LOWES
INVESTMENT MANAGEMENT

Income Focus

Quarterly Report to 30 September 2024

Objective

To provide a higher level of income relative to the broader market at the potential expense of capital appreciation over the medium to long term.

Strategy

To achieve a higher level of income, the portfolio will typically invest in strategic bond funds which have the flexibility to invest across the fixed income spectrum, along with equity income funds which employ covered call strategies to earn additional premium. It will be invested in line with the parameters of the Investment Association Mixed Investment 20-60% Shares sector, so this portfolio will always have at least 20% of its assets invested in equity funds but never more than 60%. As most of the return generated by the underlying holdings is by way of income, there is likely to be little or no capital growth over the medium to long term.

Market Commentary

From an economic perspective concern clearly shifted from inflation to economic growth. For now, inflation appears to be behaving itself. In the euro area the rate has fallen below 2%. In the UK, consumer price inflation has now held steady at 2.2% for two consecutive months. In the US, meanwhile, we have also seen a move down towards target, falling most recently to 2.5%. Whilst there are still some components of the inflation basket which remain sticky, such as housing rents, concerns are dissipating.

Narrative is now more closely focussed on economic growth and how central banks protect it. Whilst the most recent forecast from the Organisation for Economic Co-operation and Development (OECD) remains relatively positive, investors are keen to understand how western central banks will navigate from the current higher interest rate environment to one more commensurate with lower inflation. There was concern that the US Federal Reserve (Fed) had left it too long after a weak August jobs report. This triggered them into action, with their first move being a 0.5% reduction. The market also priced in a number of subsequent cuts in quick fashion. It has not been uncommon for the market to get ahead if itself, a point in case being the fourth quarter of last year. It may have done so again this time too, following a stronger than expected employment report for September which appears to have reinforced the soft-landing thesis.

The Fed, European Central Bank (ECB) and Bank of England are all expected to continue their path of cutting moving forward. The exception to the rule is the Bank of Japan who appear to be in hiking mode. They caught the market off guard with their most recent hike at the end of July, which sent equity markets into a downward spiral. Whilst the hike was only a small 0.15%, it was enough to unsettle investors.

With US interest rates moving one way and Japanese in the other, we saw what appears to be a partial unwinding of the carry trade in early August, the carry trade being where investors borrow in a lower yielding currency, i.e. the Japanese yen, to invest in higher yielding currencies/assets. No one is quite sure exactly how large the positioning in the carry trade is, with some wide ranging estimates. The general consensus is that positions in the carry trade still exist and therefore a keen eye will likely be kept on the Bank of Japan.

The weakness in markets was met this time with investors keen to get back into the market at lower valuations. Liquidity is certainly abundant, with the Investment Company Institute reporting $6.46 trillion in money market funds in the US. The question is, is this money likely to make its way into investment markets or stay parked where it is. Plenty to monitor as we enter the final quarter of 2024.

Performance

The portfolio posted a return for the period of 4.11%. This was ahead of the IA Mixed Investment 20-60% Shares sector average return of 2.28%.

Given the increased expectation for further interest rates to come it was little surprise to see the top performing fund spot taken by a fixed income fund. Janus Henderson Fixed Interest Monthly Income was that fund. Strong performance came from its longer duration positioning, and therefore increased sensitivity to interest rates, which at the end of September stood at over 7 years, whilst the underlying holdings had a weighted average life of over 8.5 years. This fund also has a meaningful exposure to high yield, non-investment grade bonds. Despite credit spreads being narrow compared to history, investors continued to the higher all in yield which these bonds offer. Default rates in this asset class also remain benign.

The Jupiter Strategic Bond fund was also a strong performer during the period. This fund also benefited from a long duration position, which stood at almost 10 years at the end of September. Like Janus Henderson above, this fund also has a material weighting to non-investment grade bonds, therefore contributing to the positive return achieved.

Strong performance was not only reserved for fixed income funds however and we also saw a very strong return from the Schroder Income Maximiser fund which achieved in excess of 5%. The fund benefited from the strong stock picking of the underlying Schroder Income fund. The Fidelity Global Enhanced Income fund was also a positive contributor.

Source: FE Analytics, Bid-Bid, Total Return

Portfolio Activity and Positioning

This Managed Investment Portfolio was only launched at the end of June 2024. During its first quarter there have been no changes made to the portfolio. In terms of equity fund holdings, this remains focussed on those which operate a covered call overlay with a view to enhancing the natural yield available from the underlying stocks. Three of the funds are predominantly investing in UK equities whilst the four is investing on a global equity basis. We continue to monitor funds which invest using covered call strategies, but these tend to be specialist funds and therefore their availability is limited.

All bar one of the remaining fund holdings are fixed income funds. These are strategic bond funds, their mandate therefore allowing them the flexibility to invest across the fixed income spectrum, including government, corporate and non-investment grade bonds. The latter tend to have a higher yield given their raised risk premium. A larger exposure here has been beneficial given the total yield available and the stability that these bonds have shown recently due to low default rates and strength in corporate earnings. In the event of a soft economic landing this could continue to prove the case.

We remain conscious however that a hard landing could lead to a widen in credit spreads which could negatively impact these bonds. We therefore carefully monitor these funds in terms of the allocations which they currently have. Jupiter Strategic Bond for example, currently invest with a barbell approach, where they have a meaningful exposure to high yield bonds on one side but then balance this with exposure to government bonds.

As well as researching alternative funds within the equity and fixed income asset classes we also continue to research other asset classes which could meet the objective of providing a high level of income stream. This includes areas such as property and infrastructure.