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Third Quarter Report

September 2021

- **Capital Gearing Trust**

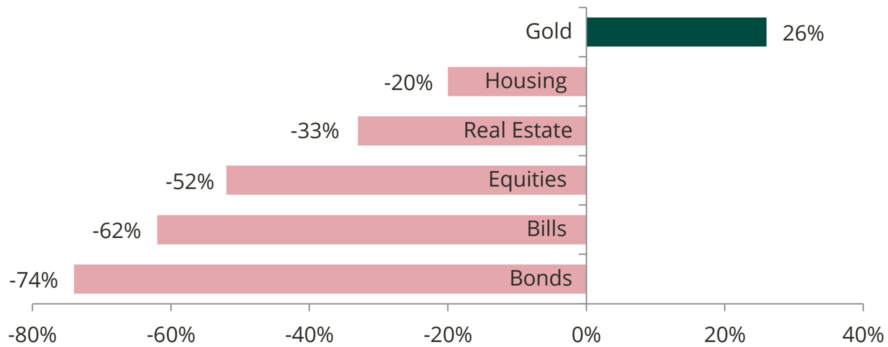
General Commentary

September 2021

Dimson & Marsh's rather dismal statistics (see chart below) on the historic returns in a large number of markets over 111 years suggest that elevated inflation is unhelpful to the prospective returns in almost all asset classes. That includes so-called hard assets which are often represented as a place to hide. Why is it that the impact of inflation is so negative?

The first and most important reason is that nominal interest rates rise. Take UK house prices, among the most resilient of asset classes. Currently the average house price is a little over 8x average earnings. At existing mortgage rates that is sustainable, with first time buyers in March 2021 paying about 1/3 of their net income in mortgage payments; with a 2-year fixed rate at 1.56%, at 90% LTV. Since then the rate has actually fallen to 1.20% which explains why prices continue to be so buoyant even in the face of subsidy withdrawals. If inflation rises and the Bank of England is forced to raise rates, then affordability deteriorates pretty fast. Even doubling the 2-year fixed rate to 2.4%, hardly a high rate historically, puts a significant pressure on household finances. So even if real interest rates fall, the equilibrium price for housing also falls, possibly even in nominal terms if both inflation and nominal rates rise.

Regression of annual real return vs. same year inflation 1900-2011 [1]



One characteristic of that process that has broader significance is that liabilities of the same maturity have shorter duration if the interest rate rises. So, a borrower at a 10% coupon when inflation is 10% can be thought of as paying no real interest rate but having to repay 10% of the capital value of the loan each year over on a long-term loan. The shortening of duration, as inflation rises, increases re-financing risk and increases the fragility of highly indebted markets, including equities.

Perhaps more relevant to equities is the tendency of both corporate managers and investors to think in nominal rather real terms. Famously, Warren Buffett asserted that in the inflation of the 1970's the (nominal) return on equity did not rise.[2] Subsequent studies suggest that that was an exaggeration, but ROE's did not rise by enough to compensate for the higher inflation. Equally, investors tended in the 1970's to discount future earnings at the high nominal rates rather than low real rates. I can recall discussions 30 years ago as to whether a quality stock was overpriced at 8 times after tax earnings.

[1] Credit Suisse Global Investment Returns Yearbook 2012, Dimson and Marsh

[2] http://www.valueinvesting.de/warren-buffett-on-inflation/

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Part of the reason for those low valuations was the uncertainty that came with inflation; uncertainty as to future levels of inflation, uncertainty over political strains from the unfortunate distributional effects of inflation; and uncertainty over the timing and extent of the monetary and fiscal austerity that would eventually be needed to control it.

This is all on top of the impact on inflation on the effective rate of corporate rax. The most dramatic example was in the UK in 1973 and 1974, when FIFO accounting meant that manufacturing companies were paying tax on the sale of goods where most or sometimes all of the profit was an inventory gain; the squeeze on cash flow was devastating and only a switch in one of several budgets in 1974 that moved tax on to LIFO basis avoided large scale bankruptcies. After such a long period of negative inflation, it seems likely that many such traps will be revealed as inflation grows.

Dimson & Marsh's categories are of course very broad. Commercial offices are not like residential flats. Indeed, office rents where we are in the City have not materially moved in 30 years. Residential rents have more than kept pace with inflation. So, we hope that we can find strong inflation-proofed streams of income in specialised real estate and infrastructure that will perform relatively well. Careful assessments of the capital value put on those cash flows will be essential.

Of course, the one asset class that was differentiated was gold. TIPS did not exist, but we would be comfortable that they too would outperformed and indeed expect the financial repression that is likely will produce further capital gains in real terms. Gold has a role, but for us a comparatively minor one, given the elevated starting price. But overall, it will take some luck as well as sound analysis to produce positive real returns for investors if indeed inflation does accelerate over the next few years. Dimson & Marsh's chart illustrates the challenge.

Peter Spiller

October 2021

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The scale of issuance in the Investment Companies sector has been something to behold. We stopped counting the number of secondary placings in the quarter as it moved into double digits but the result was £4.2bn of new capital raised. Year to date there has been £11bn raised which has helped to grow the total net assets of the sector to £247bn. In all likelihood 2021 will be the second largest year ever for issuance by Investment Companies, after only 2006. That is not an altogether comforting fact given 2006 proved to be an extremely poor investment vintage.

One notable feature of issuance in 2006 was that it was dominated by IPOs in temporarily hot asset classes that then went on to disappoint. There have been eight investment company IPOs so far in 2021 (and there are more in the pipeline) and they include specialist private equity funds respectively investing in space, hydrogen and specialist segments of shipping. In each case these companies have gone straight to double digit premia often without the companies having invested a single penny. It is possible that pursuing topical sectors will prove fruitful but there is more than a whiff of speculation in the air. Some of the capital raised might be considered the transatlantic cousin of Special Purpose Acquisition Vehicles ("SPACS") so popular in the US. If so the results are likely to be mixed.

Whilst undoubtably there are similarities between current and historic periods of exuberant issuance, it is also worth emphasising the differences. Importantly the Investment Companies sector is more than three times the size it was in 2006. In that year the £15bn of capital raised expanded the sector by a blistering 20%. Issuance in 2021 is likely to increase the sector by a more reasonable 6%. Of the issuance this year almost 90% has been secondary issuance by existing companies with well established track records. In 2006 it was the inverse with almost 90% of new issuance coming in the form of new IPOs in hot asset classes.

These distinctions might be important, as somewhat to our surprise we have found ourselves being reasonably active during this period of secondary issuance. We have used it as an opportunity to marginally rebalance away from property towards infrastructure. Both of these sectors do have similarities in risk profile due to their asset backing and long dated inflation protected cash flows. So why the switch? Property, which represents 20% of the portfolio has enjoyed a dramatic re-rating over the last 12 months. In many cases this has resulted in our holdings moving from significant discounts to premia. We have taken profits in many holdings and three property companies have been subject to bids, so these positions will be fully realised.

In contrast infrastructure has had rather a lackluster 12 months and has been de-rated significantly since 2019 notwithstanding a solid performance over the Covid crisis. Of course part of the reason these infrastructure companies do not trade on higher ratings is precisely due to their frequent issuance activities. Even with this caveat the opportunity to establish or build positions at close to NAV makes sense in an increasingly inflationary environment. During the period the fund took secondary placings in, amongst others, International Public Private Partnerships ltd, Digital 9 Infrastructure plc, Gore Street Energy Storage plc and the Renewables Infrastructure Group ltd.

We frequently write about index-linked bonds, equities and alternatives in these quarterly reports. Our allocation to corporate credit gets rather less attention, with good reason. Government bond yields are low and credit spreads are tight. In addition our concerns with inflation means that, we see no general attractions in investing in corporate credit as an asset class.

In recent years we have been content to purchase short dated, high quality liquid credit to provide a pick-up to short dated nominal gilts within our "dry powder" bucket. Today, the extreme monetary policy interventions of central banks have created such desperation for income that spreads on liquid, high quality paper have fallen to nugatory levels.

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While this letter was being written an offer arrived to purchase 10 month IBM paper at a heady spread of 15 bps over gilts, 50 bps annualised all-in. If those are the rules of the game then – for the time being, at least – we elect not to play.

In our assessment, credit markets have a characteristic analagous to the "impossible trilemma" of the FX market.[1] You can have quality, yield or liquidity. But you can't get all three at the same time. We are never prepared to sacrifice quality[2] and, in the current environment, liquid names have limited appeal. That leaves illiquidity as a source of excess return. The majority of our dry powder comprises cash, treasury bills and short dated UK index-linked which are all pristine and highly liquid. We are therefore prepared to tolerate some illiquidity in our corporate credit provided that: i) we sufficiently compensated with spread and ii) the bond meets our quality criteria.

A favourite hunting ground in recent years has been short dated index-linked corporate bonds. One such bond redeemed shortly after the quarter end, the National Grid 1.25% 06/10/21. We mourn its loss. We love all our investments but feel redemptions especially keenly where we struggle to replace them on similar terms. We were able to purchase this over the last 18 months on spreads between 250 and 450 bps over the reference gilt. That compares with spreads of less than 50 bps for similar duration nominal paper by the same issuer. Over the same period, we were able to buy index linked paper by less well-known issuers – though of similar quality to National Grid – on even better terms. Sadly, most of our remaining holdings of these kind are approaching redemption.

In the past, the closing of one credit niche presaged the opening of another; over the years our multi-asset funds have cycled first from Zero Dividend Preference shares, to bonds issued by property companies and then to corporate linkers. Today it is not obvious where the fund will find attractive credit exposure. The privilege of running a multi-asset fund is that we are not compelled to allocate to sectors where we do not see value. Today we are turning our attention to other areas: long lease property has many of the characteristics of credit, though with far higher yields. We are also happy to do nothing: allowing our holdings to redeem and park the resulting cash in treasury bills. If we are patient better opportunities will present themselves.

We content ourselves with the fact that, even in this yield starved world, our corporate bonds returned 6.5% over the last 12 months and 1.8% in the last quarter. Given their low weighting their contribution to the fund's overall return of 8.9% and 3.1% (over the same time periods) was modest but nevertheless satisfactory.

[1] "The impossible trilemma" holds that a country cannot have all three of: i) a fixed exchange rate, ii) free movement of capital; iii) independent monetary policy.

[2] We do purchase junk bonds from time to time but we class them as risk assets and they have to compete directly with equities in terms of prospective returns to form part of the portfolio.

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Fund information as at:

30th September 2021

Share prices:

£50.30

Status:

Open

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.	£863m
Dividend Yield	< 1%
OCF*	0.58%
OCF (PRIIPS)	0.90%
Comparator Index	RPI

*Ongoing Charge Figure

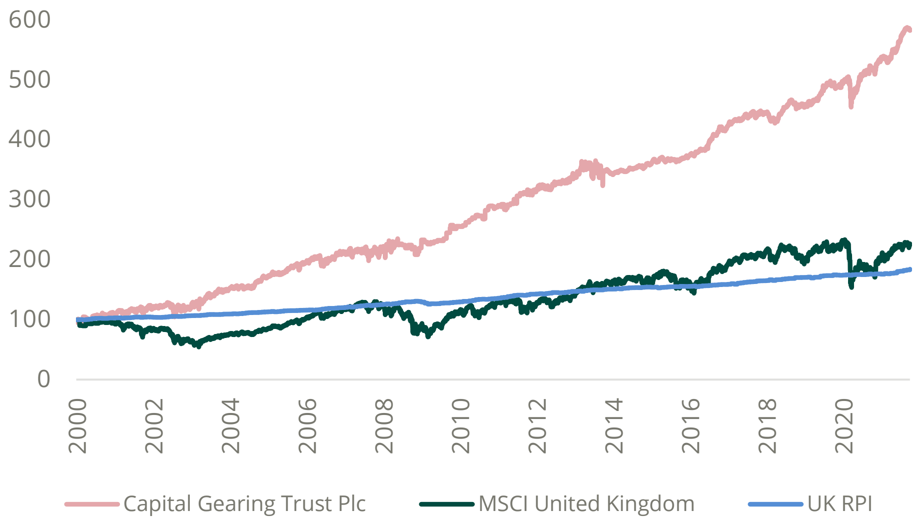
Return history (total returns)

1 month	-0.7%	2020	8.3%
3 months	3.1%	2019	8.6%
6 months	8.9%	2018	2.1%
Year to date	8.9%	2017	5.1%
1 year	12.6%	2016	13.0%

Largest fund/equity holdings

Ishares MSCI JP ESG Screened ETF	4.6%
Grainger	2.2%
North Atlantic Smaller Co	2.1%
Vonovia	2.0%
Secure Income	2.0%

Performance since January 2000 (total return)



Largest bond holdings

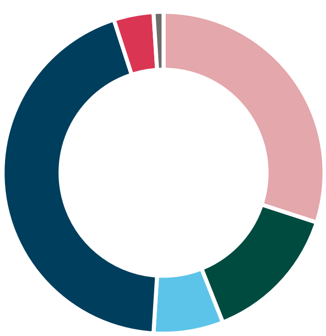
UK I/L 0.125% 22/03/24	3.8%
US I/L 0.125% 15/04/26	1.4%
JP I/L 0.10% 10/03/29	1.3%
US I/L 1.375% 15/02/44	1.3%
US I/L 0.75% 15/02/45	1.3%

Currency exposure

GBP	54%
USD	26%
SEK	4%
EUR	7%
JPY	8%
Other	2%

Asset allocation

Index Linked Gov't Bonds	30%
Conventional Gov't Bonds	14%
Pref Shares / Corp Debt	7%
Funds / Equities	44%
Cash	4%
Gold	1%



Fund/equity breakdown

Equities	18%
Property	17%
Loans	4%
Infrastructure	5%
Private Equity / Hedge	1%

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