Close Diversified Income Portfolio Fund

Monthly fund manager update

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PERFORMANCE

The Close Diversified Income Fund returned +0.3% in December. This compared favourably to the -0.9% decline for the Investment Association (IA) 20-60% Shares sector. Diversified Income finished 2022 down -6.1%, which again compares favourably to the -9.5% return for the IA peer group.

Equities struggled in December with the S&P 500 falling -5.9% (-6.1% in GBP terms), Europe declined -4.3% (-1.6% in GBP terms), while the UK market was down -1.6%. The 10 year gilt yield rose sharply from 3.16% to 3.67% over the month, leading to price falls in sovereign bonds. Despite the risk off sentiment in equities, corporate bond spreads continued to rally, with investment grade BBB spreads falling to 2.36% from 2.45% over the month (still above the 2.1% long-term average). Overall, credit spreads have bounced quite strongly after reaching the 3% level breached in previous recessions.

The calendar year 2022 will be remembered as a particularly difficult one for investors - only the 3rd time since 1929 that both bonds and equities have posted negative returns. Reducing risk in 2021 and going into 2022 with plenty of cash did help protect capital to some degree, and relative performance was ultimately strong on the back of that prior positioning.

It is worth reiterating again that after investing most of the cash weighting into bonds as yields become much more attractive during the year, investors in the fund will be faced with two important implications. Firstly, being fully invested means one should expect more volatility as we are no longer sat on a double digit percentage cash position. Secondly, we enter 2023 with a yield of 6.9% (this is c.0.6% of return being generated per month from income). This compares to the 3.9% yield we entered 2022 with (c.0.3% of yield a month), and means investors should have more protection against falling asset prices as the fund is generating a greater cash flow on an ongoing basis.

Indeed, as I write this commentary, the Fund has just gone ex-dividend 1.53p (X Income units). This is an 18.6% rise year-on-year, and follows the inflation-beating 17.3% rise in the October declared dividend too.

With regards to individual fund holdings in December, it was pleasing to see Barclays - whose bonds we were buying at yields as high as 11.4% - was put under review for a credit rating upgrade by Moodys. Trafigura posted yet another set of record results – their bonds are a top 10 holding in the Fund. In the renewables sector the Chancellor, Jeremy Hunt, reported that the GBP75/MWh threshold for the new Electricity Generator Levy would escalate with the Consumer Price Index, which is a small positive.

PORTFOLIO ACTIVITY

It was a very quiet month for dealing, with just the TP ICAP 2028 bond added to at a yield of 8.1%.

Over the course of the 2022 sell-off we added to 23 bonds at >8% yields (equivalent to the long-term annualised return on equities) and 15 of those were at >10% yields.

The cash weighting rose to 2.6% in the month, from 2.2%.

YIELD

Diversified Income's yield (based on end of month prices) remained at 6.9%.

OUTLOOK

The US yield curve remains inverted (see last month's commentary for more detail on that), which suggests a US recession is increasingly likely. We think this is most dangerous for equities (given the increased chance of profit warnings, and current valuations) and remain underweight equities as a result. Volatile markets increase the likelihood of finding more investments at valuations we consider good risk / reward.