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Close Diversified Income Portfolio Fund

Monthly fund manager update

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PERFORMANCE

The Close Diversified Income Fund was up +2.7% in November. As mentioned in last month's commentary, now that the Fund is close to being fully invested (we have decreased the cash weighting considerably) a greater level of volatility in the portfolio should be expected. Volatility works both ways (up and down). This was the 8th best monthly return in my near 12 years of running the Fund. November's return compared to +3.4% for the Investment Association (IA) 20-60% Shares Sector peer group, and brings the year-to-date return to -6.4%, versus the IA 20-60% at -8.6%.

The new UK government double act of Rishi Sunak and Jeremy Hunt continued to calm markets, as previously announced tax cuts were reversed and tax hikes were put in their place. This helped the gilt market reverse some of its previous losses. The 10 year gilt yield fell from 3.5% to 3.16%. Within corporate bonds, BBB spreads also continued to rally, falling to 2.45% from 2.74% (still above the 2.1% long-term average). Some of the bonds we have bought within the Fund in recent months have bounced hard, such as the Bupa 2035 bond which was bought at 65.4 and now trades at 81.5.

Global equities also continued to recover with the S&P 500 advancing +5.4% (but only +0.5% in sterling terms), European equities up +9.6% (+7.2% in sterling terms) and the UK large cap index +6.7%. The Fund also benefitted from strong dividend growth from two of its equity holdings (Visa's +20% and Diploma's +26%).

Alternatives proved to be the laggard again in November, though it was good to see the renewables sector finally get some clarity from the government on energy policy with regards to windfall taxes. The Electricity Generator Levy will take effect for the period 1 January 2023 until 31 March 2028 at a rate of 45% of Exceptional Generation Receipts, which are calculated as revenue from power sales above a benchmark price of £75/MWh. A £10 million per year allowance will apply, such that Exceptional Generation Receipts below this threshold will be exempt from the levy. This was taken well by investors, with Greencoat UK Wind rising +3.2% over the month. The electricity price has recently spiked again with the colder winter weather, and is currently back over £300 MW/hour (it was c. £35-60 MW/hour pre-Covid).

Three of the Fund's REIT holdings reported in November: Residential Secure Income, our largest REIT position, reported a +3.1% total return for the full year, with their Net Asset Value (NAV) holding up thanks to the inflation linkage on the rents; Warehouse REIT reported a first half of the year total return of -6.2%; and Urban Logistics reported a total return of -0.7%. Further property price falls are likely, but the REITS are trading at discounts of up to 49% to NAV, so the market is clearly pessimistic already. AEW UK REIT decided the time was right to re-enter the market and spent £18m of their spare cash on two properties. Gold rose +7.3% (+2.4% in sterling terms) whilst the property debt funds continued to fall (despite the rally in fixed income markets). The Fund now has c.6% of performance tied up in investment trusts trading at discounts to NAV.

With regards to the wider macroeconomic backdrop, long-time readers of this monthly may recall this from March 2019:

"*Campbell Harvey, a professor of finance at Duke University's Fuqua School of Business, discovered the relation between the yield curve and future economic growth in 1986. Importantly, there is only a prediction of recession when the T-bill yield is greater than the five-year yield for a full quarter. The model has gone on to predict all three recessions since: in 1991, 2000-2001, and the global financial crisis. Importantly, there are no false signals to date.*"

The 2019 inversion was also followed by recession in 2020 and we find ourselves back in the same position today, with the chart inverting once again in November 2022. We will follow it with interest to see if it stays this way for a full three months. But it does suggest that the US Federal Reserve is in danger of raising interest rates too far, too fast and that a recession could be on the way.

Elsewhere, following on from last month's commentary on inflation, it was interesting to see the Eurozone join the US in starting to report lower inflation numbers. Economists are forecasting that the UK will not be far behind.

PORTFOLIO ACTIVITY

We only undertook a few trades at the start of the month, before the recent stock market rally really started kicking in. We tend to prefer to buy on the way down.

We added a new holding in the HSBC 8.201% 2034 bond (callable in 2029). This new issue came with a very attractive yield compared to existing HSBC bonds of equivalent risk (1% higher yield). The bonds rose 4.5% by the end of the month from the issue price.

We also added a new holding in the TP ICAP 2028 bond at yields as high as 8.8%. We already own some of the shorter dated bonds in the Fund.

And finally, we added a new holding in the Bupa Perpetual bond (callable 2031) at a yield of 10.4%. We already own the Bupa 2035 bond.

Over the course of the sell-off in fixed income markets this year, we have added to a total of 23 bonds at >8% yields (broadly the long-term return on equities historically), while 15 of those were brought at >10% yields.

As predicted last month, we have seen a pick-up in companies tendering for their own bonds. We had one such tender from Just Group to buy back their 2026 bonds, but we declined both their initial offer and their higher revised offer, believing the prevailing yield of 7.2% to be decent compensation for the risk.

The Fund's cash weighting fell further to 2.2%.

YIELD

Diversified Income's yield (based on end of month prices) fell from the record high last month to 6.9%. This was due to the NAV rising strongly in the month. If you make oversized returns in any month then mathematically your forward-looking return must come down.

At this level, the Fund is still generating c.0.6% of income a month.

OUTLOOK

Given the yield curve inversion noted above the probability of a recession in the US and in other areas is increasing. We think this is most dangerous for equities (given the increased chance of profit warnings, and current valuations). We remain underweight equities in the Fund and, after becoming fully invested due to further corporate bond purchases, we look forward to the next ex-dividend date (1st December) to see the year-on-year growth (more on that in next month's write up). In the meantime, volatile markets will increase the likelihood of finding more investments at valuations we consider good long-term risk / reward.