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 flat in October. This compared to 0.6% for the Investment Association (IA) 20-60% Shares Sector. The Fund is now down -8.8% year-to-date, which compares favourably to the IA 20-60% peer group at -11.6% over the period.

October proved to be another turbulent month, especially in the UK, where the gilt sell-off continued and both the new Chancellor and Prime Minister were forced to exit their roles after little more than a month in position. The new Sunak/Hunt partnership has led to a recovery in the bond markets, and a small bounce for sterling too, as the government dismantled the previous policies of unfunded tax cuts.

Within the bond markets, the 10 year gilt yield briefly rose from 4.1% to 4.5% before ending the month at 3.5%. BBB credit spreads rose from 2.89% to 3.05%, before dropping back to 2.74% at month end (still well above the 2.1% long-term average).

Global equities were particularly strong with the US S&P 500 index advancing +8% (+5.4% in GBP terms), European equities were up 6.9% (+5.1% in GBP terms), while the UK large cap index was up +2.9%.

The sell-off in the alternatives space continued. They will no longer get a Net Asset Value (NAV) boost from the reversal of the UK corporate tax rise (as the new Chancellor Hunt has reversed the reversal). The rise in gilt yields has seen some of the securities we hold in the alternatives space (which tend to use a discounted cashflow methodology to calculate their NAVs) use a higher discount rate. This has the impact of dampening today's NAV and share price in return for potential higher future returns. Greencoat UK Wind reported a NAV of 155p, up from 153.6p, despite raising their discount rate by another 0.5% (to 10.2%), as other factors such as the current high inflation rate more than offset it.

We wait to see if the Chancellor announces anything firm on the UK electricity generators price cap / long term Contracts for Difference, or a windfall tax in the upcoming November budget statement, as the uncertainty is impacting the renewable sector's share prices. Starwood European Real Estate Finance (SWEF), which makes largely floating rate loans, has seen its expected return rise naturally with rising rates, with its average return up to 7.4% at the end of Q3 2022, up from Q2's 7.1%. The Board is proposing a wind up of SWEF, following in the footsteps of ICG Longbow, which, if it were voted through, would leave the Fund with just one real estate debt fund, Real Estate Credit Investments. It was encouraging to see GCP Asset Backed Income start a share buyback programme in response to the large discount to NAV the shares are currently trading at.

In the REIT space, we are seeing some valuation falls, with AEW UK posting a Q3 total return of -2.1%, and Ediston Property reporting a -2.3% total return. It remains to be seen how long valuations will keep falling for (and whether gilt yields keep falling back from here). AEW is sitting on a £38m cash pile, and Ediston on £82m, after some timely sales. They should now be able to reinvest the proceeds at notably higher rates of return, or use it to reduce borrowings. Given the huge sell off in the UK investment trust sector post former Chancellor Kwarteng's budget speech, virtually all the Fund's holdings are now trading at discounts to NAV – if one were to add up the potential performance tied up in in these discounts, it amounts to 5.8% of Diversified Income's NAV. This is very reminiscent of March 2020 during the height of the pandemic induced market sell-off. Some of this performance will not come back as the REITs are going to see some NAV cuts, but there should be plenty of performance to come back if sentiment towards the UK investment trust market improves, or in the case of SWEF and ICG Longbow as the funds are shut down and the cash returned to shareholders. These two trusts alone have 0.6% of potential return locked up in their discounts to NAV.

PORTFOLIO ACTIVITY

The yields available in the fixed income market continued to look very attractive, so we further added to the asset class. During the month we:

- Added to Just Group Perp (2031 call date) at yields as high as 13.75%. These bonds yielded 4.7% in September 2021.

- Added to Aviva (2031 call date) at yields as high as 10.25%. This bond did not exist back in September 2021.
- Added a new name in Legal & General (2031 call date bond), at yields as high as 10.3%. This bond yielded 4.1% in September 2021.
- Added to Phoenix Perp (2028 call date) at yields as high as 12.9%. These bonds yielded 6.4% in September 2021. It was also reassuring to see three Phoenix directors active in the equity market, buying a total of £275,000 worth of shares in the month.
- Added a new Rothesay Life bond (2031 call date) at yields as high as 11.6%. These bonds yielded 5% in September 2021. Insurance company solvency ratios benefit from rising gilt yields and falling life expectancy (both being observed currently).
- Added a new name in the Bupa 2035 bond, at yields as high as 8.68%.
- Added to IPF 2025, after their Q3 trading update, at a yield of 19%. These bonds yielded 7.1% in September 2021.
- Added to Lloyds Perp (2029 call date) at yields as high as 11.1%. This bond yielded 3.5% back in September 2021.
- Added to Nationwide Perp (2027 call date) at yields as high as 11.7%. These bonds yielded 3.4% in September 2021. Nationwide is a big position in the Fund, so it was very pleasing to see these bonds upgraded to investment grade by Moody's during the month.

The BHP Billiton Perp (callable 2022) successfully matured in the month, but despite this the fund's overall weighting to fixed income still rose, from 48.4% to 49.9% (it was as low as 32.9% back in February of this year). Duration ticked back up to 3.9 years given the generally longer duration nature of the bonds we are buying currently. The yield of the bond segment of the Fund now stands at 9.7%. In this sell-off we have added to a total of 20 bonds at yields in excess of 8% (which is equivalent to the long-term return on equities), with 14 of those additions at yields of more than 10%.

One interesting point to note is that, despite the high current inflation rate and the huge pick up in yields seen over the past year or so, the expected inflation rate over the next 10 years has barely moved in the past year; remaining at around 3.7%.

If inflation comes down as the market expects, then these high yields we have been able to secure on recent bond acquisitions are going to provide attractive real returns - as well as a lot higher nominal returns than historically seen.

Hiscox (we own their bonds) issued a trading statement, which nicely encapsulates what we have been saying about bonds. They have a USD7.2bn investment portfolio, predominantly in bonds. It is showing a mark to market loss of USD293m this year, which will "unwind as the bonds mature". The yield they are reinvesting at has risen from 1% in December 2021 to 4.8% as of September this year, meaning "much improved prospects for investment returns for 2023 and beyond."

We also think that with many bonds trading now at 60-80p in the pound, we could start to see opportunistic tenders from companies who want to reduce debt cheaply.

The Fund's cash weighting fell to 3.25%.

YIELD

Diversified Income's yield (based on end of month prices) remained at a record high of 7.3%. At this level, the Fund is generating c.0.6% of income a month, which will help to offset some of the prevailing volatility, and can be continually invested into any further falls at attractive rates of return.

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 (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 further investments at valuations we consider good risk / reward. As we have become more constructive on valuations, we are getting closer to a position of being fully invested. As a result, it is likely that the Fund will be slightly more volatile than when it was cautiously sitting on c.15% in cash. We are happy to accept slightly higher volatility overall in return for the opportunity to lock in double-digit returns on some recent acquisitions, as we consider these a good risk / reward trade off.