Close Brothers
Asset Management

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Close Diversified Income Portfolio Fund

Monthly fund manager update

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PERFORMANCE

The Close Diversified Income Fund returned -0.6% in February. This compared favourably to a -0.8% contraction for the Investment Association (IA) Mixed Investment 20-60% Shares sector.

Equities were more mixed in February than in January, with the S&P 500 dropping -2.6% (-0.1% in sterling terms), European equities adding +1.8% (+1.3% in sterling terms) and the UK market advancing +1.4%. The 10-year gilt yield rose from 3.33% to 3.83% over the month, leading to heavy losses for sovereign bonds (the IA UK Gilts sector was down -3.5% in February). Corporate bond spreads were little changed, with BBB spreads rising to 2.06% from 2.03% (broadly in line with the 2.1% long-term average). Sub-investment grade BB spreads continued to rally, falling to 4.09% from 4.59% (now also below their 4.25% long-term average). We remain short duration within our fixed income exposure (3.9 years) and believe the higher yields will help, though may not fully, offset potential future bouts of volatility.

The latest corporate results season is in full swing with a number of our holdings reporting. Bunzl increased their dividend 10%, as did Roche (+2.2%), CVS Group (+9%) and British American Tobacco (+6%). The commodity related equity holdings have much more cyclical/volatile earnings and so their dividends will follow a less linear path. Here we saw BHP Billiton cut their dividend 40%, while Barrick Gold and Woodside Energy Group increased theirs 76% and 81% respectively.

The alternatives had a weak month with most of the private finance initiative (PFI), renewables and digital infrastructure holdings down, as were the fund's REIT holdings. Gold also gave back most of January's gains (-5.1% or -2.6% in sterling terms). Only the property debt funds put in a positive performance.

PORTFOLIO ACTIVITY

In the month we continued to buy high yielding investment grade bonds. After all the bond additions of 2022 the Fund is generating a lot of income (£3.90m in the first two months of 2023 vs £2.98m in the same period in 2022) and the re-investment of this income into further high yielding opportunities should help drive higher dividends from the Fund in the future.

- We added to the Just Group (2031 call) bond at a 9.4% yield
- We added to the Legal & General (2031 call) bond at a 7.4% yield
- We added to a Real Estate Credit Investments position at an 8.5% yield
- We added a new issue in the form of a Barclays (2028 call) bond at a 9.25% yield
- We reduced the Travis Perkins 2023 bond at yields as low as 4.8%

Outside of bonds, we added materially to 3i Infrastructure in their discounted placing at 330p. We calculate this issue of shares to be at a slight discount to their live Net Asset Value (NAV), which our Quant Model equates to buying the shares on a 10% per annum expected return. This compares to the expected annual return of 8% when we first bought the shares at 275p back in 2019 (back then the shares traded at a large premium to NAV, and as we know the higher the valuation we pay for any asset the lower we should expect future returns to be). We were happy to buy these on an expected 8% return, and we are even happier today to be able to buy them on an expected 10% return.

The cash weighting fell in the month from 2% to 0.8%.

YIELD

Diversified Income's yield (based on end of month prices) rose to 6.8% from 6.6% due to the decrease in the NAV and as a result of our investing cash.

OUTLOOK

The US yield curve has now been inverted for over 3 months, an indicator that, to date, has always signalled a recession to come. (See last November's commentary for more detail on that). We think that an economic slowdown would be most dangerous for equities (given the increased chance of profit warnings and current high valuations). We therefore remain underweight equities. Volatile markets increase the likelihood of finding more investments at valuations we consider good risk/reward and which will aid forward looking returns.

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