Close Brothers Asset Management

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Close Diversified Income Portfolio Fund

Monthly fund manager update

JULY 2022

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PERFORMANCE

The Close Diversified Income was up +1.41% in July. This compared to +2.59% for the Investment Association (IA) 20-60% Shares sector. Diversified Income is now down -2.41% year-to-date, which compares very favourably with the IA 20-60% return of -7.1%.

Markets rebounded over the month after a particularly weak period. The US S&P 500 rose +9.2% (9.2% in sterling terms) despite the US recording its second straight quarter of falling GDP. Whilst this is one definition of a recession, it is not the US's definition. Only the National Bureau of Economic Research (NBER) can declare a recession in the US and they have stayed quiet on the subject. European equities rose +7.3% (+4.7% in sterling terms), while the UK equities were up +3.5%. Investors are assuming that slowing GDP growth will lead to fewer interest rate hikes by central bankers, BUT slowing growth also increases the risk to corporate earnings. In one day alone towards the end of the months we saw profit warnings from Adidas (sportswear), Wal-Mart (supermarket), Weber (BBQs), Wickes (DIY), Logitech (IT equipment), Whirlpool (white goods), UBS (banking) and Moody's (bond rating agency) due to varying combinations of supply chain issues, falling demand and inflationary cost pressures. These stocks are not owned by the Fund. It is largely consensus now that the S&P 500's aggregate earnings expectations are starting to fall.

Time will tell if July's equity market gains will be sustained or if this is a bear market rally. The two equities we added to last month rose strongly with Diploma +23% and Brenntag +10%.

The 10-year gilt yield fell from 2.23% in July to 1.86%. Corporate bonds outperformed sovereign bonds as BBB spreads fell from 2.47% to 2.34% (still above the long-term average of 2.1%). Riskier BB spreads went from 5.81% to 5.63% (still well above their long-term average of 4.25%).

Most of the Fund's equities have reported early in results season and they have generally been positive, so there are only a handful left to go in August. GCP Infrastructure reported a Q2 2022 Net Asset Value (NAV) total return of 2.9% and Greencoat UK Wind reported a 4.2% gain. Greencoat's would have been more but the Board decided to increase the discount rate they use to value the future cash flows from 7.2% to 7.7%, in part to be more conservative in a rising interest rate world. This dampened the rise in the stated NAV (and in all likelihood the share price) today, in return for a higher forward looking return. Electricity prices remain high with the July electricity price averaging £245MW/hr, which compares to £176 for H1 2022.

PORTFOLIO ACTIVITY

So what did I do in July?

Despite it being a risk-on month, the first week of July was weak and we were able to reinvest the maturing Severn Trent bond proceeds at the highest yields seen this year. We also:

-Added to Aviva Perp at a yield of 8.1%. This was a new issue last month

-Added to Marks & Spencer 2037 bonds at a yield of 8.0%. These bonds yielded 5% in September 2021

-Added to Nationwide Perp at yields as high as 8.75%. These bonds yielded 3.4% in September 2021

-Added to Rothesay Life Perp at a yield of 7.94%

-Added to Travis Perkins 2026 bonds at a yield of 7.7%. These bonds yielded 2% in September 2021

-Added to Trafigura Perp at yields as high as 10.36%. These bonds yielded 5.88% in September 21

The average yield on these purchases was 8.5% and they extended duration of the fixed income component of the fund to 3.9 years from 3.8 years.

This increased yield reinforces the point I have made in previous commentaries around falling markets being a positive for future returns. But you need to stay invested to harness those returns.

Finally, the gold weight (0% yield) was top-sliced again, and the cash weighting rose slightly from 4.7% to 5.1%.

YIELD

Diversified Income's yield (based on end of month prices) remained at its record level of 5.7%, with the high yielding purchases being offset by the strongly rising NAV over the month. 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 generating attractive risk-adjusted returns for clients. We will continue to tilt the portfolio away from areas and ideas that are more expensive (offering lower forward-looking returns) and continue to use our Quant Model to focus research efforts on those areas and ideas with better value. Volatile markets will increase the likelihood of finding more investments at valuations we consider good such risk/reward. When such periods come, we should neither be surprised or overly concerned: they are part and parcel of investing in public markets and investors may often see good returns in the long run.