# Close Portfolio Funds

## Monthly fund manager update

SEPTEMBER 2022

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### STRATEGY OVERVIEW

The Close Portfolio Funds seek to achieve resilient returns over the long term through an equity-led approach to 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 September, with mixed performance against their Investment Association (IA) peer groups (in brackets): Conservative fell -4.7% (-4.9%), Balanced -5.7% (-5.2%) and Growth -6.8% (-4.4%). The currency overlay detracted significantly – see more below.

Since inception the Funds have increased by an annualised 3.9% (3.8%), 5.4% (5.6%), 6.4% (5.9%) with capture ratios of 100%, 98% and 101% across Conservative, Balanced and Growth respectively.

### MONTH IN REVIEW

Asset prices made fresh lows in September as the summer bear market rally unwound further. Bonds slumped, with the ICE Bank of America Sterling Broad Market index declining by -15.3%, whilst global equities declined -9.3% in US dollar terms. Although continued US dollar strength meant this converted into a -4.8% decline in sterling terms. Our strong bias towards cash and cash-like short-duration bonds within fixed income helped cushion against the rise in yields, and our underweight position in equities protected against broad market declines. The currency overlay suffered materially from the US dollar strength and, at the end of the month, sterling weakness. The top three contributors were O'Reilly Automotive, Prudential, and UnitedHealth Group; while the largest detractors were Avantor, Alphabet, and Partners Group (trimmed early in the month).

### AUGUST THOUGHTS - PART I: UNCONSTRAINED

Since March 2015 currency hedging has been applied to the Close Conservative, Balanced and Growth Portfolio Funds. The strategy was to hedge up to 50% of the exposure from all assets denominated in non-sterling currencies back into sterling.

Having undertaken a detailed review, we decided to modify the hedging strategies. With effect from 29 September 2022, we will now hedge 100% of non-sterling fixed income assets only for these funds. No other asset classes will be hedged. The benefits are twofold.

First, the prior hedging strategy was adding to overall portfolio volatility. The currency mix was structurally short the US dollar against long sterling. In 'risk off' market environments when equities are falling the dollar tends to strengthen; in 'risk on' periods the pound tends to do well relative to the US dollar. Put differently, in bear markets the hedge was exacerbating the losses from our equities, whilst in bull markets it was amplifying the gains. The new hedge construction has been designed to dampen volatility.

Secondarily, the prior hedging strategy was restricting our capacity to invest beyond the sterling fixed income space. Going forwards, we will be able to isolate the currency risk to a UK investor by entirely matching the overseas bond purchases, providing the ability to 'lock in' foreign yields without incurring an unhedged portion of currency risk.

### LOOKING AHEAD – PART II: PRESERVE CAPITAL, MAKE MONEY

Performance has been weak year-to-date despite being underweight equities into a bear market and maintaining a short duration position in fixed income, which avoided the most significant capital losses from rising yields on high duration bonds. How could this turn around?

- We will maintain our bear market stance of **selling equity rallies** until we gain confidence that the economy has bottomed. This is the opposite behaviour of the 'buy the dip' mentality which has rewarded investors in the years since the financial crisis. *Preserve capital*.

- The proceeds are now contributing to a substantial cash pile. Now unconstrained in fixed income, we may elect to shift portions of this into foreign currencies such as **buying dollars**. This year has been all about dollar strength in currency markets, up 20% this year against sterling, but the pound hasn't depreciated materially against the euro or yen whilst the UK political risk has increased. Elsewhere central bankers are more reluctant to raise interest rates than in America. The last time an inflation-busting central banker was in the Federal Reserve the dollar *doubled* in the early 1980s. *Preserve capital.*

- We are also starting to gently **add to corporate bonds**, where yields approaching double digits on investment grade short-term paper are making equities look expensive given the c.8% historical nominal return from stocks. *Make money*.

- We are also looking to get **long duration** within our fixed income exposure, but only once signs emerge that the Federal Reserve (Fed) has stopped raising interest rates. All year the rate increases at the short end of the curve have dragged up the long end, but our belief is that long-term Treasury bonds will appreciate once recession hits. *Make money*.

- Any pause from the Fed in the monetary tightening cycle will likely trigger a relief rally in equities. Into this we will **swap equities for gold**. Gold has been under pressure all year as the lack of yield is increasingly unattractive as rates rise. But, gold has zero earnings risk, unlike equities which will see profits undercut in a recession. *Preserve capital*.

- Eventually the economy will bottom and the risks in equities will have become sufficiently discounted, at which point we will **buy the equity market**. Our research project queue is bursting with competitively advantaged, economically cyclical businesses ready to buy as they profit warn. *Make money.*

- Meanwhile, we have the ongoing **application of our 'cheap durables' investment framework** in purchasing predictable and sustainable businesses at attractive cash-based valuations. The behavioural ingredients here are patience and conviction - exploiting opportunities when the market makes a mistake. Aggregating our purchases of new holdings this year we have been right twice as often as we have been wrong ('hit rate') and when we are right we make twice as much money as we lose when we are wrong ('skew'). Volatility plays to our advantage here, as we turned over the portfolio at a 50% annualised rate in the first half of the year, but the process cannot be forced and we have found little to do in the third quarter. *Make money.*

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