Third Quarter Report

September 2019

Capital Gearing Trust plc

CG Asset Management

General Commentary

September 2019

In 1970 Milton Friedman opined that "There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase profits so long as it stays within the rules of the game." That principle has over the 50 years since been the basis of corporate development as refined by business schools around the world. Gradually the emphasis shifted from long term profit maximisation, what Friedman meant, to something much closer to maximisation of the share price; especially in the short term. The pursuit of shareholder value has morphed into maximising the value of the share options given to the CEO. Often investors have supported the alignment of management with shareholders, possibly suggesting that they too have a short term horizon.

As a result, corporate behaviour has changed. Customers, formerly nurtured to secure sustained loyalty, are subject to obscure and variable pricing. Clients of utilities, insurance or airlines, for example, know only too well that they are dealing with an algorithm designed to persuade them to pay more than their neighbour. It does not engender goodwill. Perhaps even more importantly, a long period of paying insufficient attention to externalities, notably environmental impacts, has put corporate America in a politically defensive position. The Democratic Convention will not make comfortable viewing in the C-suit.

Another strategy has been to present accounts in a rosy light. The difference between "adjusted earnings" and GAAP earnings goes in part to explain why the prospective P/E ratios in America often look more reasonable than cyclically adjusted P/E ratios. Earnings are further exaggerated by write-offs. These are a correction of past overstatement of earnings or a promise, through lower depreciation or goodwill amortisation, of future overstatement. Investors have been trained to look through such adjustments because they are interested in the earning power of companies. For the market as a whole, though, such write-offs are recurring; they are a constant feature.

However the current cyclically high earnings are not purely an accounting mirage. They are in part a result of industry concentration; the development of oligopoly or monopoly. Regulators have been quite lax in controlling mergers designed for this purpose, even in Europe employing concepts like "national champions". About 50 large US companies account for a significant proportion of the unnaturally high share of US GDP that goes to corporate profits. But these things are cyclical. Profits were high in the early 20th Century under aggressive monopolisation by leaders who came to be known as "robber barons". The political response in breaking up these companies, most famously Standard Oil, was a result of popular revulsion.

There are reasons to believe that a similar inflection point is developing now. The narrow short termism that has led to high leverage, low investment and exploitation of customers has reached its limits. In Europe, the EU commission is pursuing abuse of monopoly, especially by tech companies. In the UK, nationalisation across broad sectors polls well. In the US, the national conversation going into next year's election is not supportive of corporates.

Interestingly, the Business Roundtable in New York that renounced the Friedman dictum in favour of corporate responsibility to employees, customers, suppliers and the community has been received with great scepticism, as offering "lip service". But those leaders were surely right. Whether by voluntary or dictated means companies over the next 20 years will reform, or be reformed; probably both.

In a free society, the share of GDP that goes to profit should always revert to a socially acceptable level. Margins in the US sit at unsustainably high levels after decades of anti competitive behaviour and a front loading mentality. It appears that the era of payback maybe about to start.

Peter Spiller

September 2019

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Fund Information as at:
30th Sept 2019

Share price:
£43.60

Investment objective

The Company's dual objectives are to preserve shareholders' real wealth and to achieve absolute total return over the medium to longer term

Fund information

Market Cap.	£446m
Dividend Yield	< 1%
OCF* (AIC)	0.7%
OCF* (PRIIPS)	1.01%
Comparator Index	RPI

*Ongoing Charge Figure

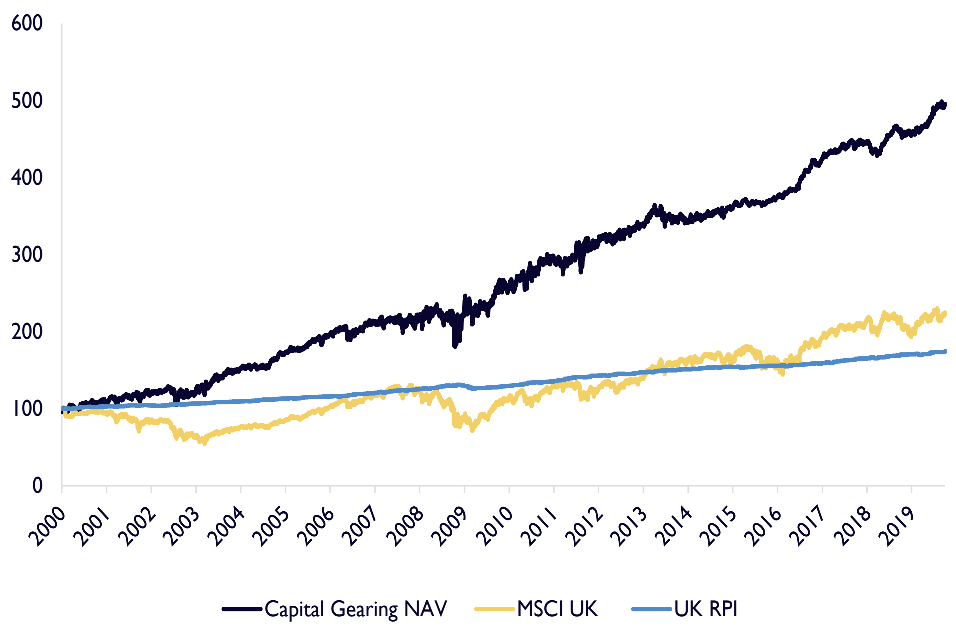
NAV return history (total returns)

1 month	-0.3%	2018	2.1%
3 month	2.7%	2017	5.0%
6 month	6.1%	2016	13.0%
Year to date	8.9%	2015	4.2%
1 year	7.1%	2014	5.2%

Largest fund/equity holdings

Ishares FTSE 100 ETF	3.7%
Vanguard FTSE Japan ETF	2.7%
Grainger	1.9%
Investor	1.8%
North Atlantic Smaller Co	1.7%

NAV performance since January 2000 (total return)



Largest bond holding

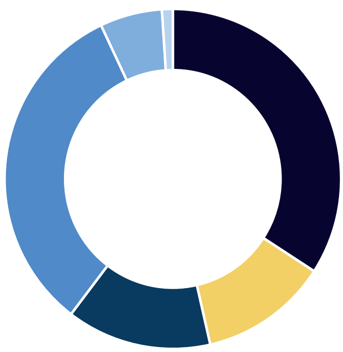
UK I/L 0.125% 22/11/19	5.9%
US I/L 2.00% 15/01/26	2.3%
US I/L 2.375% 15/01/25	1.5%
US I/L 3.875% 15/04/29	1.4%
US I/L 1.75% 15/01/28	1.3%

Currency exposure

GBP	55%
USD	30%
SEK	5%
EUR	4%
JPY	3%
Other	2%

Asset allocation

Index Linked Gov't Bonds	34%
Conventional Gov't Bonds	16%
Pref Shares / Corp Debt	13%
Funds / Equities	33%
Cash	3%
Gold	1%



Fund/equity breakdown

Equities	15%
Property	12%
Loans	3%
Infrastructure	2%
Private Equity/Hedge Fund	1%

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The aim of your Company, simply stated, is to generate long only absolute return. The "absolute return" part means that over a 12 month period it should generate a positive return, regardless of market conditions. The "long only" part means this should be achieved without using derivatives, complex strategies or short selling. Our approach has been to have a lower than average exposure to equities and seek to find assets that are negatively correlated to equities.

We have written before how bonds provide that role and shared our fears that relationship might come to an end. It is worth remembering that stocks and bonds have been positively correlated for most of recorded financial history. However the negative correlation has been a feature of the last 40 years since central banks became more active in managing demand through setting interest rates. Since we don't see any immediate change in central bank mandates, it is a reasonable assumption that this negative correlation will continue to hold.

A more challenging question is what currency to hold those bonds in. Given that the majority of our investors have sterling liabilities we would, for choice, hold UK bonds. However real yields in the UK are exceptionally poor value: 10 year linkers yield -2.7% real. Even after adjusting for differences between RPI and CPI this is exceptionally poor value when compared with a 10 year US TIPS offering +0.25% real.

There is another reason for preferring TIPS to linkers which relates more to portfolio construction than to absolute value. To illustrate this we constructed a simulated portfolio of 50% UK Equities and 50% Sterling Agg (a broad basket of sterling denominated bonds) and frequently rebalanced it. We then ran the same simulation using unhedged US TIPS in the place of the sterling bonds. The portfolio using TIPS did rather better delivering an annual return of 6.7% vs. 6.0%. This result, by itself, is not particularly interesting. Over the period sterling has depreciated and TIPS have had on average higher yields. It would be unwise to extrapolate such trends for the next 20 years. What is more interesting is the portfolio effect. We crudely calculate this by adding together the annual nominal return from owning just UK equities and just TIPS and dividing by two. Comparing this return to the simulated portfolio we can extract the return due to rebalancing. This amounted to 61 bps per annum in the case of the portfolio containing TIPS and 48 bps for the portfolio using Sterling Agg. This additional return of 13 bps per annum is not to be sniffed at, over 20 years it adds 8% points of total return.

There are two explanations for this finding. The first is that introducing currency volatility actually serves to enhance returns through the rebalancing process. The second is that such rebalancing is particularly useful from the perspective of a sterling investor in hedging against equity volatility. Sterling is, and is likely to remain, a "risk on" currency. When equity markets fall sterling tends to fall in sympathy. Therefore holding overseas bonds is particularly effective when redenominating portfolio returns into sterling.

Of course, one should not get too carried away with this result. Some of the simulated returns would be lost to trading costs in the real world (though much of that can be mitigated through rebalancing against fund inflows or outflows). Strong correlations over the last 20 years may reverse over the next. However the combination of significantly better value available in US TIPS and their potential hedging characteristics mean they continue to hold a central role in our asset allocation.

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The portfolio performed surprisingly well during the period due to a very supportive backdrop. Falling bond yields, rising equity markets, strength in gold and sterling weakness allowed all areas of the portfolio to contribute.

The performance of the risk asset portfolio was comfortably ahead of comparator indices such as the MSCI UK and the Investment Trust Index. The stand out performers were the c.2% holdings in a range of Swedish commercial property companies, including Castellum AB and Kungsleden AB. These collectively rose c.18% in the period and over 30% in the last 12 months. The c.2% holding in Investor AB, a broadly diversified Swedish holding company also performed strongly. We initiated all these Swedish holdings within the last two years after by a period of marked Kronea weakness. These companies hold a selection of very high quality property and corporate assets denominated in a currency that seems to us to be significantly undervalued. Notwithstanding these attractions their performance has been so strong that we will keep them all under careful review.

After a period of marked weakness in the second quarter, the c.2% holding of German residential property performed well. After proposed rent control legislation introduced in June our assessment is that Berlin is the most fundamentally attractive but politically risky region in Germany. A majority of the fund's residential holdings are in Vonovia SE, Grand City Properties SA and LEG Immobilien AB, with very limited Berlin exposure. These holdings made steady progress. After a period of marked weakness, we did re-initiate a position in Phoenix Spree plc, the Berlin landlord that seems to us to be best positioned in that market. That holding has performed well since purchase.

Almost all other areas of the equity portfolio made contributions, with the renewable energy and PFI infrastructure funds once again making solid gains. Conventional holdings of US and Japanese equities also performed well.

The large portfolio of US Index linked bonds (c.25% of the portfolio) delivered c.5% returns. This was a combination of currency gains and falling yields; the former driven by Brexit concerns and the latter by actual and anticipated interest rate cuts. This asset class will continue to play a central role in portfolio construction but in the short term is exposed to currency and interest rate reversals.

The corporate bond and preference share holdings delivered consistent low risk returns. Significant additional purchases were made in the bonds of Burford Capital Ltd. This is a large vehicle that finances litigation and was subject to a high profile short selling report issued by Muddy Waters' research in August. The equity and bonds sold off markedly on publication of the report. In our assessment the former was justified but the price fall in the bonds was far greater than was warranted by the analysis presented. We used the opportunity to considerably increase our position at levels we considered very attractive.

The Company continues to hold in excess of 35% of the portfolio in cash, treasury bills and short dated high quality sterling debt. In relative terms these holdings were a drag, at a time of strong gains elsewhere in the portfolio. However we value the stability and optionality of this "dry powder" highly. We look forward to a time when either the equity market or the bond market offer materially better value and will deploy this dry powder when better value emerges.

The portfolio remains highly defensive, in the short term seeking no more than to preserve the value of investor's capital after fees, taxes and inflation. If this objective can be achieved during a period of market weakness then the Company will be well positioned to deliver stronger gains in the future.

Thoughtful Investing

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