fund fell -0.3% (-0.5%), Balanced fell -0.4% (-0.9%) and Growth declined -0.4% (-0.9%).

Since inception the Funds have delivered annualised returns of +4.6% (+4.6%), +6.2% (+6.3%), +7.4% (+6.5%) with capture ratios of 103%, 101% and 106% across Conservative, Balanced and Growth respectively.

MONTH IN REVIEW

Fixed income markets declined notably again in May as markets continued to price for higher interest rates. Our positioning in cash and other short-dated Gilt securities protected on a relative basis, further assisted by low exposure to corporate bonds, as credit spreads continued to widen. After declining in April, stock markets were little changed in May. Pleasingly, our equities outperformed, with the top three contributors being Cenovus Energy (purchased in March), Canadian Natural Resources (also purchased in March), and Valvoline (added to mid-month when it dipped following a results announcement). The three most significant detractors were Microsoft, Alphabet, and Costco (trimmed in March & April, and repurchased late in May). We explore Alphabet further in this commentary

MAY THOUGHTS: IN PLAIN SIGHT

Let's talk about Alphabet, the biggest single direct equity holding in your fund and the second largest detractor in May, declining -5.2%. Alphabet is perhaps better known as Google, the family of applications around their core asset of internet advertising. The prize Search business has literally become the gateway to the internet, a ubiquitous trove of information, sometimes knowledge, occasionally understanding and at times even wisdom, that gives humans demi-god omniscience. Is my flight delayed? What's the population of Canada? Where is the nearest supermarket? Google has achieved this default position not through monopolistic coercion but because it offers the best experience, cemented by force of habit. This is monetised primarily by selling adverts within the search results.

Nineteenth-century advertising pioneer John Wanamaker complained that "one-half the money I spend for advertising is wasted, but I have never been able to decide which half." This was true for newspaper adverts, targeted imprecisely around readership demographics. But internet search comes with very high intent. 'Best dishwasher' is worth nothing to most businesses but everything to a white goods retailer. No surprise, then, that internet search has gobbled up an increasing proportion of the advertising share in the past two decades. Moreover, high-intent internet search is so potent it has even grown into areas beyond conventional advertising, such as shopping centre rents. Stores are a form of customer acquisition: Visiting a retail park to browse what is on offer has been displaced by an internet search without leaving the house. This structural shift cannot continue indefinitely, but decades-old Google Search grew revenues 24% in the last quarterly period, on top of 30% the year before, a cumulative 76% above 2019 levels. And yet the stock is on its knees. One of the best businesses the planet has ever seen is trading for the lowest ratio of profits relative to the market since it floated in 2004. On an absolute basis, it is below the March 2020 market bottom when the world shut indefinitely.

Could we be wrong? The venture-capital backed startup world has imploded in the last year and is reigning in spending, but Alphabet is diversified across industry verticals and between customer size from large corporates down to SMEs. Advertising is admittedly cyclical and the stock market is bracing for recession. But the pessimism in Alphabet stock looks disproportionate relative to other cyclical businesses with fewer structural tailwinds. Alphabet continues to undergo regulatory scrutiny, but the company has been able to adapt to previous interventions, and were a breakup to be forced upon the business it would lift the informal margin cap the conglomerate operates under, allowing profits to expand rather than being a value-destructive event.

Alphabet has compounded earnings at 34% over the past five years and 22% over the previous decade. The future continues to look bright so we have added to value in plain sight.

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 downturn 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. The near-term path is set: will inflation roll over sufficiently to provide central banks with room to manoeuver, or will the recessionary consequences of their interest rate increases arrive first?

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