LOWES INVESTMENT MANAGEMENT

Income Focus

Quarterly Report to 31 March 2025

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

Within UK fixed income markets it was the high yield, non-investment grade bonds which continued to post the strongest gains. Whilst credit spreads, i.e. the additional amount of yield investors demand for holding more risky assets, remain tight relative to history, default levels remain benign. We did see some widening, however, towards the end of the period, as economic concerns arose and as 'liberation day' approached, where we would learn the extent of the tariffs the US were going to impose on goods arriving from other countries.

Meanwhile, a greater level of volatility and lower returns were seen in investment grade and government bond markets. Price movement in these markets is driven to a much greater extent by the perceived and actual direction of inflation, economic growth and therefore interest rates. With inflation continuing to remain 'sticky' in many countries, maintaining a level above central bank targets, interest rates saw little downward movement during the quarter. Yield curves have seen a little steepness return, but are still relatively flat compared to their normal upward sloping shape.

We saw a great deal of divergence across equity market returns during the quarter in local currency terms. Within the UK, concerns regarding economic growth weighed on the performance of those stocks more heavily reliant on the domestic economy. This meant that both mid and small cap indices succumbed to weakness, with both in negative territory. Conversely, large cap stocks continued to power ahead, with the large cap index posting a return in excess of 6%. Large cap stocks typically derive a large proportion of their earnings from overseas. The index was also helped by its sector breakdown which is more defensive than others. A low level of exposure to technology stocks finally proved a benefit rather than a hinderance.

US equities struggled during the quarter. Technology stocks were negative as sentiment towards the sector turned. A weaker outlook for economic growth weighed on the sector, which was compounded by high share valuations. After a strong period following the inauguration of Trump, smaller companies share prices also succumbed to weakness. The weaker outlook, changes in regulation looking like they will take longer to come through, along with the potential inflationary impact of tariffs, all weighed heavily as these stocks gave back all of their previous gains and then some.

The more defensive nature of the European equity markets in terms of sector breakdown, along with lower valuations, meant we saw a positive change in sentiment, leading to outperformance against most other developed markets.

Performance

The portfolio posted a return for the period of 1.47%. This was ahead the IA Mixed Investment 20-60% Shares sector average return of 0.20%.

UK equity income funds featured as top performers within the portfolio. Both the Schroder Income Maximiser and Fidelity Enhanced Income funds benefited from their biggest exposure being to large cap stocks, which performed well during the period, outperforming their mid and small cap counterparts. The Schroder fund also benefited from its value style bias and material exposure to the financials sector. The Fidelity Global Enhanced Income fund was also a strong performer, again having predominantly large cap exposure, a meaningful weighting to UK stocks and a material underweight to US companies.

The strongest performing fund over the period, however, was Jupiter Strategic Bond. The fund performed strongly despite it long duration position. Corporate bond exposure was predominantly taken in the high yield area of the market which continued to produce stellar returns given the lack of defaults in the sector and lower interest rate sensitivity. Whilst there is a large exposure to government bonds, which is providing the longer duration, this is taken in geographies such as Australia and Asia, with very little in the US. Australian government bonds did not see the same negative price moves during the period as seen in other developed markets.

Only one fund in the portfolio produced a negative return during the quarter, being Aegon Diversified Monthly Income. Exposure to technology names within equities was a drag to performance. A long US dollar position and corresponding short position in sterling was also a detractor, as the latter strengthened during the period.

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 the quarter the portfolio was rebalanced to bring the underlying fund allocations back in line with their original allocation.

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 fourth 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.

The fixed income allocation within the portfolio is achieved through an allocation to strategic bond funds. The greater flexibility in their investment mandate permits them to invest across government, corporate and high yield bonds. The latter usually carry a higher yield due to the increase in credit risk taken. These bonds have also displayed less volatility more recently due to them being less interest rate sensitive and a relative calmness in terms of the credit conditions outlook. In additon, these funds tend to have more flexibility in terms of managing their duration position. We are conscious of the level of credit exposure that these funds have and continue to monitor this closely in case there was some deterioration here.

There also remains an allocation to a multi-asset fund within the portfolio. This helps provide a further level of tactical asset allocation. As investment in equities and fixed income is done by in-house teams, typically through specific mandates, this means costs can be controlled carefully. This fund also provides access to more esoteric asset classes such as specialist income.