Second Quarter Report

June 2019

Capital Gearing Trust plc

CG Asset Management

General Commentary

June 2019

The travails of Neil Woodford has brought liquidity, or rather the lack of it, into focus. There are a whole range of reasons why liquidity conditions have deteriorated.

Start with equities in Europe. The evolution of regulation by the EU and the FCA in the UK has seen analytical coverage shrink markedly. Meanwhile, changes in the cost of capital as a result of enhanced risk weightings and requirements for reduced balance sheet leverage have led to market makers providing much less capital to their trading businesses. Both these effects have led to reduced trading volumes and transaction sizes. Interestingly the consequences were foreseeable and foreseen, but are now treated as unintended consequences. And this is all taking place at a time when institutional volumes have grown, both as a result of rising market capitalisations and of the long term tendency of retail money to invest indirectly in stock markets. As a result the market for smaller and, indeed, many medium size companies has ceased to be efficient in providing price discovery or liquidity. This situation creates opportunity for funds like North Atlantic Smaller Companies capable of conducting their own analysis. It also ensures that open-ended funds have to control their exposure to less liquid quoted stocks as well as unquoted. It has been observed, for instance, that wealth managers have shifted the emphasis of their property investments from open-ended to close-ended instruments. The latter will at least maintain a quote, even if at a substantial discount, in adverse conditions.

Mark Carney has told the Treasury Committee that the rise of funds promising liquidity while holding illiquid assets could create “a potential systemic issue”. “These funds are built on a lie which is that you can have daily liquidity for assets that fundamentally are not liquid”. He might be said to have some insight, because the banks supervised by the Bank of England are in the same situation; they rely on confidence that not all depositors will come for their money at the same time. Nevertheless the point is well made. The growth of liquidity transformation has been notable over the last decade, not least in the explosion of ETFs as a mechanism for holding a whole range of assets.

Of course, where those assets are freely traded in large size, such as the S&P500 or government bonds, there is not a problem. But where that is not true, the belief of investors that they can redeem their investment at any time may well be tested. In a sense, the structure of ETFs is a hybrid of closed and open-ended funds. Subscriptions and redemptions are mediated by Authorised Participants, typically banks, who subscribe or redeem units for cash or specie. In normal times that works well, although it was notable that in the second quarter withdrawals of $7.1 bn from high yield bond funds moved the credit spread by 30%, from 3.7% to 4.8%. A small $6.6 bn flow back into the funds tightened the spread back to 4.1%. There was no obvious catalyst other than these modest flows to explain the moves in prices. The system worked though. But it does raise the question of what happens when rather more substantial redemptions are made and where the APs cannot easily sell the specie they receive from the ETF. Presumably, the shares would behave like any other closed-end fund and move to a discount, whereas the open-ended funds would simply gate, with probably less liquidity. That raises two issues. First of all, investors who have believed that they can sell at any time at close to par might be frightened into more aggressive selling. Secondly, with junk bonds accounting for roughly $1.2 trillion of financing in the US, and a similar amount in leveraged loans, any prolonged period of net withdrawals would make refinancing problematic; any increase in defaults would reinforce the cycle. More than twice as much, $2.5 trillion, is in BBB rated debt. Much of that is held in funds that could have to sell if the bonds are downgraded. It is easy to envisage the Federal Reserve having to take vigorous action.

Forecasts that fixed income ETFs will double to $2 trillion in 5 years will come true only if such fears are unfounded. So liquidity may move more into much greater focus everywhere, not just in the UK. Any reversal of the expansions of liquidity transformation would tighten financial conditions in the real economy as well as move the price of financial assets.

Peter Spiller

July 2019

Capital Gearing Trust plc

Fund Information as at:

30th June 2019

Share price:

£42.40

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.	£365m
Yield	< 1%
OCF* (AIC)	0.7%
OCF* (PRIIPS)	1.01%
Benchmark	RPI

*Ongoing Charge Figure

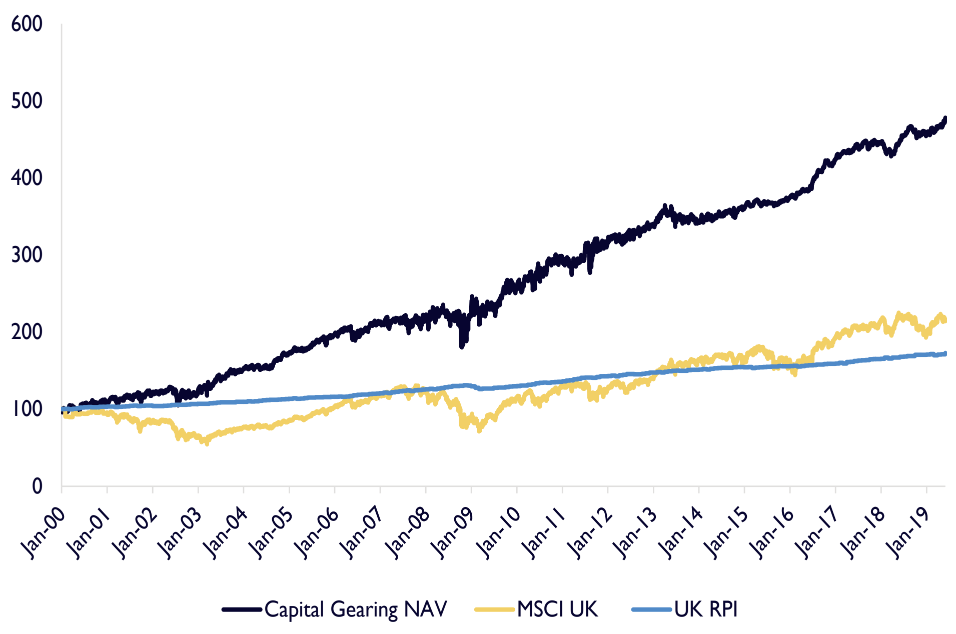
NAV return history (total returns)

1 month	0.9%	2018	2.1%
3 month	3.3%	2017	5.0%
6 month	6.0%	2016	13.0%
Year to date	6.0%	2015	4.2%
1 year	6.0%	2014	5.2%

Largest fund/equity holdings

Ishares FTSE 100 ETF	3.0%
Vanguard FTSE Japan ETF	2.5%
North Atlantic Smaller Co	2.1%
Investor	1.9%
Grainger	1.6%

NAV performance since January 2000 (total return)



Largest bond holding

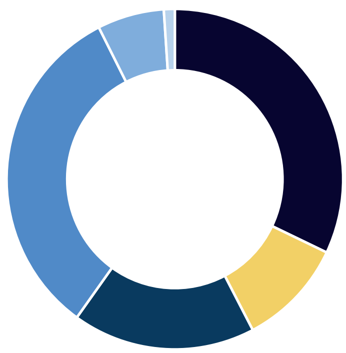
UK I/L 0.125% 22/11/19	6.3%
US I/L 2.00% 15/01/26	2.7%
US I/L 0.25% 15/01/25	2.7%
US I/L 3.875% 15/04/29	1.8%
US I/L 2.375% 15/01/25	1.7%

Currency exposure

GBP	56%
USD	29%
EUR	6%
SEK	4%
JPY	3%
Other	2%

Asset allocation

Index Linked Gov't Bonds	32%
Conventional Gov't Bonds	10%
Pref Shares / Corp Debt	18%
Funds / Equities	33%
Cash	6%
Gold	1%



Fund/equity breakdown

Equities	16%
Property	11%
Infrastructure	3%
Loans	2%
Private Equity/Hedge Fund	1%

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Goodhart's law is an adage stating that as soon as an economic measure gains prominence it ceases to be accurate. It has no theoretical underpinning but history is replete with examples of its occurrence. The cyclically adjusted price to earnings ratio (CAPE) is defined as the price of a share divided by the average of the last ten years earnings (adjusted for inflation). CAPE was popularised by Robert Shiller in two very well timed books in 2000 and 2005 and, historically, has proven to be a far more powerful valuation measure than forward PE multiples. No sooner had CAPE risen to prominence than it has apparently started to misbehave. Since Robert Shiller's original publication of Irrational Exuberance in 2000, CAPE has continuously suggested the S&P 500 is overvalued. Today CAPE sits at close to 30x a level similar to the 1929 peak, and only once meaningfully exceeded during the peak of the dot com bubble.

As the S&P 500 hits all-time highs commentators have lined up to explain how and why CAPE is a classic case of Goodhart's law in action. Many of the arguments against CAPE revolve around recent changes in the tax code, accounting standards or the functioning of the modern economy. These approaches may or may not be valid however the effects they identify are typically far too small to impact the fundamental message. When alternative variants of CAPE have been devised to adjust for the factors the arguments raise, the ratio has barely changed and the S&P still looks to be at extreme levels relative to its history.

A more powerful challenge to CAPE is that it has been materially distorted since the financial crisis due to the sheer scale of the earnings recession in 2008. It was argued that the huge losses recognised in the financial system in 2008 continued to artificially depress CAPE earnings which looks back over the last decade. There were a number of reasons that this argument seemed unlikely. Firstly the massive losses in 2008 were simply a correction massively overstated profits in the run up to the crisis. As long as CAPE earnings looked back to the period before and during the financial crisis it seemed unlikely to be materially understating earnings. Secondly, notwithstanding the historically steep earnings recession in 2008, margins rebounded rapidly to levels so high they have rarely been seen in history. In any case time has negated the need to continue this debate. The trough earnings of 2008 are no longer included in the CAPE measurement. The impact of this earnings trough falling out of CAPE earnings was negligable.

The final challenge to CAPE is that any information it provides cannot be profited from. CAPE has suggested that US equities have been consistently expensive for the last decade, during which time one of the great bull markets of all time has blossomed. This argument certainly hits home, particularly to value investors like ourselves who have all but avoided holding US equities over this period. However this line of argument confuses what information any valuation metric can ever provide to an investor. Even a brief look at the history of CAPE makes it obvious that long periods of overvaluation or undervaluation are the norm. It gives no information as to timing.

A high valuation relative to history suggests nothing more than that, over the long term returns are likely to be below the historic norm. Investing is a game of percentages, and the struggle to get rather more than half your decisions correct. All a measure like CAPE can do is assist an investor in avoiding the worst errors by making more transparent risks that valuations have diverged from historic norms.

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Your fund returned 6.0% in the six months to the end of June with every major asset class contributing positively. A wider survey of financial markets reveals a similar picture: so far this year pretty much everything has "gone up". This is an unusual state of affairs. We have previously written about the negative correlation between stocks and bonds which has been the prevailing relationship over most of the past 40 years. More surprising is that gold has also performed very strongly this year. Gold usually shines as a safe-haven and so it is rare to see gold performing well alongside equities.

How should a prudent investor rationalise this? The most benign explanation is that the shake-out of risk assets in Q4, with the subsequent dovish volte-face by the Federal Reserve, gives investors confidence that interest rates will be much lower for much longer than had previously been thought. In this view, the discount rate applied to all financial assets has fallen and the net present values of their cashflows has risen. Of course, investors as a whole aren't actually richer – the cashflows they are entitled to are just the same as they were before.

Our interpretation is rather less benign. If interest rates are to be "lower for longer" then the US economy must itself be more fragile, or its prospects dimmer, than previously thought. This weakness must eventually manifest itself in lower cash-flows from equities and eventually in lower stock prices. Indeed we can identify both the fragility and the dimmer prospects. The fragility is found in corporate debt whose outstanding stock has risen by 65% since 2010; meanwhile, over the same period, profits rose by only 29%. The dimmer prospects relate to the historical observation that real earnings growth has lagged real GDP growth over time. Furthermore, trend GDP growth is expected to be much lower in the future than in the past. Neither of these considerations are reflected in today's high P/E multiples.

With prices higher on unchanged cashflows, prospective returns have dropped. Investors can lock in some of those gains by selling assets and parking the proceeds in short dated treasury bills – this is the approach your fund has taken. Cash and treasury bills increased from 16% at the beginning of the quarter to 22% at the end. This is not an investment in which we take much pleasure. But we must remind ourselves to invest in the world as we find it, not as we wish it would be.

During the quarter one investment performed particularly poorly, this was the fund's holdings in German residential property which fell after a draft law was proposed in the Berlin state government to put a freeze on rent increases. Prior to its announcement, the fund had trimmed its exposure to the sector due to our rising concerns about political interference. With hindsight we should have done more. We continue to think these assets offer great long term potential but the risks have clearly risen and so the position has been resized accordingly. The misstep cost the fund c. 40bps in the quarter. This loss, as managers and investors, we feel keenly. However the year to date performance for the German resi remains positive and the long term performance since the fund initiated the position has been exceptional.

On a more positive note Ranger Direct Lending ZDP matured profitably in June. Due to the extremely aggressive approach taken by the board of Ranger Direct Lending plc (RDL) towards ZDP holders, CGAM co -lead an investor coalition and engaged legal advisors to robustly represent our position. RDL ultimately accepted our position and paid our legal costs resulting in a profitable exit for the fund.

Thoughtful Investing

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