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Close Diversified Income Portfolio Fund

Monthly fund manager update

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PERFORMANCE

The Close Diversified Income Fund was down -3.0% in June, but this compared favourably to a -4.0% decline for the Investment Association (IA) 20-60% Shares sector. On a year-to-date basis, the Fund is now down -3.8%, which again compares favourably with the peer group which has fallen -9.4% in 2022.

Investor sentiment was weak over the month of June as fears of a recession grew. The US equity market fell -8.4% (-5% in GBP terms), the tech-heavy NASDAQ was down -8.7% (-5.3% in GBP terms), UK equities fell -5.8%, and European equities declined -8.8% (-7.8% in GBP terms). This completed what was the worst first half of a year for the US equity market since 1970, and the worst for the NASDAQ in its history.

Despite recessionary fears leading to sovereign bond yields retreating from the highs reached towards the end of the month, inflation concerns and rising interest rates had already pushed them up significantly. Over June as a whole gilt yields were still higher (leading to losses in gilts). The 10-year gilt yield rose from 2.1% to 2.2% (having been as high as 2.7% on 21st June).

Corporate bonds underperformed sovereign bonds as BBB spreads rose from 2.0% to 2.5%, putting them above the long-term average of 2.1%. Riskier BB spreads went from 4.4% to 5.8%, meaning they are now well above the long-term average 4.3%, and close to the March 2020 Covid-19 sell off level of 6.4%. The yield of the bond holdings we own in the Fund continued to rise, advancing from 6.1% to 7.4%. We took advantage of the sell-off to put some of the double-digit cash position (zero-yielding) to work at much more attractive valuation levels than we were seeing at the start of the year. As such, the weighting to bonds within the Fund increased again this month, from 39.2% to 43.9%.

News flow from the Fund's holdings was generally positive in June. The value-add distribution companies are actually currently benefiting from higher inflation (selling more in GBP terms, even if volumes are not strong) and both Brenntag, the German chemical distribution company, and UK multinational Bunzl upgraded profit guidance in the month - Brenntag by 20%. Despite this news, Brenntag shares still ended the month heavily down, falling -13.7%.

Looking ahead, July should have some good NAV (Net Asset Value) announcements from GCP Infrastructure and Greencoat UK Wind (over 5% of the portfolio combined) given the ongoing strength in the electricity price and continued rise in forward power curves.

PORTFOLIO ACTIVITY

Following on from an active May, June also saw plenty of portfolio activity. After further purchases this month, we have now increased the bond weighting of the Fund by 11% since February. June's purchases included:

Adding to Abrdn Perpetual bonds at yields as high as 9%, this bond came to the market in December last year at a yield of 5.3%. We also added to Nationwide Perpetual bonds at yields as high as 8.3% (having yielded just 3.4% in September 2021). A new position was taken in a newly issued Aviva Perpetual bond at yields as high as 8%, while the Pension Insurance Corporation perpetual bond was added to at yields as high as 7.9% (these bonds yielded 3.9% in September 2021). We also added to Marks and Spencer 2037 bonds at yields as high as 7.6%, having yielded 5% in September 2021, and we added to Travis Perkins 2026 bonds at yields as high as 7.5% (yields were just 2% back in September 2021). Elsewhere, the British American Tobacco (BATS) 2040 bonds were also added to at yields as high as 7% (3.4% in September 2021). And finally, we also added to the Pershing Square Holdings 2031 bond at yields as high as 6.1% (3.3% in September 2021).

Given that we consider the long-term return on equities to be c.8%, you can see that bonds are starting to get to very attractive valuation levels and the TINA (There Is No Alternative) trade of simply buying equities is increasingly challenged. If bond yields continue to go higher, then this may also put further pressure on equity valuations.

In equities, we added to Brenntag four times through the month following the sell-off noted above. It is currently trading on a Price to Earnings (P/E) ratio of 10.7x and a free cash flow yield of 7%, which our Quant Model deems attractive. We also added to specialist technical products and services provider Diploma (another value-add distributor) which fell -14.3% in June on no meaningful stock specific news.

With dry powder being put to work, the Fund's cash weighting fell from an elevated level of 10% to 4.7% over the month.

YIELD

The Fund's yield (based on end of month prices) rose to 5.7% from 4.8%, the highest it has ever been in its 11-year history. This was driven by the sell-off across most asset classes in June, and our recycling half of the cash position into higher yielding investments. As explained last month, the fall in bond markets should be a positive for longer-term returns, as we are able to buy bonds with much higher yields today than the same bonds were offering just a few months ago.

OUTLOOK

The Fund remains diversified by asset class, geography and sector with the aim 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 our Quant Model to focus research efforts on those areas and ideas with better potential value. Volatile markets should increase the likelihood of finding more investments at valuations we consider good risk/reward.