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Close Diversified Income Portfolio Fund

Monthly fund manager update

MARCH 2023

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PERFORMANCE

The Close Diversified Income Fund returned -3.2% in March. This compared to a -0.6% contraction for the Investment Association (IA) Mixed Investment 20-60% Shares Sector.

Despite the notable US bank failures experienced in March, the S&P 500 equity index rose +3.5% (+0.9% in sterling terms) and the tech-heavy NASDAQ added +6.7% (+4.1% in sterling terms). Banking issues then spread to Europe, with UBS ultimately acquiring Credit Suisse after troubles compounded at the latter and it warned of "*material weaknesses in financial reporting controls*". But again European equities shook off the news, rising +1.8% (+1.8% in sterling terms). However, despite the UK avoiding the banking malaise last month (Barclays even had a credit rating upgrade from Moody's), its equity index fell -3.1%. The UK's array of financial companies (banks, fund managers, life insurers and Lloyds of London insurers) all underperformed, along with their respective corporate bonds.

The 10-year gilt yield fell in the risk-off environment from 3.83% to 3.49% in the month, leading to gains for sovereign bonds (the IA UK Gilts Sector advanced +3.1% in March). Corporate bond spreads rose from 2.03% to 2.23% (above the 2.1% long-term average). Sub-investment grade BB spreads rose from 4.09% to 4.56% (above the 4.25% long-term average). Whilst BBB and BB corporate bonds underperformed gilts, financials further underperformed given the news around the banking sector. To give an idea of this underperformance, the spreads on subordinated bank bonds (AT1s) rose from 3.95% to 5.16% in the month, back up to the levels seen in the autumn during the panic caused by the UK political / interest rate environment.

It is worth remembering that since 2013 we have seen these kinds of spreads on a number of occasions, so this is nothing unusual in the ebb and flow of investor sentiment. As we have talked about before, sell-offs tend to lead to buying opportunities; and future annualised returns differ dramatically depending on when you buy - logically one tends to make higher returns when spreads are higher.

We added Lloyds and Barclays bonds to the portfolio last year in the sell-off, and added to our Nationwide exposure at the same time. Almost all of these trades were executed at spreads of over 5%, which - given the much higher gilt yields nowadays - equated to buying at yields as high as 11.7%.

At 3.9 years we remain short duration and the high yield will help offset any future bouts of volatility.

The Fund's alternatives allocation had a weak month in March, with most of the Private Finance Initiative (PFI), renewables and digital infrastructure holdings, property debt funds and REITs down. Gold was the sole riser (+7.9% or +5.3% in sterling terms).

So with no gilts, little tech exposure, little US equity, and an overweight to UK assets (UK-listed alternatives and corporate bonds in particular) it meant the Fund underperformed the IA 20-60% Shares peer group in March.

Results season is in full swing with a number of holdings reporting. German chemical distribution company, Brenntag, increased their dividend 38%, while Phoenix Group and Schroders increased theirs by +5% and +0.5% respectively – all of which will further help income generation for the Fund. Starwood European Real Estate Finance announced an unexpected special dividend of 2p alongside their results, with the high dividend cover in the year (due to rising interest rates on their loan book) allowing for this. International Public Partnerships extended their dividend guidance to 2024 from 2023 – indicating an expected increase of 2.5% in 2024.

It was interesting to see a pick up in the number of new buybacks / insider deals, indicating they believe the sell-off in their stocks has been overdone:

- Brenntag announced a EUR 750m buyback
- Cordiant Digital Infrastructure started a buyback and Steven Marshall, the lead fund manager, bought GBP 250,000 more stock
- Digital 9 Infrastructure saw three directors purchase GBP 75,000 of stock
- GCP Infrastructure started a buyback as the, "*current share price does not reflect the ongoing positive performance.*"

- Atrato Onsite Energy saw purchases totalling GBP 375,000 from four fund managers / board members
- Ediston REIT announced a strategic review to "*maximise shareholder value*."
- Greencoat UK Wind saw a director and fund manager buy GBP 220,000 of shares between them
- HICL Infrastructure saw four of the fund managers buy GBP 154,000 of shares between them
- Residential Secure Income saw a director and fund manager buy GBP 230,000 of shares between them

As I write this monthly update it is also worth noting some good news since the Fund's end of March Net Asset Value (NAV) was struck.

1. Specialist legal finance company, Burford Capital, has announced a win in its two largest cases (Petersen and Eton Park) against the Argentinian government. The lawyers now have 14 days to decide how to proceed. The judge did not give a figure on the compensation Argentina owes (given that further proceedings will be required to decide on the exact dates and rate of interest applicable), but the outcomes look to be in the range of USD 3.3bn to USD 6.2bn to Burford (before any discount is applied for an early agreed settlement). Every day the case drags on interest is being accrued, so Burford are being paid for their patience. This case has been dragging on for 8 years now and this news lifted its share price by +63%.
2. TP Icap 2024 bonds have been tendered for at 100p (the price in end-of-month NAV was 98.15p). This will mean we can sell these bonds back to the company at a price above the current market value, which equates to a yield of 5.25%. Their other bonds (2026 and 2028), which we also own, currently yield >7%. The group is looking to issue a new 2030 bond in the coming days.
3. Blackstone has made a cash bid for Industrials REIT at a 42% premium to the month end closing share price, and a 4% premium to the September 2022 NAV. Whilst we do not own Industrials REIT – we own other industrial focused REITs trading at large discounts to NAV, and these have all received a share price fillip on the news. We have had bids from private equity for two of our REIT holdings in the past (GCP Student Living and Hibernia REIT).

These 3 positives saw the Diversified Income Fund's NAV rise 0.8% on the first trading day of April.

PORTFOLIO ACTIVITY

The only portfolio change of note during the month was the successful maturity of the Trafigura 2023 bond. Continuing the theme of volatility, this bond certainly experienced periods of high volatility (especially in the Covid-19 sell-off which led to all asset classes falling). The bond price fell as low as 79c, but sure enough it was dragged back towards the final maturity figure of 100c, which all bonds will do as long as the issuing company remains in business.

The cash weighting rose in the month from 0.8% to 2.2%.

YIELD

The Close Diversified Income Fund's yield (based on end-of-month prices) rose back to the record high of 7.3%, from 6.8%, due to the decrease in the NAV. The Fund went ex-dividend on 3rd April to the tune of 1.776p. This is a rise of 22.3% year-on-year and drives the rolling 12-month dividend to a new record high. This is largely the result of investing the previously high cash balance into what we considered good value opportunities in the 2022 sell-off.

As I have said before, low valuations are a positive for long-term investors. In the first three months of the year the Fund has accrued GBP 7.57m worth of income and this needs re-investing. So the better the yields and valuations we can reinvest at, the better for long-term wealth creation.

OUTLOOK

The jury is out on whether the current interest rate hiking cycle will lead to a recession. We think that an economic slowdown would be most dangerous for equities (given the increased chance of profit warnings and current high valuations). The Fund remains underweight equities. Volatile markets increase the likelihood of finding more investments at valuations we consider good risk / reward and those which will aid forward-looking returns.

Close Brothers
Asset Management