Second Quarter Report

June 2021

Capital Gearing Trust plc

CG Asset Management

General Commentary

June 2021

In the 1970's, unlucky Federal Reserve staffers had to inform the Chairman Arthur Burns of each month's CPI increase. When asked why the numbers were so bad, they would respond that, as it might be, bananas had doubled in price. Burns would shout "take them out of the index". By the end of his time in office, 65% of the index had been thus removed. There sometimes are echoes of that approach in the assertion that the current surge in inflation is 'transitory'.

And it is certainly correct that the make up of the recent rise in CPI in the US in particular is narrow. Most of the large increases have been in durable goods, notably in cars, and energy. But the converse is also true, sectors like healthcare and education have been weak, suggesting that they also are subject to mean reversion. More importantly "owners' equivalent rent" at a 2.3% y-o-y increase contrasts with a rise in median house prices of 23% over the period. With a weighting of 24%, that looks like a pent-up boost for the CPI.

Part of the background to the rapid increase in the price of goods and indeed commodities in recent months has been the shift in spending in both the US and the UK away from services towards durable goods and that will be reversed as economies normalise. So the demand side will reduce quite soon. On the supply side, the timescale for response varies. Lumber in the US has already come full circle and semi-conductors may see a better balance within a year. New mines, by contrast, can take a number of years and face significant ESG hurdles.

Nevertheless, it does seem likely that as base effects wither and some 're-opening' inflation, such as used cars, is partially reversed, that the CPI will reduce in the autumn and is pretty well certain to be lower than the 5% recorded for May. Much depends on the extent to which the $5trillion of excess savings in consumer accounts gets spent.

More significant for the longer term is the extent to which wages rise in response to both an improving economy and higher prices. Companies like Unilever have tolerated margin pressure as a result of higher commodity costs because they feel unable to raise prices; that makes them resistant to wage hikes. But it can also change if inflation expectations

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change. Certainly, the conditions that in the past have signaled wage inflation are flashing at least amber. The 'quit' rate in the US is at record levels. The output gap, in the view of the Congressional Budget Office will move positive by the end of this year and by this measure the economy will be running at a level as hot as it gets by the 3rd Quarter of next year. And that would take into account the returning workers as unemployment subsidies come to an end.

In the UK, the output gap is larger, but the distortions in the labour market caused by Brexit are profound and the political pressures on public sector wages are powerful. All in all, wages will be rising in both countries.

The Federal Reserve persists in regarding the current increase in the CPI as 'transitory' partly because they believe it and partly because they wish to 'frame' wage negotiations. The surprise is the extent to which the market has accepted the forecast. In a world where economists cannot forecast the change in the CPI for the month just past within 0.5%, it seems foolish to assess the coming months and years with any precision. Given the asymmetric monetary policy response and the fiscal stimulus, combined with a less favourable demographic and globalisation background, the range of outcomes is quite large. But the markets assessments, as expressed by breakevens, looks like the bottom of the range. It seems more likely to us that any Autumn disinflation will prove transitory and that elevated inflation is here to stay.

Peter Spiller

June 2021

CGAM

Capital Gearing Trust plc

Fund Information as at:

30th June 2021

Share price:

£48.75

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.	£751m
Dividend Yield	< 1%
OCF*	0.61%
OCF* (PRIIPS)	0.94%
Comparator Index	RPI

*Ongoing Charge Figure

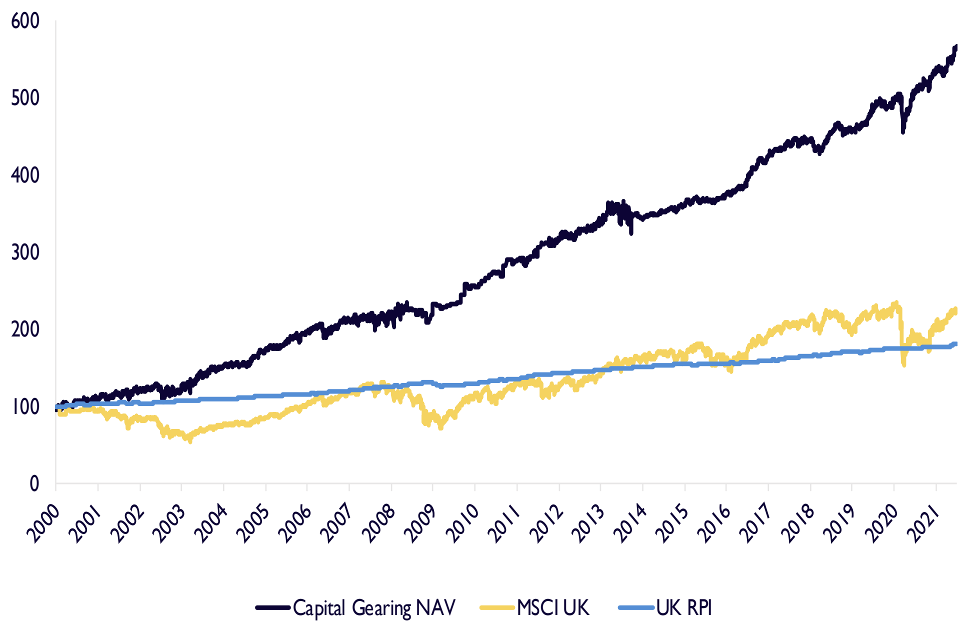
NAV return history (total returns)

1 month	2.4%	2020	8.3%
3 month	5.6%	2019	8.6%
6 month	5.7%	2018	2.1%
Year to date	5.7%	2017	5.0%
1 year	11.4%	2016	13.0%

Largest fund/equity holdings

Vanguard FTSE Japan ETF	4.8%
Vonovia	2.7%
Vanguard FTSE 100 ETF	2.4%
North Atlantic Smaller Co's	2.2%
Grainger	2.0%

NAV performance since January 2000 (total return)



Largest bond holdings

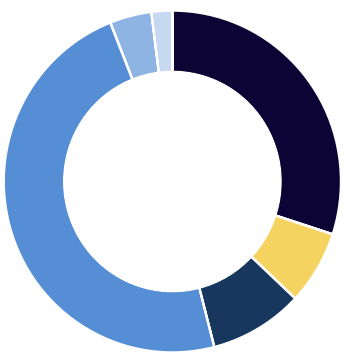
UK I/L 0.125% 22/03/24	3.2%
US I/L 1.375% 15/02/44	1.4%
US I/L 0.75% 15/02/45	1.4%
JP I/L 0.10% 10/03/29	1.4%
UK I/L 0.00% 02/08/21	1.4%

Currency exposure

GBP	52%
USD	27%
SEK	4%
EUR	7%
JPY	8%
Other	2%

Asset allocation

Index Linked Gov't Bonds	30%
Conventional Gov't Bonds	10%
Pref Shares / Corp Debt	7%
Funds / Equities	45%
Cash	6%
Gold	2%



Fund/equity breakdown

Equities	18%
Property	19%
Loans	5%
Infrastructure	2%

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Your Company had a good quarter delivering returns of 5.6% with positive returns from all asset classes, and particularly strong performance from risk assets of 7.8%. After a tough Q1, index linked- bonds performed much better returning 3.5%.

There is a natural cadence or rhythm to your Company's investment style. Sometimes, our efforts go into sowing investment seeds in the anticipation of future returns. At other times our energy is expended harvesting earlier work. Though the rhythm may not have the regularity of the seasons it is just as pronounced. At present your Company is in harvesting mode. There are two crops which are coming to maturity. The first are investment trust special situations, many of which were purchased shortly after the coronavirus pandemic. The second crop is the Company's holdings in property companies. While equity markets bounced sharply in April 2020, property companies languished and provided more extensive opportunities to buy on good terms. In investment terms these latter opportunities were more mundane: cheap assets which we judged unloved by the market. Nevertheless, they have provided wonderful nourishment: our property holdings returned 9% in the last quarter alone.

Among the investment trust "crop" Weiss Korea is a perfect example of a situation that the Company exploits: an attractive asset class, a high quality board & manager and a structural unwind of a discount (thanks to periodic tenders for shares at NAV). Weiss Korea invests in preference shares of Korean companies. To Anglo-Saxon ears this is something of a misnomer: Korean preferreds usually rank pari passu with the ordinary equity, occasionally with enhanced dividend rights and often with fewer voting rights. But they typically trade at steep discounts to their common equity cousins. We were able to purchase shares in the trust on mid-single digit discounts in October and November 2020 and participated in the tender this June. Our ownership coincided with outstanding underlying NAV performance. Returns on those purchases were 45% return over 9 months. During the quarter a number of similar situations matured, with similar results: Miton UK Micro Cap (83% return over c. 12 months); Diverse Income Trust (38% over 9-12 months); River & Mercantile Micro cap (60% return over c. 6 months).

During the quarter a large position was exited as a result of active engagement with the board. A trust came to market recently with a prospectus stating that its shares would trade close to its NAV. We built a material position in the trust at discounts of around 15% to NAV. We engaged with the board, encouraging them to honour their promises. This they did and we were able to exit the trust at a 5% discount. This was a very satisfactory result for our investors as well as the trust's other shareholders, since that narrower discount persists today.

Shortly after the end of the quarter Gabelli Value Plus+ was put into liquidation, after an extensive campaign by us and fellow shareholders. We initiated the position in May 2020 and finished adding in June this year. The overall return has been 42% so far, with further to come as the trust is liquidated. Finally, GCP Student Living received a takeover bid on 5 July at a 32% increase in price to the quarter end and 65% over the Company's average purchase price.

As we harvest these opportunities the Company's cash levels have risen and exposure to risk assets has fallen while we await the turning of the investment seasons..

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"Life can only be understood backwards, but it must be lived forward" Soren Kierkegaard, 1843.

Kierkegaard is widely considered the first philosopher of the existential school, whose writings have had a huge influence on both philosophy and psychology [1]. Few quotes could sum up the challenges of the human condition as pithily; it could certainly be paraphrased to sum up the challenges of investing.

This Company's open ended sister fund, the Absolute Return Fund's, recently celebrated its 5th birthday. This landmark caused us to reflect on performance over the last 5 years, a frantic period including Brexit and Covid. Over that timescale this Company has delivered a steady annualised NAV total return of 7.5%, suffering a maximum drawdown of 4% [2]. This compares favourably to the MSCI UK All Cap which has returned 6.6% annualised with a maximum drawdown of 25%. Pleasingly this Company also outperformed those conservatively managed, derivative free (or lite) multi-asset funds that we consider to be our peers. "Understood backwards" the Company has thrived over the past 5 years.

The strong risk adjusted performance can be framed as three good decisions that have fortunately, more than offset a substantial error. On the positive side of the ledger our bond portfolio has comfortably outperformed the sterling aggregate bond index, delivering higher returns with lower volatility. Critically it did so with a high negative correlation to our equity portfolio, resulting in the smooth profile of returns the Company has delivered. The substantial focus on US TIPS has been key to this dynamic. Also helpful has been our tactical allocation to risk assets which were reduced during 2019 and then substantially increased during the Covid crisis. It is always helpful to own more equities on the way up the escalator than on the way down in the lift! Finally our stock selection has been strong, with each sub segment of the risk asset portfolio outperforming its relative index. This has allowed the Company to focus on defensive low beta equities, such as property and infrastructure, whilst not sacrificing returns.

Our substantial error, the Company's original sin, has been a huge underweight to the US equity market. Valuations of US equities looked stretched to us in June 2016. Since that time the S&P 500 has doubled, hugely outperforming global ex US equity markets. We grossly underestimated the capacity of the FAANGS+ to defend and enhance their monopolies and to exploit a global profit pool. What have we learned from our error? Not much! Like true stubborn 5 year olds your managers are digging their heels in. We continue to place value on deeply unfashionable fundamental valuation metrics, such as cyclically adjusted PE and the price to sales ratio. In the US these metrics have expanded from elevated levels in 2016 to the highest levels ever seen (CAPE c.40x, price to sales c.3.2x). Our focus will remain on value markets such as the UK, which has been a terrible recent performer but as a result appears to be far more sensibly valued (CAPE 13.5x, price to sales 1.4x).

The Company faces the future with a defensively positioned portfolio, focused on inflation protected cash flows and an unfashionable preference for value equity markets. Our cash balances have been building as certain special situations have matured (as summarised earlier in this report) and we will wait patiently for the opportunity to redeploy this dry powder on more attractive terms at some point in the future. Thank you for your support over the last 5 years in building this Company into what it is today,

1 Sadly, my first introduction to existentialism was not Kierkegaard but a work of drama by Jean-Paul Sartre, an experience that still fills me with, well, existential dread.

2 For those that like these sort of things, a Sharpe ratio of 1.4

Thoughtful Investing

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