Close Brothers Asset Management

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Close Portfolio Funds

Monthly fund manager update

APRIL 2023

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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 that will grow in value and repay their debts purchased at attractive cash-based valuations – is complemented by allocations across fixed income and alternatives as appropriate.

MONTHLY PERFORMANCE REVIEW

April was characterised by ongoing stress in the US banking sector caused by Federal Reserve interest rate policy. Sterling bonds fell -1.3% whilst equities rose +1.4% in US dollar terms (muted to a 0.7% rise for the Sterling-based investor as the pound strengthened). Each Fund delivered positive returns in the month ahead of their respective Investment Association peer groups. It was a strong month as the US Treasuries we own rose and our defensive stocks outperformed equity indices.

APRIL THOUGHTS – EXPECTED RETURNS

2022 was a difficult year 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 -25%. The decline experienced by equities last year wasn't remarkable – they typically decline one year in every three, whilst producing good returns over the long run – however bonds usually cushion the equity drawdown and only rarely perform worse than stocks. With open talk of recession and the Funds positioned cautiously, the most common question we receive is: "should clients brace for more losses?"

Let's take a scenario where stocks fall by a further -20%, resulting in a cumulative drawdown that would not be outsized compared with previous historical bear markets. If fixed income has a duration (or "interest rate sensitivity") of 10, then a two percentage point fall in interest rates would see a +20% capital gain from those bonds (ignoring income for simplicity). The movements of those two asset classes produce a result varying by the risk profile. An 80/20 'Growth' investor would lose -12% (an 80% equity allocation falling -20% is a return of -16% plus a 20% bond allocation growing +20% equates to a total return of +4%), a 60/40 'Balanced' investor would lose -4% (-12% from equities plus +8% from bonds) whilst a 40/60 'Conservative' investor would gain +4% (-8% plus +12%). We would hope to do better than this: we own fewer equities than simple benchmarks and the ones we do hold are defensive with the potential to lose less than the average, whilst we have correspondingly more invested in fixed income and gold to capture any appreciation. Moreover, from this point equities would, by definition, have very strong forward-looking returns. So far, year-to-date, all three Funds have positive returns.

We could stop at this juncture – but sterling is the wildcard. Last year a devaluation of the pound converted the -18% stock decline into a -9% fall in sterling terms from the perspective of a UK investor. Let's add a 10% sterling fall to our previous example. In this scenario stocks decline not -20% at the index level but -10% in pounds sterling. The nominal return from fixed income is unaffected. In our previous calculation Growth lost -12%; now, the nominal return improves to just -4% (an 80% equity allocation falling -10% returns -8% plus a 20% bond allocation growing +20% adds +4%). Balanced was -4%; now, +2% in pounds; Conservative was +4%; now, +8%. In an alternative scenario where sterling instead appreciates, the opposite occurs and the nominal returns from all risk profiles are lower, all else equal.

Should clients brace for more losses? With some arithmetic we answer: "it depends, but not necessarily."

LOOKING AHEAD

The forward strategy outlined in our September 2022 commentary 'Preserve Capital, Make Money' remains in action. We maintain our slight underweight position in equities with a bias towards defensives over cyclicals. With conviction that yields have peaked we have swapped some equities for gold – which doesn't have earnings risk – and invested our cash in 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 longer duration and may continue to swap equities for gold if stocks rally. We are looking to replace outperforming holdings with fresh defensive stocks, buy new cyclical equities on profit warnings, and add to corporate bonds into any selloff.

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.

IMPORTANT INFORMATION

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