Close Brothers Asset Management

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Close Sustainable Select Fixed Income Fund

Monthly fund manager update

MARCH 2023

FUND PERFORMANCE

The Sustainable Select Fixed Income Fund returned -2.1% in March, and +0.5% year to date (YTD). In comparison, the Investment Association (IA) Sterling Strategic Bond sector returned +0.2% in March, and +1.6% YTD.

As of 4 April 2023 (i.e. four days after month-end), the Sustainable Select Fixed Income Fund has returned +1.4% YTD, while the IA sector has returned +2.2% YTD. The continued recovery in bank and insurance bonds over the last four days, as well as the Fund's new government bond holdings, are the key drivers of performance.

FUND NEWS

In Q1 2023, the Sustainable Select Fixed Income Fund undertook a series of improvements:

1 – On 31 January, Fund OCF reduced to 0.45% (from 0.48%);

2 – On 3 March, AUM increased to c. GBP 410m (from c. GBP 260m), as the Close Sustainable Bond Fund merged into the Select Fixed Income Fund;

3 – On 31 March, the Fund formally incorporated a new sustainable methodology. As a result, the Fund name was changed from 'Select Fixed Income', to 'Sustainable Select Fixed Income.' Given the Fund has been operating in-line with the new methodology for the past twelve months, no fund changes or trading occurred following incorporation.

Overall, the Sustainable Select Fixed Income fund has reduced costs for investors, increased scale (while remaining nimble), and formally improved already strong sustainability credentials.

MACRO BACKDROP

Newsflow in March was dominated by the collapse of Credit Suisse and liquidity issues at several US regional banks. As a result, subordinated bank bonds underperformed and government bonds outperformed. In the final week of March and first five days of April however, this trend reversed as contagion fears eased and bank bonds continued to rally back to more 'normal' valuations.

Away from the headlines surrounding banks, central banks remained active while clearly signalling that both policy rates and inflation are "at or near peak".

The Bank of England raised the policy rate to 4.25% (from 4.00%) on 23 March. Futures markets expect one additional rate hike (of +0.25%) in 2023 (to 4.50%).

The Federal Reserve raised the policy rate to 5.00% (from 4.75%) on 22 March. Futures markets expect one additional rate hike (of +0.25%) in May 2023, followed by three to four rate cuts in the second half of 2023.

While we do not expect the Fed to cut rates by this magnitude in 2023 (futures markets are volatile and changeable), the Fed clearly communicated that the current policy rate of 5.0% is unusually high, and that it expects to cut rates in 2024 and 2025 towards more normal levels (i.e. 2-3%). This clarity from the Fed underpinned changes we made to the Fund in March.

The European Central Bank raised policy rates by +0.50% on 16 March and also commenced quantitative tightening at a rate of EUR 15bn / month. The Depo Rate was raised to 3.00% (from 2.50%); and the Refi Rate was raised to 3.50% (from 3.00%). ECB rhetoric remained relatively hawkish, and futures markets remain volatile - forecasting the Depo rate to reach c. 3.50% in summer 2023.

In the UK, the Composite Purchasing Managers Index (PMI) data weakened slightly to 52.2 (from 53.1 in Feb' 23), while consensus 2023 GDP growth forecasts improved to -0.4% (from -0.9% in Jan' 23 and -0.7% in Feb' 23). CPI inflation increased to +10.4% in Feb' 23 (from 10.1% in Jan' 23) though was largely attributed to exceptional items including elevated food prices. Forecasts indicate inflation will continue to decline throughout 2023 to c. +3.6% in Q4 2023. Unemployment remained strong at 3.7%.

In the US, Composite PMI data improved to 53.3 (from 50.1 in Feb' 23), while consensus 2023 GDP growth forecasts improved to +1.0% (from +0.7% in Feb' 23). US inflation declined for the eighth consecutive month to +6.0% (peak in Jun' 22 was +9.1%), and forecasts indicate inflation will decline to +3.3% in Q4 2023. Unemployment increased to (a still very strong) 3.6%.

In the Eurozone, Composite PMI data improved to 54.1 (from 52.0 in Feb' 23), while consensus 2023 GDP growth forecasts improved to +0.5% (from +0.4% in Feb' 23 and 0% in Jan' 23). Eurozone inflation declined to +6.9% (from +8.5% in Feb' 23), and forecasts indicate inflation will decline to +3.0% in Q4 2023, albeit forecasts are volatile given ongoing concerns over Russian gas supplies. Unemployment remained stable at 6.6%.

PORTFOLIO ACTIVITY

March was an interesting trading month for the Fund, as banking-led volatility created the opportunity to increase portfolio quality and portfolio duration - while maintaining a 'big' overall fund yield. Key investments during the month included:

1 – We increased our holdings in US and UK government bonds to 8.2% (from 0%). In order to increase duration and increase overall portfolio quality, we bought 4% positions in US Treasuries and UK Gilts (focused on the 11 – 16yr part of the curve). This trade was funded by selling shorter-dated corporate bonds.

As a result of our government bonds trade, the average rating of the Fund increased to BBB+ (from BBB) and duration increased to 4.7 years (from 4.0 years).

2 – We increased our holding (to 2.0%) in the GBP Ford Motors 2026 bond at a yield of 6.9% (rated BB+). We expect the bond be upgraded to Investment Grade (BBB- or better) over the coming 6 – 12 months;

3 – We increased our holdings (to 3.4%) in Trafigura bonds, by adding to the EUR 2024 Corporate Hybrid bond at a yield of 8.8% (unrated).

On the portfolio construction side, the yield-to-call is 8.0%; duration is 4.7 years; the average rating of the fund is BBB+; cash levels are 3%; and the unrated portion of the fund is 3%.

OUTLOOK AND STRATEGY

Fixed Income sub-asset classes:

- **Sovereign bond yields** are volatile and reactive to macro data – and offer fair value in the UK, US and Eurozone

  Sterling Investment Grade bonds are slightly cheap versus all historical timeframes, with sterling 'BBB' credit spreads at 233bps, versus their 5yr average of 187bps; 10yr average of 188bps; and 20yr average of 216bps

- **Sterling High Yield** spreads are slightly cheap versus all historical timeframes, with 'BB' spreads at 456bps (5yr average of 370bps; 10yr average of 349bps; 20yr average of 430bps)

In an effort to preserve capital and deliver a good level of monthly income, we continue to seek out the best risk/reward ideas across investment grade, high yield and unrated sectors. We maintain our focus on stock selection reinforced by in-depth credit research.