

Henderson Diversified Income Trust

Death rattle for bull market

After a serious wobble in the last few months of 2018, the resurgence in markets that we have seen in 2019 may be the death-rattle of what is now a 10-year bull market. The managers of Henderson Diversified Income (HDIV) have been warning that markets are heading for falls as the economic cycle turns, and that we are likely to slip back into a prolonged period of low-no growth and low-to-no inflation. That would suit HDIV's high quality, long duration portfolio (the expected cash flows from its investments are weighted towards the longer-term, making it more sensitive to changes in long-term interest rates).

High income from a flexible fixed income portfolio

HDIV's objective is to seek income and capital growth such that, on a rolling annual basis, the total return on the NAV (including the reinvestment of dividends) exceeds three-month sterling LIBOR plus 2%. It invests in a diversified portfolio of global assets including secured loans, government bonds, high yield (sub-investment grade) corporate bonds, unrated corporate bonds, investment grade corporate bonds and asset backed securities. The trust may also invest in high-yielding equities and derivatives. The managers use gearing to enhance returns.

Dividends, which make up the bulk of returns for investors, are paid quarterly.

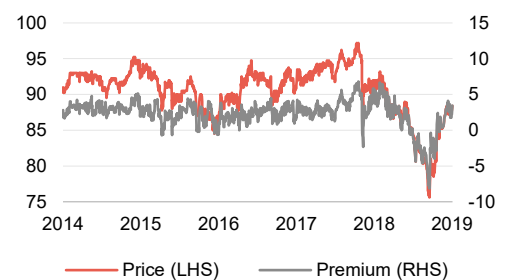
Year ended	Share price total return (%)	NAV total return (%)	Three-month LIBOR plus 2%/1.25%*(%)
31/03/15	8.5	8.3	2.1
31/03/16	(2.1)	1.4	2.6
31/03/17	12.1	9.7	2.5
31/03/18	5.2	2.4	2.3
31/03/19	0.7	3.8	2.8

Source: Morningstar, Marten & Co. Until 31 October 2014 Henderson Diversified Income used three-month sterling LIBOR + 1.25% as a target return. Three-month sterling LIBOR +2.0% has been used since 1 November 2014.

Sector	Global high income
Ticker	HDIV LN
Base currency	GBP
Price	87.4p
NAV	86.3p
Premium/(discount)	1.3%
Yield	5.0%

Share price and discount

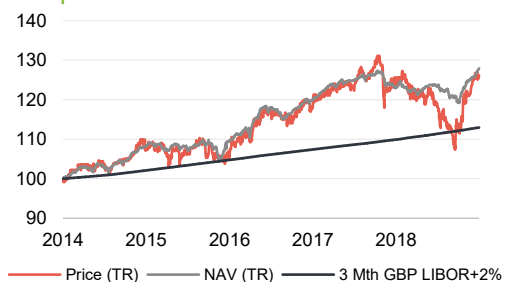
Time period 31/03/2014 to 01/04/2019



Source: Morningstar, Marten & Co

Performance over five years

Time period 31/03/2014 to 31/03/2019



Source: Morningstar, Marten & Co. * 3-month sterling LIBOR + 1.25% pre 01/11/14, 3-month sterling LIBOR +2.0% since.

Domicile	United Kingdom
Inception date¹	18 July 2007
Manager	John Pattullo and Jenna Barnard
Market cap (GBPm)	165.7
Shares outstanding	189.618m
Daily vol. (1-yr. avg.)	331,867 shares
Net gearing²	21.3%

Note: 1) of predecessor company. 2) net gearing comprises borrowings of 4% and synthetic gearing of 17.3%, both as at 28 February 2019

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Hitting the buffers

Readers may want to refer to our previous note, [Winter is Coming](#)

QuotedData's previous note on Henderson Diversified Income (HDIV), [Winter is Coming](#), included a discussion around some of the thinking behind its managers' assertion that we are quite late in the economic cycle and that, in most developed economies, inflation is not a problem.

Going into the last quarter of 2018, the Federal Reserve (the US Central Bank) was still talking aggressively about further interest rate rises and quantitative tightening (the reverse of quantitative easing, whereby the Federal Reserve would stop buying debt and let its existing debt holdings mature or seek to sell them). The US yield curve (which shows how interest rates vary according to the length of the debt) was flattening, indicating that long-term interest rates were not much higher than short-term rates, and money supply was shrinking. The Chinese yield curve had already flattened. The US currency was strengthening, which was having a negative effect on emerging markets.

Faltering Chinese growth and an Apple profit warning unnerved investors in Q4 2018

Markets took a tumble at the end of 2018. The managers think that the trigger for the market falls was a sense that economic growth was faltering (particularly in respect of China, which has been the engine of global growth for some time). This was linked in part to the tariff wars instigated by President Trump against China but evidenced in areas such as a sharp decline in export volumes for Germany and Japan (who export a great deal to China). In addition, a profit warning from Apple unnerved growth/technology investors. Equities fell and credit spreads (the extra interest that a borrower pays relative to a low risk borrower, such as a government) widened. For a while, it looked as though the managers' predictions were becoming reality.

Figure 1 charts the shift in credit spreads for BBB/Baa rated debt relative to US Treasuries (debt issued by the US government). In the first week of 2019, these borrowers were paying almost 1.9% a year more to borrow than the US government, up from a low of 1.2% about a year earlier.

Figure 1: 10-year BBB/Baa spreads versus US Treasuries



Source: Bloomberg, Marten & Co

No US rate rises this year

Since Christmas, however, we have seen a sharp rally (although through the dip and the subsequent recovery, it often felt as though liquidity was quite thin). The chairman

of the Federal Reserve, Jerome Powell, performed a sharp U-turn in policy and began to talk in terms of supporting the economy rather than clamping down on it. At its March meeting, the Federal Reserve signalled that it will not raise interest rates in 2019 and said quantitative tightening would now slow from May and cease in September.

Rising inventories may unwind

The managers highlight that inventory (the stock of goods for sale and parts for use in production) has been building within the global economy and suggest that there are two possible reasons for this – China tariffs and concerns about Brexit. In the short term, this will have been positive for economic output (as companies and consumers bring forward spending) but it is storing up problems for the future; activity will be depressed when inventories unwind.

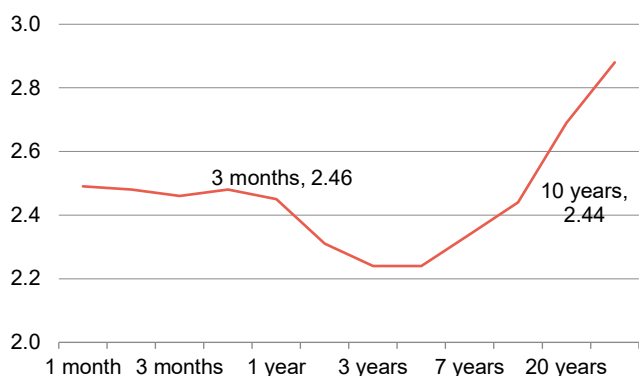
The managers believe we have seen a classic bear market rally in 2019

The managers believe that we are now seeing a classic bear market rally which might, in itself, signal the end of the economic cycle and the start of a new bear market phase. There is a pattern – which has been seen quite often at similar stages of the cycle – that after interest rates peak, equities have a final push and bond yields fall. The managers are convinced that we have seen the high point in US rates for this cycle. They say that there is a one-in-four chance of a soft landing (avoiding a full-blown recession) but it is more likely that there is a global slowdown coming and markets are overvalued.

The US yield curve is starting to invert

The US yield curve has inverted (long-term rates are lower than short-term rates) between three months and 10 years for the first time since 2007, as depicted in Figure 2; this is often a lead indicator of recession. We have been travelling in this direction for a while. The managers monitor the spread between the yields on US Treasuries with an average of two years to maturity and those with an average of 10 years. This, shown in Figure 3, is still positive for the moment, but has been on a declining trend for some time.

Figure 2: US yield curve (22 March 2019)



Source: US Department of the Treasury, Marten & Co

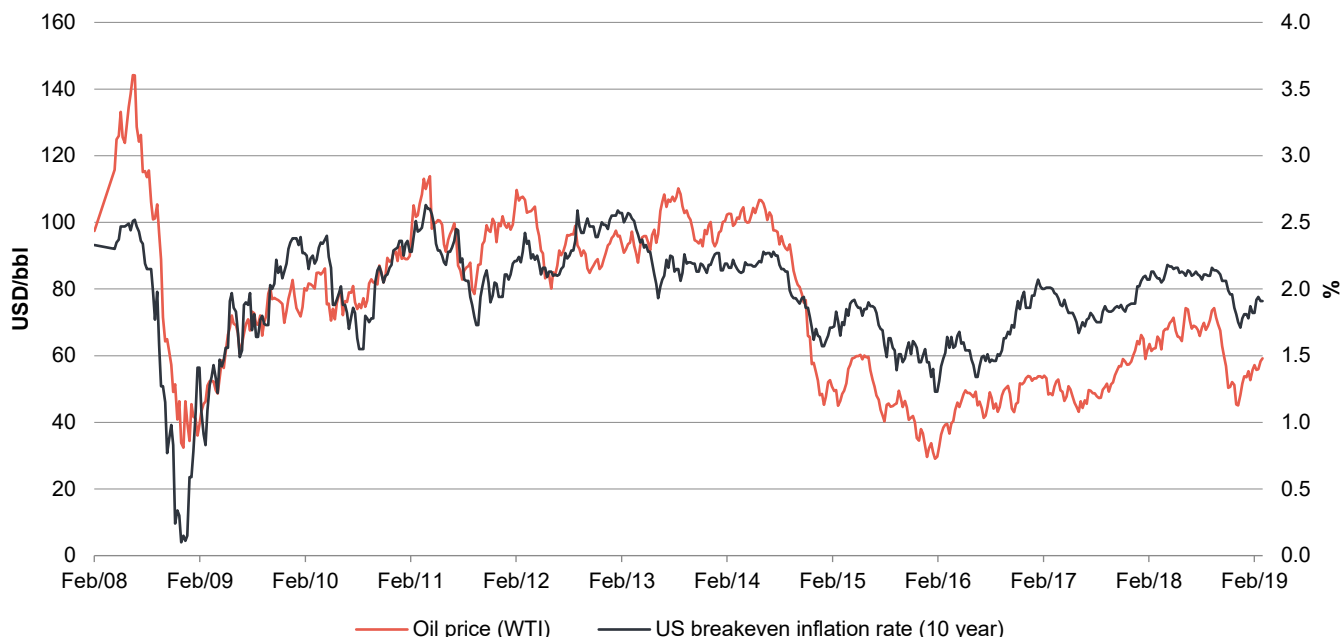
Figure 3: Spread between 2's and 10's (USA)



Source: Bloomberg, Marten & Co

The managers are convinced that inflation is under control, helped by a weaker oil price towards the end of 2018. Figure 4 demonstrates the strong link between the oil price and breakeven inflation in the US (breakeven inflation is an estimate of future inflation rates implied in the pricing of index-linked government debt versus conventional US Treasuries).

Figure 4: Breakeven inflation and the oil price



Source: Bloomberg, Marten & Co

The US boosted its economy by 2.9% last year, chiefly in the form of the Trump tax reforms enacted at the end of 2017. The effects of this are petering out. Some evidence of this may be the ‘surprise’ slowdown in US job creation in February 2019 (20,000 new jobs versus analysts’ estimate of 180,000).

China reflation unlikely

Figure 5: Spread between 2’s and 10’s (China)



Source: Bloomberg, Marten & Co

Figure 6: Australia 10-year government bond yield



Source: Bloomberg, Marten & Co

China’s yield curve is fairly flat already, as is evident in Figure 5 where the gap between two-year bond yields and 10-year bond yields has been hovering at around 0.5%. The managers stress that China needs to address a potential bad debt problem within its banking sector and bring its shadow banking sector (peer-to-peer lending, loans dressed up as asset management products and the like) into line with the more regulated banking sector. Given this, the managers doubt that China has the capacity to inject stimulus to prop up global growth again in the way that it did in 2015. China also faces a demographic constraint to growth (China’s one child policy has left it with a rapidly ageing population which could translate into having a high proportion of

retirees relative to workers – this is unusual for emerging markets, which typically benefit from a young population) and this is one reason why the managers' long-term prediction is that China's economy will start to resemble Japan's pattern of low growth/low inflation/deflation. However, they think Australia will get there first. Already we have seen yields on 10-year Australian government notes hit record lows (see Figure 6).

Credit markets

Take carry, don't be a hero and add yield when the opportunity arises

The managers' advice in the current environment is to take carry (the gap between the yield obtainable from investments and the cost of HDIV's borrowings), don't be a hero and add yield when there is opportunity to do so. The exhortation to take carry is, for the moment, offset by the urge not to take excessive risk. As discussed on page 8, HDIV's financial gearing has been reduced as a precautionary measure, given the current economic environment. The managers are actively avoiding companies whose business models are in structural decline and those with little pricing power. In other words, those that are not masters of their own destiny.

Focus on companies that can generate the cash needed to service their debt

The managers point out that, in the round, a lot of companies destroy value because their cash return on invested capital exceeds their cost of capital (an argument made by Terry Smith, Aswath Damodaran and others). The managers want to lend to companies that do not really need to borrow. They want companies whose cashflows will allow them to reduce their future debt burdens, not those reliant on securing funding to survive.

Good default experience

HDIV's managers successfully avoided defaults within the portfolio in 2018. Leveraged loan default rates are still low in the US (running at about 1.4% in January 2019). However, there is a sign of an uptick in distressed loans (those that are priced by markets at 80p in the pound or cents on the dollar, or less) and this is a good leading indicator of defaults. Notable defaults at the end of 2018 included Sears Holdings Corp (the US department store company) and Pacific Gas & Electric (the utility company exposed to liabilities arising from California wildfires in 2017 and 2018).

No hiding place in short duration bonds

If growth is stalling, companies with shaky business models and those that are overleveraged will soon run into trouble. The managers note that in the last quarter of 2018, the high-yield market shut down as investors sat on their hands. If that happens again for a longer period, there are a number of companies reliant on refinancing their debt that could run into serious trouble. Some other investors have been advocating buying short-duration bonds as a way of reducing risk in the current environment, but often these bonds are from companies that might struggle to issue longer-dated paper; this is not a place to hide.

In an environment where credit became harder to obtain, some companies might resort to issuing new expensive debt to the detriment of existing debt holders. This is a scenario that the managers are keen to avoid, and they are screening out companies that they feel might take this route.

Until recently, loans were cannibalising the high-yield market

Until very recently, the loan market was booming at the expense of the high yield market (this was a topic addressed in [QuotedData's last note](#)). The managers' response has been to reduce exposure to this part of the market. The managers point out that, if rate rises are off the table for now, floating rate issues look less attractive (part of the attraction of floating rate debt is that investors earn more from it as interest rates rise). Data from LCD (from S&P Global Market Intelligence) suggests that there has been an upsurge in high-yield issuance in the first few months of 2019, with the proceeds being

used to retire floating-rate leveraged loan debt. In addition, private investors are pulling money from funds invested in US loans.

In Europe, most loans end up in CLOs – collateralised loan obligations – where debt is packaged up and sold off in tranches. The highest-ranking tranche, which gets paid out first, should be the safest and so pays the lowest interest rate, the most junior tranche, often called the equity tranche, is the first to suffer any losses. Japanese banks are big buyers of the senior notes, they want safe assets and are attracted by the yields available even on the highest-ranking tranches as Japanese government bond yields are negative except for very long-dated bonds. This concentrated buyer base for the senior paper concerns the managers. Citi believes there is a queue of managers looking to issue their first CLO. The managers note that the CLO market is less frothy in the US, however. A widening of CLO spreads in December has weighed on both US and European CLO issuance ever since.

Managers are highly selective

The managers do feel that the high-yield market remains competitive. The strength of the loan market has helped in this regard. The managers have been very selective in the deals in which they have participated, rejecting eight or nine deals in every 10.

BBB-rated debt in bubble territory and vulnerable to downgrades

Investors have put significant focus on the BBB-rated part of the market as this has seen explosive growth. The managers say that investment grade issuers have been downgrading themselves to fund mergers, acquisitions and share buy-backs which have been structured to meet the threshold for a BBB (or equivalent) rating. The managers think BBB may be in bubble territory and caution that credit rating downgrades may emerge swiftly in the event of a slowdown. The problem has been compounded by rating agencies being generous on the degree of leverage they will permit on BBB-rated issues. Companies asking for a rating are making bold promises about their ability to de-lever (pay back their debt) and the rating agencies are believing them. On a more optimistic view, many of the larger issuers have levers to pull to protect their credit ratings. The managers say that stock selection remains key; this is an area of the markets where they will be cautious and selective.

Given that private equity firms are sitting on record levels of uncommitted cash, it is perhaps no surprise that there has been a pick-up in merger and acquisition activity, especially in areas such as food & beverage, technology, cable and telecoms. This is accompanied by new debt issuance.

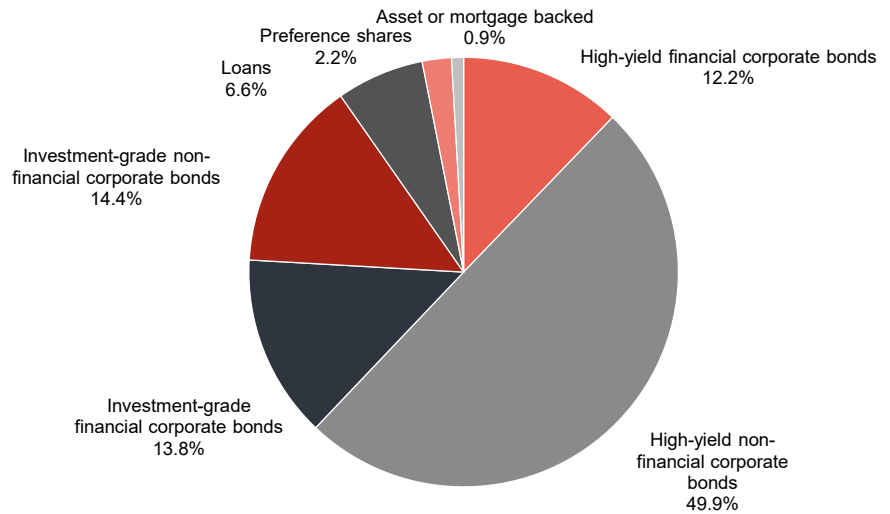
Asset allocation

US bias remains (was about 80% of the portfolio in December 2018)

The portfolio continues to have a heavy weighting toward the US (this was about 80% of the portfolio in December 2018, according to the trust's most recent report), as the managers think that it is easier to find better-quality companies there. By contrast, they think that European issues seem to be more prone to defaults and frauds. The managers are emphasising long duration, government bonds and high-quality companies within the portfolio. They are steering clear of challenged sectors such as the car manufacturers.

There were 122 positions in the portfolio at the end of February 2019. Figure 8 shows how the portfolio was split between various types of credit. The managers' preference is for high-yield corporate bonds and investment-grade corporate bonds, notwithstanding the shrinkage of the former sector. Loans do not offer an attractive balance of risk versus reward, in their view.

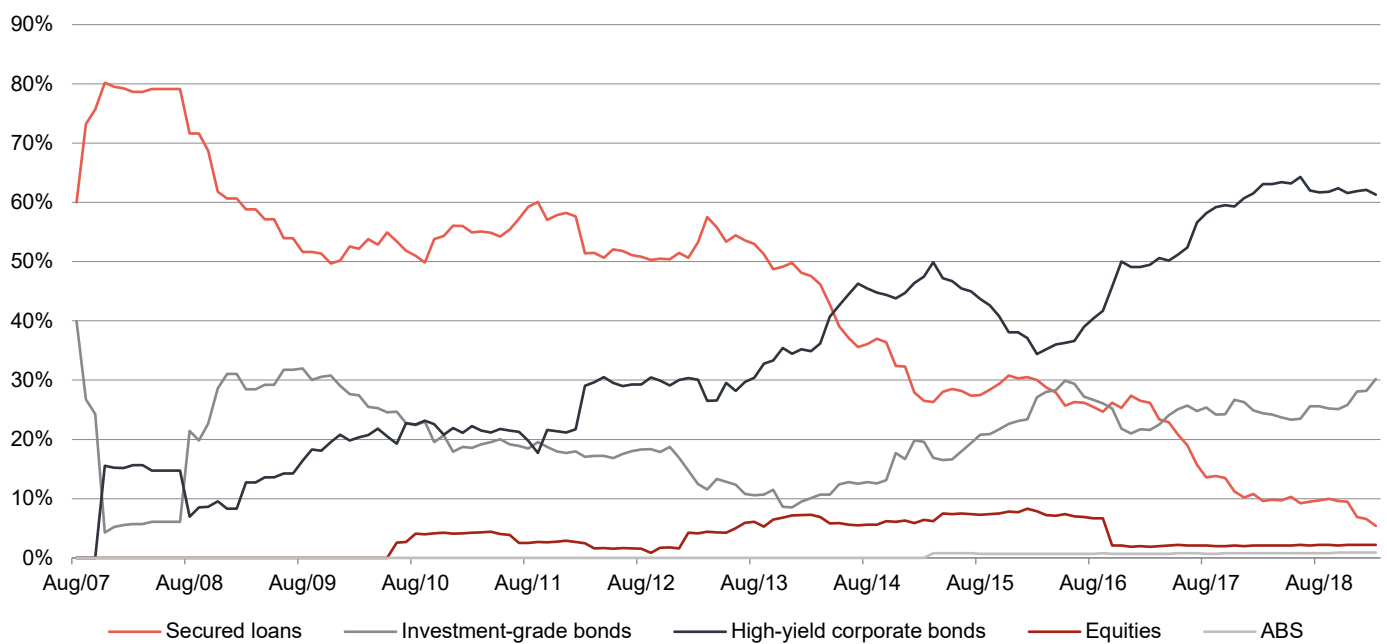
Figure 7: HDIV sector breakdown as at 31 January 2019



Source: HDIV, Marten & Co

Investment grade is relatively stable and they are marginal buyers of investment-grade loans. When credit spreads have widened, they will look to switch some sovereign exposure (government debt) into corporate debt.

Figure 8: HDIV asset allocation over time to end February 2019



Source: Henderson Global Investors, BNP

10 largest exposures to individual issuers

HDIV's list of top 10 holdings changes more frequently than the trust's actual level of turnover would suggest. There is not much variation in portfolio weightings, and so small changes in allocation and valuation have a marked impact on the line-up.

Figure 9: 10 largest holdings at 28 February 2019

Holding	Industry	(%)
IQVIA 5% 2026	Healthcare, clinical trials	2.4
Aramark Services 4.75% 2026	Consumer services, food service, facilities and uniforms services	2.4
InterXion 4.75% 2027	Technology, cloud data centres	2.3
Lamb Weston 4.875% 2026	Consumer goods, frozen food supplier	2.3
Crown Castle International 3.65% 2027	Wireless infrastructure in the US	2.3
Arqiva Broadcast Finance 6.75% 2023	Broadcast transmitter sites for UK digital terrestrial television	2.3
Co-operative Group 2011 7.5% 2026	UK food retail, funerals and legal services business	2.2
Phoenix Group 6.625% 2025	Financials, life assurance	2.2
Nationwide Building Society	Building society	2.2
Elanco Animal Health 4.9% 2028	Animal food producer	2.0
Total		22.6

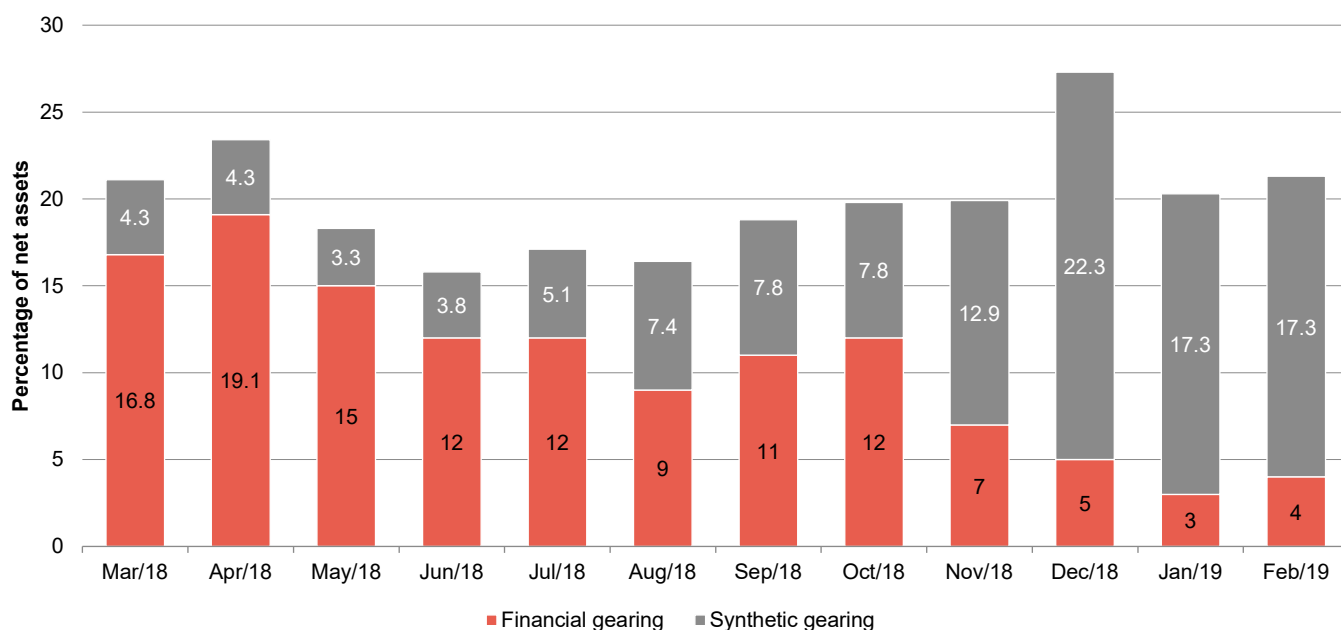
Source: BNP Paribas

The managers also recently bought an issue from McCormick, a company that sells spices. It needed to finance an acquisition of a portfolio of products from Reckitt. The managers say that the company's sales are growing and the price point of its products is low. Therefore, it can adjust prices without having too much impact on demand. It is also genuinely deleveraging.

Leverage

The managers have cut HDIV's bank gearing (bank borrowing) and have introduced an element of interest rate futures within synthetic gearing (interest rate futures were 13.3% of HDIV at the end of February 2019). The futures help extend the duration of the portfolio by about a year.

Figure 10: HDIV leverage over the past year



Source: HDIV, Marten & Co

It is also important to note that cuts to financial gearing translate into reduced carry (normally HDIV can borrow for less than the yields it generates by investing) and therefore lower revenue generation for the trust. Low financial gearing is not expected to be a persistent feature in the portfolio, however. HDIV does have revenue reserves (£2.2m at the end of April 2018, equivalent to 1.15p per share) available to support the dividend, if necessary.

Performance

HDIV has had a strong start to 2019, reversing most of 2018's losses

As Figure 11 shows, HDIV's NAV performance has had a welcome fillip in 2019 after a more difficult 2018. Nevertheless, HDIV's performance is well ahead of its objective over most time periods.

As yields rose in 2018, alongside higher US rates and widening credit spreads, HDIV's long-duration portfolio was affected. The managers stuck to their guns, however. As sentiment turned at the end of 2018, HDIV's portfolio came into its own. If the managers are correct in their assumptions about stagnant US rates, a slowing global economy and no effective attempt at reflation, the outperformance that we have seen so far in 2019 could be extended. The managers' efforts to focus on quality companies should also prove beneficial in such an environment.

Figure 11: HDIV NAV total return performance versus objective



Source: Morningstar, Marten & Co

Up-to-date information on HDIV is available at the [QuotedData](https://www.quotedata.com) website

Figure 12: Total return cumulative performance over various time periods to 31 March 2019

	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)
HDIV NAV	6.9	3.5	3.8	16.6	27.9
HDIV Price	10.9	7.0	0.7	18.8	26.2
Objective	0.7	1.4	2.8	7.8	13.0

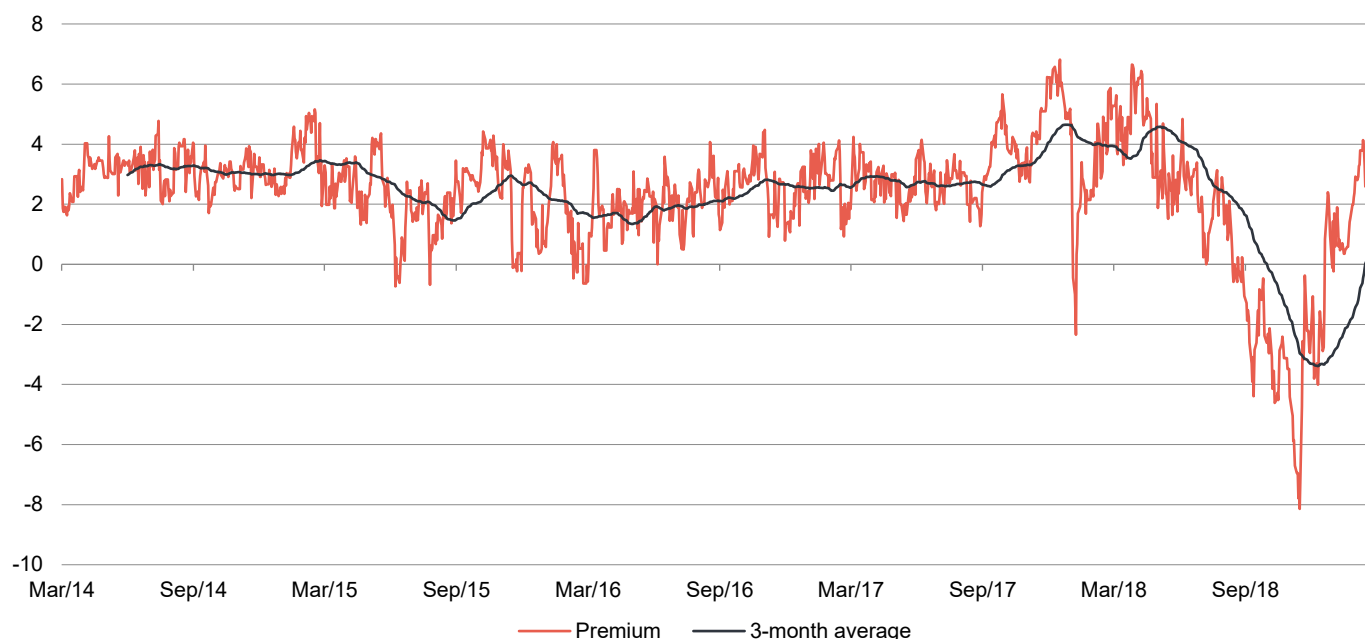
Source: Morningstar, Marten & Co

Premium/(discount)

Shareholders' authority to repurchase up to 14.99% of HDIV's then-issued share capital is taken at each AGM. Likewise, shareholders are asked at each AGM to approve the issue of new shares. Shares will only be issued at a premium to NAV.

The board does not operate a fixed discount policy, but tries to minimise the absolute level and volatility of the discount through share buybacks and share issuance where appropriate. Shares repurchased may be held in treasury and reissued. All buybacks are done at a discount to asset value, and all issuance is done at a premium.

Figure 13: HDIV premium/(discount) over five years



Source: Morningstar, Marten & Co

As Figure 13 shows, HDIV has traded at a small premium for most of the past five years. Over the past year it has moved within a range of an 8.1% discount to a 6.7% premium, averaging at a 0.9% premium. The discount that opened up around the time of the publication of the last note has been eliminated, possibly as investors came around to HDIV's managers' way of thinking and as HDIV's performance has improved.

Fund profile

Invests selectively across the full spectrum of fixed income asset classes to generate NAV returns exceeding three-month sterling LIBOR plus 2%

Henderson Diversified Income Trust (HDIV) invests selectively across the full spectrum of fixed-income asset classes, including – but not limited to – secured loans; government bonds; asset-backed securities; investment-grade corporate bonds; high-yield corporate bonds; unrated bonds; preference and selective high-yield equity shares; hybrid securities; convertible bonds; and floating-rate notes.

Its objective is to seek income and capital growth such that, on a rolling annual basis, the total return on the NAV exceeds three-month sterling LIBOR plus 2%. It has a global mandate and the managers use gearing to enhance returns. The company was redomiciled to the UK from Jersey with effect from 27 April 2017.

More information is available at the trust's website

www.hendersondiversifiedincome.com

The managers

Henderson Investment Funds Limited is HDIV's alternative investment fund manager (AIFM) and Henderson Global Investors Limited (Henderson) is the delegated investment manager. Parent company, Janus Henderson Investors, had around £258bn of AUM at the end of December 2018. The named fund managers for HDIV are John Pattullo and Jenna Barnard. They have been managing the fund since it was launched in 2007 and have been working together at Henderson since 2002. They are part of a five-strong Strategic Fixed Income team, including Nicholas Ware, who has been working closely with John and Jenna on HDIV since he joined the team in 2012. They are supported by Janus Henderson's wider fixed-income team and its seven-strong specialist secured-loan team. Responsibility for the selection of suitable secured loans is delegated to the specialist secured-loan team, led by David Millward.

Previous publications

Readers interested in further information about HDIV, such as investment process, fees, capital structure, trust life and the board, may wish to read QuotedData's annual overview note, [Winter is coming](#), published on 4 October 2018, as well as its previous update note and initiation note (details are provided in Figure 14 below). You can read the notes by clicking on them in Figure 14 or by visiting www.QuotedData.com.

Figure 14: Marten & Co. previously published notes on HDIV

Title	Note type	Date
Shift to onshore	Initiation	May 2017
Dear Prudence	Update	November 2017
Winter is coming	Annual overview	4 October 2018

Source: Marten & Co.

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