Close Brothers Asset Management

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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 -6.5% in September compared to -4.9% for the Investment Association 20-60% Equity sector. On a year-to-date basis, the Close Diversified Income Fund is down -8.8% versus -12.1% for the same sector.

PORTFOLIO ACTIVITY

Asset prices were again weak, but the UK had a very specific additional issue to deal with. The new Chancellor, Kwasi Kwarteng, announced his first 'mini-budget' and unveiled a raft of unfunded tax cuts despite the government already facing a huge unknown liability this winter (guaranteeing a £2,500 price cap on domestic energy bills). The strategy was widely criticised with Joe Biden, the International Monetary Fund and Mark Carney (former Bank of England Governor) all putting in their two-penneth worth. This reduced investors' confidence in the UK, leading to a depreciating currency and a higher gilt yield (investors demanding a higher rate of return to lend to the UK government). The rise in gilt yields was so rapid that it led to pension fund managers having to sell gilts to raise cash, so they could post collateral on their derivative positions. This selling in turn led to further gilt price falls (yields rising). The Bank of England (BoE) had to step in to the market and offered to buy unlimited gilts to restore order.

Ratings agency S&P revised the UK's gilt rating outlook to 'negative'. This perceived government policy error meant that UK mid-caps, small caps, investment trusts, sovereign bonds and corporate bonds all underperformed in the month. As I write this on the 3 October, it is noteworthy that the government has started somewhat of a U-turn, with the 45% higher tax rate now to be kept in place. The market will be awaiting Kwasi's medium-term fiscal plan with interest.

In the month the 10 year gilt yield jumped from 2.8% to 4.1% (having hit 4.5% on the 27 September). BBB spreads rose to 2.89% from 2.43% (well above the 2.1% long-term average) and are now at the levels seen at the height of the Covid and tech-bubble recessions.

Why are gilt yields important? Gilt yields represent the risk-free rate. In theory any investment with additional risk should offer you a higher return than you are able to make on gilts. When gilt yields are 0% then a riskier asset may appear attractive on a 3% return for instance. But what happens when the risk-free asset now gives you 4%? For relative riskier assets to look attractive once more, price falls are required. Not all assets will fall by the same amount – there are lots of factors at play, such as how risky the investment is perceived to be, the profile of cash flows, and the maturity date of the investment (i.e. equities give you the right to cash flows for ever, so these are long duration assets, as are bonds with maturity dates far out in to the future). This is one reason why you would expect loss-making tech stocks to underperform in this type of environment too (as their future cash flows are a long way off and very sensitive to changes in the required rate of returns). It's been a tough for returns in all sectors, with global equity income fairing the best (helped by weak sterling, especially against the UD dollar.

In September the S&P fell -5.3% (-1.4% in sterling terms, in brackets), European equities fell -5.7% (-4.1%) and the UK large-cap index (comprising lots of overseas earners) fell -5.4%; but the mid-cap index which is more UK-centric index slid -9.9%.

The Close Diversified Income Fund went into 2022 with this context in mind and as such was underweight equities (invested into a basket of generally shorter-duration alternatives instead) and underweight bonds (bonds were sold in 2021 to generate a cash weighting of c15%). The bonds held were of short duration too. Our strategy had worked well all year but September relinquished some outperformance as UK assets were heavily sold off - which was reminiscent of March 2020 in its speed and ferocity - and FX hedging reduced the gains from a weak sterling. Despite the alternatives (mostly investment trusts) getting heavily sold off, some will actually benefit from the reversal of the UK corporate tax rate rise that the Chancellor announced. For instance, Greencoat UK Wind will see a 3% boost to its September Net Asset Value, yet the UK sell-off meant its share price was down 8.6% in the month; GCP Infrastructure a 1.5% boost, but shares fell 9.6%; International Public Partnerships a 1.2% boost, but shares fell 7.6%; and HICL Infrastructure a 2.4% boost but shares fell 6.3%). All will benefit from this policy change. Their future expected returns rose in September due to the fall in share prices.

SO WHAT DID I DO IN THE MONTH?

With gilt yields rising and bond spreads rising to recession levels, the yields available in the fixed income market continue to look attractive and in a tumultuous month for markets we were particularly active.

- Added to Lancashire 2031 at a yield of 8.3%. This bond yielded 5.9% in Sep21
- Started a new position in Lloyds Perp (2027 call date) at a yield of 8.5%. This bond did not exist back in Sep21
- Added to British American Tobacco 2040 at a yield of 8.7%. This bond yielded 3.4% in Sep21
- Added to Barclays $ Perp (2029 call date) at yields as high as 9.2%. This bond did not exist back in Sep21
- Added to Pension Insurance Corp (2029 call date) at yields as high as 9.6%. These bonds yielded 3.9% in Sep21
- Added to Aviva (2031 call date) at yields as high as 10.25%. This bond did not exist back in Sep21
- Added to Phoenix Perp (2028 call date) at yields as high as 10.4%. These bonds yielded 6.4% in Sep21
- Added to Lloyds Perp (2029 call date) at yields as high as 10.7%. This bond yielded 3.5% back in Sep21
- Added to Nationwide Perp (2027 call date) at yields as high as 11%. These bonds yielded 3.4% in Sep21
- Added to Rothesay Life (2028 call date) at yields as high as 11.4%. These bonds yielded 4% in Sep21
- Added to Barclays £ Perp (2027 call date) at yields as high as 11.4%. This bond did not exist back in Sep21
- Added to Abrdn Perp (2026 call date) at yields as high as 11.7%. This bond did not exist back in Sep21
- Added to Just Group Perp (2031 call date) at yields as high as 13%. These bonds yielded 4.7% in Sep21
- Added to IPF 2025 at a yield of 21%. These bonds yielded 7.1% in September 2021

The weighting to fixed income rose to 48.4% from 45.4% (and was 32.9% back in February 2022). The passing of time and the mathematical effect of falling prices meant that the Fund's duration ticked down to 3.8 years from 3.9 years in September. The yield of the bond segment of the Fund stands at 9.7%. In this sell-off we have added to seventeen bonds at >8% yields (our anticipated long-term return on equities) and ten bonds at >10% yields.

It is worth remembering that when you buy a bond you are buying a set of cash flows. A 3-year bond (maturing in three years' time) with a coupon of 10% will pay you 10p in year 1, 10p in year 2 and 110p in year 3. Now if we buy this bond today for 100p we will make 10% per year, but remember bond prices can fall (and rise), so the return is not a straight line. You may make 0% in year 1 if the bond falls to 90p, and then 15% a year for the final 2 years. The important thing though to note is that over these 3 years, as long as the company is solvent, you will receive your 30% total return. With other asset classes such as equities and property there is less confidence around when/if you will make losses back.

Our significant sale in the month was Unilever (equity). Unilever is actually up this year (one of the few things to be) and hence its relative valuation against the UK stock market has hit historic highs. Its relative attraction against other asset classes has diminished, though. Whilst the company has defensive characteristics it still has debt that will need to be refinanced (at current interest rates this will be a 1% headwind to profit per annum), as well as an uncertain macro-environment to navigate. We are still yet to see many opportunities to invest in in the equity market. High valuations, a possible recession (bad for demand), high inflation (raising input costs, raising wages) and rising interest rates (increases finance costs and lowers the valuation they should trade at) all remain headwinds to equities and we remain underweight. The price/earnings ratio for some large-cap UK equity growth names still trade at historically very high valuations.

The cash weighting was static at 3.9%. With BHP Billiton announcing the call of their Perpetual bond, as expected, this will give the fund another 0.9% cash inflow in October. We bought this bond early this year as the sell-off started to take hold, at a 3.9% yield. It will be reinvested at much higher yields now.

YIELD

Diversified Income's yield (based on end of month prices) rose to a new record of 7.3% (up from 6.0% last month).

At this level, the Fund is generating c0.6% of income a month, which will help to offset any future volatility, and can be continually invested into any further falls at ever-higher rates of return. This is on top of the 3.9% cash held and the proceeds from maturing bonds (such as BHP Billiton next month).

This higher yield can now be seen in the dividend being distributed by the Fund. The Fund accrued some £7.8m of income in Q3, helped by recent bond purchases. The fund went ex-dividend to the tune of 1.84p on the 3rd October. This **dividend is up 27% year-on-year**, helping the upward progression in the rolling 12-month dividend.

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 value. Volatile markets should increase the likelihood of finding more investments at valuations we consider to offer attractive risk / reward characteristics.