Close Portfolio Funds

Monthly fund manager update

OCTOBER 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 positive returns in October and outperformed against their respective Investment Association (IA) peer groups (in brackets): Conservative gained 1.5% (vs 0.6%), Balanced rose 1.8% (vs 0.6%), and Growth added 2.1% (vs 0.1%).

MONTH IN REVIEW

Sterling bonds rose in October, with the ICE Bank of America Sterling Broad Market index up 3.7%, as a U-turn on prior economic policies by the new Conservative leadership saw the UK political situation stabilise. Global equity markets rallied by +5.3% on hopes that the Federal Reserve would slow the pace of interest rate increases, although this was muted to a +1.0% gain for sterling investors due to the +4.3% appreciation in sterling on the improved domestic backdrop.

Our bias towards cash and cash-like short-duration bonds within fixed income limited our ability to participate in the bond market rally, but strong stock selection within equities more than made up for this. The top three contributors were Canadian Natural Resources, O'Reilly Automotive and Cenovus Energy. The most significant detractors were AIA (discussed further below), Alphabet, and Brown & Brown (which we added to in the month).

OCTOBER THOUGHTS – EOSL

In the aftermath of the 9/11 terrorist attacks American foreign policy was preoccupied with the "War on Terror" leading to costly military interventions across Africa, the Middle East, and Afghanistan. Meanwhile, China acceded to the World Trade Organisation and militarised the South China Sea. Reunification with Taiwan remains a longstanding policy objective of the Chinese Communist Party in order to complete the founding of the People's Republic.

In October America's Commerce Department imposed export controls aimed at curtailing China production of advanced semiconductors. This builds on earlier measures; for example, the blacklisting of Chinese telecommunications manufacturer Huawei in May 2019 (which broadened to other companies in May 2020), and former President Trump's earlier 'Trade Wars' – although this is a bi-partisan issue.

The new rules go beyond straightforward sanctions of goods, and will impact dozens of firms across the semiconductor industry globally. They extend to the involvement of US citizens and green card holders - even when they are involved in non-US items not subject to the specific restrictions - irrespective of whether they work for European, Japanese or Korean firms. Our immediate portfolio exposure is low: semiconductor capital equipment manufacturers Applied Materials and Tokyo Electron combined account for 3% of the overall equity allocation. Furthermore, the management teams of these companies later confirmed our initial analysis, noting that a single digit proportion of revenues are affected. These sales are not lost, as they should be redirected to clients in other countries over time once demand rebounds exiting the coming recession.

The upshot is that China's ability to develop indigenous capabilities to support advanced computing, meaning artificial intelligence (AI) and supercomputing, has been curbed. They are stuck with the iPhone 14 – forever – and there will be a response.

Separately, in October the 20th National Congress of the Chinese Communist Party was held in which the General Secretary, Xi Jinping, installed a Politburo of loyalists. Our holdings with the biggest domestic footprints are Asian life insurers, AIA and Prudential - which Together account for 5% of the Funds' overall equity allocation – traded off in sympathy on the step-up in political risk. However, these businesses are perceived as local operators and have been able to dividend cash out of the country to western shareholders, unlike other companies such as Alibaba which have never paid a dividend and where the ownership claim of foreigners to the assets is less clear. If there is any signal in this noise, it is that a raft of western companies with substantial supply chains in China are at substantially greater risk than AIA or Prudential. We do not, for example, own any Apple, which would be substantially disrupted by an escalation in Sino-US hostilities.

LOOKING AHEAD

The near-term strategy outlined in our last commentary 'Preserve Capital, Make Money' remains unchanged. We will continue to buy US dollars on weakness, add selectively to short-term corporate bonds, and sell equity rallies until we have conviction that the Federal Reserve has stopped raising interest rates, at which time we will buy long-term bonds with cash and swap equities for gold ahead of the incoming recession. Eventually the economy will bottom and the risks in equities will have become sufficiently discounted, at which point we will buy the stock market and corporate bonds wholesale.

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.