Close Brothers Asset Management

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Close Portfolio Funds

Monthly fund manager update

DECEMBER 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

The strong autumn market rally unwound partially in December as the recessionary implications of the US Federal Reserve taking interest rates from zero to close to five percent within the space of a year set in. Equities fell -2.1% in Sterling terms whilst Sterling bonds declined by -3.6%. Each Fund delivered negative returns in December but Conservative and Balanced fell less than their respective IA peer groups, whilst Growth underperformed IA Flexible (note that this peer group fell less than the IA Mixed Investment 40-85). Performance against the respective Investment Association (IA) peer group (in brackets) was as follows: Conservative fell -0.7% (vs -0.9%), Balanced fell -1% (vs -1.4%), and Growth declined -1.2% (vs -1.1%).

On this short-term view, selling equities into the fifth bear market rally of the year was justified, as was the decision to swap the proceeds into gold (up 2.8% in the month). Being underweight equities helped too. We took advantage of the bond market sell-off to lengthen duration in US Treasuries, where our increasing but still short-duration position within fixed income was beneficial. From a stock selection point of view, the top three contributors to fund performance over the month were AIA, Ferguson and Prudential, while the most significant detractors were Alphabet, Costco, and Microsoft (which we trimmed in December).

DECEMBER THOUGHTS – CLOSING THE BOOKS

The calendar year 2022 was a difficult one for investors with stocks and bonds – the main building blocks of a multi-asset portfolio – both down. Global equities fell by -18% whilst UK Gilts slumped by -25%. The one solace was in currencies, as a devaluation of sterling over the year cushioned the -18% US dollar stock decline into a -9% fall in sterling terms from the perspective of a UK investor.
An historical perspective helps to put the unusual shape of these returns in context. Barclays investment bank produce an annual "Equity Gilt Study" which has historical stock and bond returns since 1900 – 121 years of data throughout a variety of economic environments and geopolitical backdrops.

The decline experienced by equities in 2022 isn't remarkable. Looking at the past 121 years since the record begins (and excluding 2022), equities have experienced negative total returns in 33 (27%) of them. We expect this asset class to be volatile whilst producing good returns over the long run. However the behaviour of bonds in this backdrop is uncommon. Bonds unusually performed worse than equities in 2022, when more normally they diversify the equity drawdown. Of these equity down years, returns from bonds have been worse than stocks on only six occasions in the last 121 years (5%). There have been 29 instances when a hypothetical 60/40 equity/bond portfolio has experienced negative returns (24% of all years excluding 2022) but only 7 with double-digit losses - 2022 will of course be the eighth. Putting the financial crisis of 2008 to one side, this year has been the worst investor experience since the 1970s.

Even accepting that it is a rare year when equities are down but performing better than bonds, why has the absolute drawdown in bonds been so large? Recall that the total return from any asset is composed of capital gain/loss plus income. This year the capital loss from bonds has been substantial.   In 2022 bond price returns were the second-lowest on record, down -26.1%, better only than 1974's -27.5% return since 1900. Further, what has been missing this year is the typical cushioning from fixed income yields. When factoring these in, 2022 has been the worst year on record on a total return basis given yields were +11.9% in 1974 (taking the -27.5% price return to -15.6% total return). We've not had that cushioning in 2022, with only a +1% starting yield insufficient to materially offset the -26.1% price drop. What can we expect going forwards? The good news is that bonds now have a yield of around 4%. So, whilst it's possible that interest rates may continue to rise, the total return arithmetic from bonds will be supported going forwards. Put simply, valuations are now more attractive.

What about stocks? Some commentators are pointing towards the propensity of equites to bounce back after a big down year. We'll be blunt: this only looks at historical samples when the economy was rebounding out of a recession. Was there a recession last year that ended? No, that still lies ahead in our opinion.

LOOKING AHEAD

The forward strategy outlined in our September commentary 'Preserve Capital, Make Money' remains in action. We maintain our underweight position in equities and have further trimmed our remaining cyclical stocks in favour of more economically resilient companies. With rising conviction that yields have peaked, we have swapped some equities for gold – which doesn't have earnings risk – and invested our cash in long-term Treasury bonds, which will benefit from interest rate cuts in a recession, as a way to protect portfolios. We are looking for final confirmation that the US is entering recession before moving outright long duration within our fixed income allocation. As the next selloff unfolds we will likely begin to buy corporate bonds and add selectively to cyclical equities not currently held in the portfolio on profit warnings.

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.