Close Brothers Asset Management

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Close Portfolio Funds

Monthly fund manager update

NOVEMBER 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 REVIEW

Global equity markets continued to rally in November, rising by +5.0% as the Federal Reserve signalled that the pace of interest rate increases would slow. (Although this was a muted +0.9% gain for GBP investors due to a +4.1% appreciation in sterling amidst the risk-on backdrop). Sterling bonds also rose in November, with the ICE Bank of America sterling Broad Market index up 3.1%.

Our bias towards cash, and cash-like short-duration bonds, within the fixed income allocation limited the Funds' ability to participate in the bond market rally - particularly as it was led by corporate bonds where we are positioned lightly. The top three contributors to fund performance over the month were AIA, 3i Group and Microsoft, while the most significant detractors were Olympus, Suncor Energy, and Relx (which we added to).

Each Fund delivered positive returns in November but underperformed against its respective Investment Association (IA) peer group (in brackets): Conservative gained 1.0% (vs 3.4%), Balanced rose 1.4% (vs 3.7%), and Growth added 1.8% (vs 3.5%).

NOVEMBER THOUGHTS – IMPOSSIBLE THINGS

Inflation is slowing in America and the Federal Reserve (Fed) is approaching the end of their interest rate increases, leaving the stock market at a crossroads. Either there will not be a recession, in which case the market lows are behind us and stocks will continue to rebound, or there will be a recession, in which case there is likely further downside ahead as equities and corporate bonds navigate a period of earnings cuts and defaults. Investors want to believe that inflation can abate without a recession. If this happened it would be an historical first, as once inflation has passed 5% it has never retreated without a recession, and moderate rises in unemployment have always turned into larger ones. We see the market as believing contradictory 'impossible things before breakfast' and maintain our view that a recession is incoming, with only the timing, magnitude and duration to be debated. Counter-arguments to our historically-informed and evidence-based approach are:

a) **The shape of the US Treasury yield curve has been distorted by almost two decades of Quantitative Easing and Quantitative Tightening from the central bank, rendering it ineffective as a recession forecasting tool.**

We reply: perhaps, but the yield curve is 8 for 8 in forecasting recessions since the Second World War with no false positives, and we remember others arguing why the yield curve was an ineffective predictor on the last two of those occasions.

b) **The artificial closing and reopening of the economy during the pandemic makes leading economic indicators unreliable guides to coincident economic cycle trends.**

We reply: perhaps, but these leading indicators signalled the rebound in 2020, cresting activity in 2021, and the growth slowdown in 2022, so it's unclear why they should suddenly be wrong about pointing to recession in 2023.

c) **The best historical analogue to emerging from the pandemic is the demobilisation recession of 1945, which stocks powered through.**

We reply: that may have been true in the second half of 2020, but today the current environment is more like the inflationary 1970s/80s, and except for the single post-war example of 1945, stocks never bottom before the onset of a recession, and typically only found their lows shortly towards the end.

d) The Fed will save us.

We reply: careful what you wish for. History is clear that if a recession is the outcome then interest rate cuts do not prevent further losses in the equity market, which only bottom with corporate profits. We remember 3rd January 2001 when the first Fed rate cut sent the Nasdaq up 14% on the day, after which the US market went on to decline by -41%. And 18th September 2007, when the S&P rallied 3% on the Fed cutting rates, before dropping -54% over the subsequent eighteen months, or when the market spiked 4% on the QE announcement of 25th November 2008 and there was a further -23% drawdown ahead.

LOOKING AHEAD

The forward strategy outlined in our September commentary 'Preserve Capital, Make Money' remains in action. We maintain our underweight position in equities into this bear market rally and have further trimmed our remaining cyclical stocks in favour of more economically resilient companies. With rising conviction that yields have peaked we have begun to swap equities for gold – which doesn't have earnings risk – and started to invest our cash in long-term Treasury bonds, which will benefit from interest rate cuts in a recession, as a way to protect portfolios.

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.

IMPORTANT INFORMATION

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