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The only way is up

A short history of Capital Gearing Trust

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Introduction

In 2022 Capital Gearing Trust celebrates the 40th anniversary of Peter Spiller's appointment as manager of its investment portfolio. He is the longest serving manager of any investment trust listed in London and the fund manager with the strongest and most consistent track record over the last forty years. Remarkably, the trust under his stewardship has experienced only one down year in four decades (and that was a decline of just 2%).

Over those 40 years shareholders in Capital Gearing Trust have seen the value of a share grow from 21.25p to 5140p[1]. This is equivalent to a compound annualised return of 15.1% per annum[2]. Anyone who invested £10,000 in its shares in April 1982 would today have an investment worth around £2.78 million[2]. This is comfortably ahead of the world stock market index and the rate of inflation over the whole period.

The performance is a particularly impressive record because those years have included numerous crises and market crashes, including the stock market crash of 1987, the ERM crisis of the early 1990s, the Internet bubble of 1999-2000, the global financial crisis of 2008, the Eurozone's near collapse in 2013 and of course the Covid pandemic of 2020. Capital Gearing Trust has comfortably weathered all these storms.

Although its strategy has evolved over the years towards a much more defensive approach than in its early years, the trust today has consistently succeeded in preserving capital through bad times and beating inflation comfortably over the medium to longer term. It owes its success to a combination of astute asset allocation, careful stock selection and prudent risk management.

In the next few pages I tell the story of Capital Gearing Trust from its modest origins as a small family-controlled Belfast investment fund to today's successful FTSE 250 company, now capitalised at £1.1 billion and a popular home for knowledgeable investors, private and professional alike.

As a shareholder myself for many years, while noting that any fund is only as good as its future performance, I count the day that I discovered this one's existence and bought some shares among my smartest investment decisions.

Its consistent performance has been a welcome beacon of stability in a fast changing and volatile world.

Jonathan Davis
May 2022

[1] From 6th April 1982 to 30th Mar 2022. [2] Share price total return, dividends reinvested. Source: Morningstar

Origins

Small beginnings

The investment trust that Peter Spiller took on running in 1982 was different to the great majority of other investment trusts that were in being at that time. 40 years ago the trust was still an obscure family investment fund, headquartered in Belfast. Its net assets were less than £1 million. Today it has grown in size to more than £1.1 billion, driven by growing awareness of its distinctive approach and exceptional investment performance.

Capital Gearing Trust was incorporated in Belfast in 1963 and listed on the London stock exchange in 1973. It remained for many years a closely held investment vehicle, primarily designed to manage the capital of members, friends and business associates of a prominent Northern Ireland family. The driving force behind its formation was Major Cecil Harding, an Ulsterman who worked for a London stockbroking firm after service in the Second World War. His brother, Lt Colonel Christopher Harding MC, acted as company secretary.

A distinctive approach

From early on the trust had two distinctive characteristics that in time, although not before a near-death experience in the 1970s, proved to be extremely well suited to the more favourable investment environment that emerged in the 1980s. One was its policy of investing only in a portfolio of other investment trusts, which in those days were mostly still little known or understood outside professional City circles.

The second was to amplify the potential returns from this specialist portfolio with an unusual but inspired approach to 'gearing up' the balance sheet, using borrowing to deliver even higher returns than those generated by its core investments. The name of the trust, Capital Gearing, faithfully reflected this strategy of using a variety of types of leverage to boost the returns of its holdings of investment trust shares.

Unusually geared

The primary mechanism by which this gearing was achieved involved borrowing against the future value of a series of endowment policies written on the lives of more than 400 younger employees of Capel Cure Myers, Capital Gearing's brokers. Unusually - "incredibly" by modern standards, says Spiller - the insurance company which issued the mortgages, was happy to advance the loans not against the current values of the policies, but rather against the much higher projected final values when they matured decades later.

In total Capital Gearing Trust borrowed £680,000 in the form of eight mortgages with maturity dates ranging from 1986 to 1998. The mortgages required fixed interest payments of between 6% and 11.5% per annum, depending on the term. The beauty of the arrangement was that as long as the returns from the investments exceeded the premium payments, the gearing would continue to enhance the value of the portfolio, while any terminal bonuses from the policies when they eventually matured would provide additional capital gains.

A double-edged sword

Gearing of this kind works both ways and in the wrong hands or at the wrong time can be the prelude to disaster. During the oil price crisis and stock market rout of the 1970s (before Peter Spiller was involved in running the portfolio) the asset value of Capital Gearing Trust took a nasty beating in just this way. At one point its liabilities exceeded its assets and the trust only managed to scrape through and survive by the skin of its teeth.

It was not until 1981 that the income from the investment portfolio finally exceeded the interest payments on its debt, enabling the trust to declare its first dividend. The following year it was the turn of the 33-year-old Peter Spiller to take the reins managing the portfolio full time. This proved to be the catalyst for the fortunes of the trust to take off and laid the foundations of the company we know today.

Troubled times

The 1980s were still troubled times in Northern Ireland, with sectarian violence always a threat. Travelling to the company's AGM in Belfast one year Peter Spiller recalls walking right past the offices where the meeting was to be held, failing to recognise it thanks to the devastation from a car bomb that had exploded in the street.

The coming man

In 1982 Peter Spiller had been working in the City for 12 years and was a director of the stockbroking broking firm Capel Cure Myers, whose clients made up an important percentage of the share register of Capital Gearing Trust in its early days. He was appointed a director of the trust in 1986.

> “From incorporation the performance of the company has reflected the policy of applying high gearing on shareholders’ capital resulting in the net asset value of Capital Gearing Trust shares rising or falling to a much greater extent than the change in value of our portfolio of investment trust shares”.

MAJOR CECIL HARDING, JUNE 1986

Early years

Ideal markets

By the time Peter Spiller began managing the portfolio in 1982, the prospects for the trust were considerably brighter than in the dark days of the 1970s. With the benefit of hindsight, there has rarely been a better year to start running an equity portfolio. Investors' confidence was at rock bottom and that was reflected in almost unprecedented low market valuations.

Interest rates, while very high by today's standards, were starting to decline while stock markets, after years of economic crisis and high taxation, were very cheap by historical standards - an ideal combination for a highly geared vehicle such as Capital Gearing.

The abolition of exchange controls, the market-friendly reforms of Ronald Reagan and Margaret Thatcher, coupled with the Federal Reserve's determination to root out the inflation that had destroyed so much wealth in the 1970s, helped produce more than a decade of annual double digit investment returns.

Those with the courage to recognise - and the skill to exploit - these conditions, as Capital Gearing was, performed even better.

Spectacular returns

Over the next 16 years from 1992 to 1998, the trust was able to enjoy quite spectacular returns, averaging 20%-30% per annum in many years. Both equities and bonds rose handsomely in value at the same time.

In the niche area of investment trusts, Peter Spiller's speciality, negative sentiment towards anything that was geared meant that scores of investment trust shares, particularly their capital shares, remained unloved and traded at very large discounts to their net asset values.

As early as 1988, a press article noted that Capital Gearing Trust was comfortably the best performing investment trust of all those listed on the London market, with gains of more than 1,250% over seven years, more than double the performance of every other comparable trust[3].

Having the tailwind of its unorthodox gearing gave the trust what Spiller describes "an almost unfair advantage" over its peer group.

In addition, although the trust was small, there were few sellers and a handful of favourable press articles meant that even tiny orders from individual shareholders would push the share price of Capital Gearing itself to a persistent premium, where the shares remained throughout this period.

The trust's performance was so good that even those paying a premium could still do well: one early investor paid more than a 250% premium to the net assets per share and would still have beaten the UK index if a shareholder today

Specialist expertise

Unlike most companies today, investment trusts in the 1980s and 1990s commonly issued several classes of share. Each type had different rights attached to them and offered a fertile source of profit for anyone with the specialist knowledge to analyse and value them effectively.

The three main types were capital shares, income shares and zero dividend preference shares.

From an early stage in his career Peter Spiller had taken a keen interest in all three, looking for pricing anomalies and arbitrage opportunities, and recognising the potential for outsized capital gains. In the 1980s, before the widespread adoption of computers, no brokers did this kind of work, and only a handful of professional investors felt it worthwhile to carry out the analysis that was needed by hand.

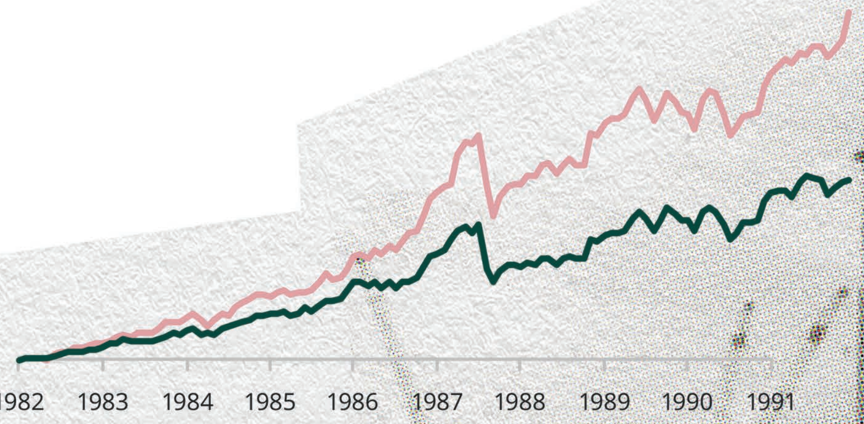
The rewards though could be substantial. Some capital shares were so illiquid and ignored that Spiller calculated you could make a big return even if the net asset value fell by 5% every year till maturity. When combined with the trust's gearing, such forays into niche situations contributed significantly to the exceptional returns.

Ulster triumph

Capital Gearing's remarkable returns were so impressive that for a while the company ranked as Northern Ireland's fastest growing business, prompting a visit from a bemused official at the Northern Ireland Development Office, anxious to find out more whether this unknown homegrown success story with no employees could help promote the province's economy.

[3] The Observer, 20th November 1988

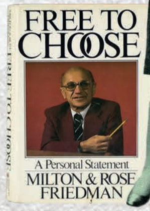
Early years



Close escape

In one of the more bizarre episodes in its history, in 1985 Capital Gearing received - but sensibly rejected - a bid approach from a notorious share ramping firm called Harvard Securities. Its high pressure sales tactics lost its targets thousands of pounds and it went out of business just three years later after an investigation by the Department of Trade and Industry. In 2011 its founder Tomas Wilmot and his two sons were jailed for a combined 19 years for a similar fraud.

> **"Belfast, that troubled City, is the home of Capital Gearing Investment Trust. In this case small is beautiful as the company has been delivering an astonishingly profitable performance for its shareholders".**
>
> EVENING STANDARD JUNE 1989



CAZENOVE
CAPITAL MANAGEMENT

A time for change

A new direction

After the exceptional returns that the trust enjoyed in the long bull market that began in the 1980s, the mid to late 1990s marked an important turning point in the continued development of Capital Gearing Trust. A number of different factors combined to set the trust on a new course and, despite shifting to a less highly geared approach, sow the seeds for the rapid growth in size and popularity that it enjoys today.

The first change was that the last of the mortgages which had provided the trust's main source of gearing in the early years matured in 1998 and the principal repaid. As the board had promised for many years, shareholders were given the opportunity to sell their shares at a small discount to the net asset value in a placing organised by Cazenove. After the exceptional performance of the trust over the previous 16 years, only a small minority of shareholders opted to cash in their gains. The great majority voted for continuation.

Reaching this milestone was the trigger for Major Harding, now aged 79, and his fellow septuagenarian founding directors to step down from the board and new directors to come in. He had been chairman for 27 years, from 1963 to 1990, when he was succeeded by Alan Tyser, a director of the broking firm Hoare Govett. He in turn was succeeded as chairman by Mark Cornwall Jones in 1995 and longstanding director Tony Pattison, a director of Capel Cure Myers, in 2005.

Changing market conditions

A second factor was an important and lasting change in financial market conditions. The long bull market in equities, which was to run from the early 1980s through to 2000 with only two significant interruptions[4], was coming to an end. From rock bottom valuations when Peter Spiller started managing the portfolio in 1982, most equity markets were now trading at much higher multiples, limiting the scope for the kind of outsized gains that Capital Gearing Trust had been able to produce earlier.

By the mid 1990s meanwhile bond yields, although much lower than they had been in 1982, were looking increasingly attractive when compared to equities and, in particular, the rate of inflation. A new breed of inflation-protected government bonds, known as index-linked gilts in the UK ('linkers' for short) and as Treasury Inflation Protected Securities ('TIPs') in the United States, had also recently been introduced for the first time and offered positive real returns for relatively little risk.

Towards the TMT bubble

1997 saw the election of a Labour Government, the first since 1979. The new Chancellor of the Exchequer, Gordon Brown, immediately removed the tax credit on dividend payments, to the great alarm of pension fund investors especially. In the event, with the chairman of the Federal Reserve Alan Greenspan leading central banks into a decade of easy money, the new government proved no deterrent to the stock market reaching giddying new highs as so-called "new economy" stocks (shares in the telecom, media and technology sectors) soared on a wave of hype to unsustainable levels.

Having become increasingly concerned about stock market valuations, by the mid-1990s Peter Spiller had already started to adjust the way that the trust's portfolio was invested, increasing the holding of bonds of all types, including those attractive inflation-linked bonds, and reducing the equity market exposure as the Internet bubble inflated. For the risk asset component of the portfolio, however, he continued to use his detailed in-depth knowledge and experience to winkle out gains from the most attractively priced investment trust shares.

A shift in approach

Overall however the approach that the trust adopted was becoming increasingly defensive in nature. In the 1998 Annual Report, the chairman Mark Cornwall-Jones noted that there was "considerable risk in the present level of equity markets", especially in the United States.

A second starker warning about the dangerously high level of market valuations appeared in the 1999 annual report.

Capital Gearing Trust, it soon became clear, was turning its back on the high levels of gearing that marked its early years and migrating to a new investment approach, one that placed a much higher premium on capital preservation and consistency of returns. This mindset, in one formulation or another, has been the hallmark of the trust's appeal ever since.

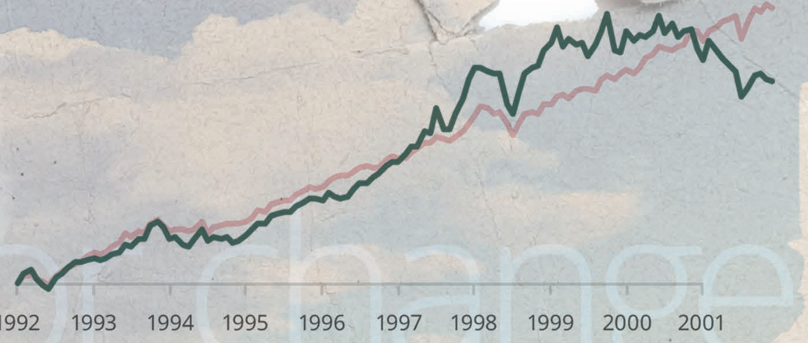
> **"We are concerned as much to protect value as to extract the last penny of capital gain"**
>
> CHAIRMAN MARK CORNWALL-JONES EXPLAINS THE NEW APPROACH IN THE 1998 ANNUAL REPORT

[4] *The short-lived market crash of 1987 and the nasty setback associated with the UK recession in 1990-91.*

A time for change

> How do we know when irrational exuberance has unduly escalated asset values?
>
> ALAN GREENSPAN

> Economists who adhere to rational-expectations will never admit it, but a lot of what happens in markets is driven by pure stupidity – or rather inattention and misinformation about fundamentals".
>
> ROBERT SHILLER



Stepping up

In 1988, reflecting his growing reputation and the success of the trust, Peter Spiller moved from Capel Cure Myers to the blue-blooded firm of Cazenove, which then became broker to Capital Gearing Trust. By the mid 1980s he had also become a significant personal investor in Capital Gearing Trust, owning more than 10% of the shares in issue in 1987. He became a partner in Cazenove in 1994.

The CGAM years

Going independent

Although the trust had turned bearish on equities too early, well before the TMT bubble peaked, the new century witnessed the bubble duly bursting, vindicating the board's earlier concerns and its manager's defensive positioning. It coincided with an important change in the trust's management arrangements. In 2000 Cazenove, the last surviving example of the private partnerships which had once dominated the old City of London, announced that it would be giving up its unlimited liability partnership and was looking to float on the London market instead as a corporate entity[5].

This was the catalyst for Peter Spiller to decide to leave the firm where he had been a partner since 1994 and set up his own specialist independent fund management business, with Capital Gearing Trust as its first and most important client. Given his track record over nearly two decades, the board was more than happy to approve the appointment of CG Asset Management, as the new entity was to be called.

Tighter focus

Although no longer being paid a fee to manage the portfolio, Cazenove continued to act as the firm's broker, so the connection with the City's most famous broking firm and its legendary market intelligence and network of contacts was not lost altogether. After a wait to obtain the necessary regulatory approvals, the new firm formally opened for business on April 1st 2001, in a small rented space in the nearby offices of the stockbrokers NCL.

The business was established with £120,000 of share capital and looked to make a profit from the word go, once the contract to continue managing Capital Gearing Trust had been secured. For Spiller himself, the decision to set up on his own was not only driven by the knowledge that the Cazenove partnership was coming to an end. It also was an opportunity to be able to focus more of his time and energies on the trust, while potentially running other funds and managed accounts with the same distinctive and specialised investment approach.

Exerting influence

In the business plan he prepared with his co-founder David Brazier, another former partner at Cazenove, who became responsible for managing the business, Spiller set out the reasons why he thought that his new firm could succeed. As well as underlining his strong track record (21% per annum annualised returns since 1982 "with exceptionally low volatility and risk") and the opportunities for gain which he continued to see in different types of neglected investment trust share classes, Spiller highlighted the scope for using his contacts and influence to make money by pressing the sleepy boards of underperforming trusts to do more to meet their obligations to shareholders.

It was difficult, he said, to carry out these kind of activist campaigns while he was still a partner of Cazenove; the broker's extensive advisory relationships with scores of other trusts were a constraint. The independence of the new firm would enable him to "put his head above the parapet", if need be, to highlight cases where boards were allowing shares in their trusts to languish at wide discounts.

In the event this strategy of investing in trusts with large discounts and then putting pressure on the directors to improve the rating has become one of the hallmarks of CG Asset Management's modus operandi, even though in the great majority of cases this kind of work is carried out discreetly behind the scenes rather than in public.

Asset allocation key

The new firm's competitive advantage, Spiller correctly predicted, would come from two main sources: exploiting opportunities to make gains from the narrowing of discounts in investment trust shares and from its 'active asset allocation'. By this he meant the choices that he would be making about the mix of assets that made up the trust's investment portfolio. While stockpicking remains an important source of returns, asset allocation has subsequently proved to be the most important factor in building its remarkable track record of consistent upward only results.

Dodging trouble

Investors with reasonably long memories will recall the split capital trust scandal of the late 1990s and early 2000s, when a 'magic circle' of corporate brokers and fund managers launched a series of new investment trusts with complex share structures, loaded them with gearing and bought the income shares in each other's trusts to keep the yield and share price high.

Many of these trusts imploded when the markets turned, leaving their shareholders nursing hefty losses and badly damaging the reputation of the investment trust sector. As an expert in specialist share classes, Peter Spiller was able to steer well clear of the trouble. While he made money from a few of the least risky zero dividend preference shares, he avoided the much more dangerous capital and income shares where the worst losses duly materialised.

[5] In the event Cazenove did not float but later sold itself to the American bank J.P.Morgan.

> “The client comes first.
> Don’t be greedy. Have fun”.

THE CAPITAL GEARING ASSET MANAGEMENT CREDO, BORROWED FROM A FORMER SENIOR PARTNER OF CAZENOVE

Philosophy in action

Horses for courses

A key part of Peter Spiller's thinking has always been the need to tailor his investment approach to prevailing market conditions, which can and do change over time. The trust has evolved to reflect these shifting trends. In the post-Harding years the board has deliberately sought to position the trust as a potential home for all of a private investor's money, as it is for all the investment managers of CG Asset Management themselves.

To that end the trust adopts a flexible, global multi-asset approach which essentially combines three distinct strands - 'risk assets' (including equities and property funds), 'real assets' (primarily index-linked bonds) and so-called 'dry powder', primarily cash and short-term bonds that earn little in today's low interest rate era but can be deployed quickly and easily when new opportunities arise.

Change in focus

Whereas in the 1980s, when share prices were remarkably cheap, equities were by far the biggest component of the trust's portfolio, more recently the focus has shifted away from these kind of risk assets towards the other two strands. Since the 1990s the proportion of Capital Gearing Trusts' portfolio in investment trusts shares and other equity instruments has rarely risen above 50% and has sometimes been as low as 23%.

From the 1990s until the global financial crisis, bonds of all kinds made up a larger part of the whole, reflecting their attractive above inflation yields and potential for capital gains as interest rates continued to decline. Since the crisis, in contrast, in a world swamped by debt and huge amounts of central bank monetary stimulus, conventional bonds have slumped to tiny or even negative yields and largely been junked in favour of index-linked securities and high levels of "dry powder".

Continuous adjustment

The balance between the three pools of capital continues to be adjusted from year to year in the light of Spiller and his colleagues' assessment of global market conditions. The elements include not just the relative valuations at which the different types of asset are trading, but a wide range of economic inputs, including interest rates, growth, inflation and currency movements. Political developments and background factors such as demographics, globalisation and technological advances are also fed into the mix.

As a lifelong student of financial history, the manager has always had a keen awareness that returns from different asset classes are cyclical in nature. For an "all weather" trust, designed to provide consistent returns in any market conditions (see chart on page 19), that frequently demands a willingness to do things differently from "the crowd". Spiller acknowledges that his ability to adjust course has been greatly helped by his "extreme good fortune" in having been able to put together such a strong track record in the early part of his career. This is a luxury that most of his peers who started out as fund managers at a later date do not enjoy.

New objectives

The objectives of Capital Gearing Trust have evolved over time in response to these changing dynamics and the board's assessment of where the best risk-adjusted returns lie. In 1982 the objective of the trust was simply stated: to use gearing to amplify the return from a portfolio of investment trust shares. Today, with many early shareholders sitting on substantial gains from the earlier period, and markets looking richly valued, the objective is now "to preserve and over time to grow shareholders' real wealth" (that is, after taking account of inflation).

What started as a happy outcome of Peter Spiller's early efforts - the unusual ability to make positive returns in every 12 month reporting period - has therefore evolved over time to become the trust's dominant ambition, as well as a powerful marketing tool. The fact that this ambition is widely shared by thousands of risk-aware investors is what has helped to propel Capital Gearing Trust to its current size and unprecedented levels of popularity.

When risk aversion pays

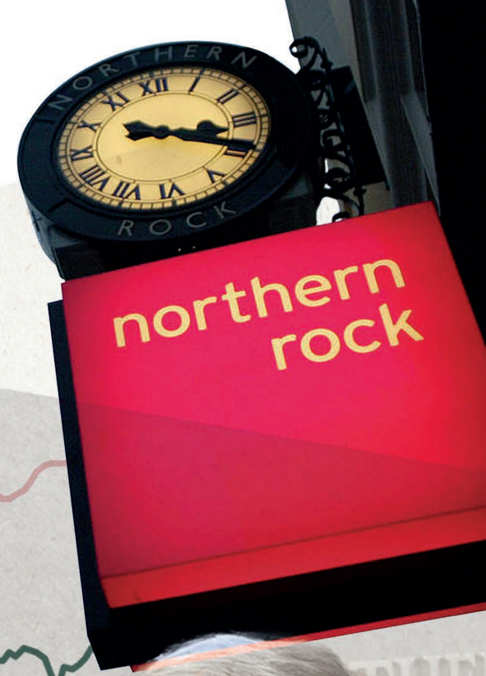
The value of the trust's focus on capital preservation has never been shown to greater advantage than during the global financial crisis of 2008. As banks imploded under a mountain of debt and worthless derivative securities, they dragged the world's stock markets down by 50% over an 18 month period. Capital Gearing's shareholders enjoyed positive returns all the way through, thanks to its careful defensive positioning and prescient warnings that a credit crisis was imminent. The Queen famously asked why nobody had seen the crisis coming; she clearly had not been reading this trust's annual reports, in which as early as 2005 Peter Spiller was warning about the "highly fragile financial system".

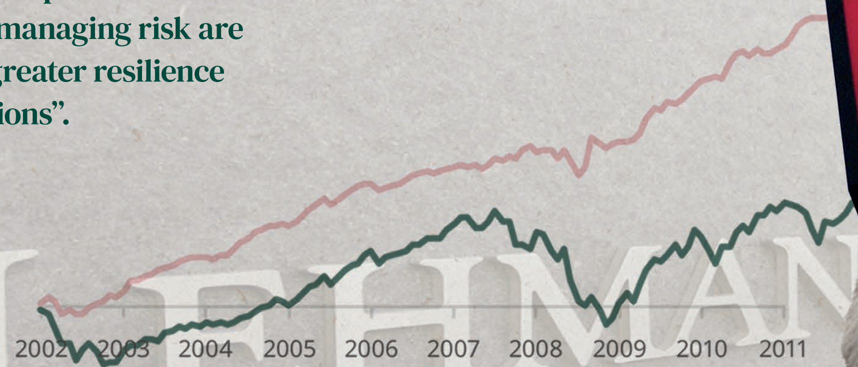
Special situation

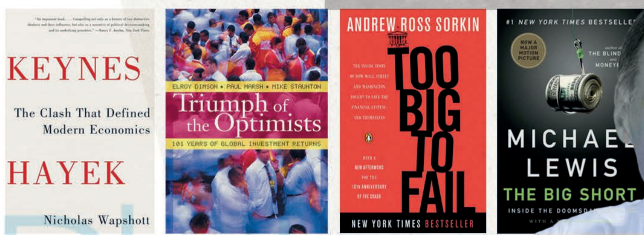
In August 2001 Peter Spiller bought 13.5m shares in Eurovestec, a venture capital investment trust, from an open-ended fund that was a forced seller as the TMT bubble burst. The price he paid was a 75% discount to the Net Asset Value and 100% covered by the trust's holdings of cash. The venture capital investments were therefore "in for free". Five years later he sold most of the shares for nine times the purchase price, a good example of the kind of outsized gains that can be made when opportunism and specialist knowledge combine.

> **"The use of a growing array of derivatives and the related application of more-sophisticated approaches to measuring and managing risk are key factors underpinning the greater resilience of our largest financial institutions".**
>
> ALAN GREENSPAN, MAY 2005

> **"The huge size of the derivative market, in particular the rapidly growing Collateralised Debt Obligations and CDO squared products, create a highly fragile financial system".**
>
> PETER SPILLER, MAY 2005







Philosophy in action

A growth phenomenon

Modest operations

When CG Asset Management was launched in 2001, Capital Gearing Trust had net assets of £24 million and was still a minnow in comparison with the bigger beasts in the investment trust jungle, such as Foreign & Colonial and Alliance Trust. With just its two directors and a secretary, the newly established business operated from rented desks in the Basinghall Street offices of NCL. NCL was soon after merged into Smith & Williamson, a larger financial services firm based in Moorgate.

There the CGAM team worked in a small partitioned cubicle measuring 380 square feet, later increased to 580 square feet. Even today, having moved to a new base in King Street this year, it remains a small and lean organisation, in keeping with its founder's frugal temperament. The investment management team has been gradually strengthened with the appointment of Alastair Laing (in 2011) and Chris Clothier (2015), who are co-managers of the trust and will take over from Peter Spiller when he eventually retires. The business has its own trading desk and a marketing director.

Immodest asset growth

The amount of money that the team looks after has grown rapidly. Capital Gearing Trust alone has an asset base which is roughly 50 times greater than it was when the management firm was launched 21 years ago. Four other funds which the team manages together account for another £2,800 million of client money. They include an open-ended version of the investment trust and two funds which provide a vehicle through which professional investors can acquire a portfolio of global index-linked bonds in a tax-efficient manner.

There are significant overlaps between all five however and the fundamental investment philosophy behind them is the same. With the great majority of the investments being highly liquid government and corporate securities, the management of the portfolios is less complex and time-intensive than the scale of the business today might imply. CGAM today still has fewer than ten employees while the administration of the trust and open-ended funds is sub-contracted to specialist firms.

Zero discount policy

Apart from its competitive fees and strong track record, a powerful contributing factor driving the growth of the trust has been the adoption of the 'zero discount policy' which the board of Capital Gearing introduced in 2015 and has maintained ever since. As listed public companies whose share price is determined by supply and demand, the issue of discounts has always been central to an understanding of how investment trusts perform.

Thanks to regulatory changes which came into force in 1999, investment trusts today can, with shareholder approval, buy back their own shares when they are trading at a discount and issue new shares when they are at a premium. In this way they can seek to keep supply and demand in balance, eliminating the risk of a persistent discount. While more than 50 trusts have a policy of keeping their discount within a certain range, Capital Gearing is one of only a handful of trusts whose boards promise explicitly to prevent its share price from falling to a discount at all, except in the most exceptional market conditions.

Working in practice

For a trust which is seeking to avoid losing money in any twelve month reporting period, the zero discount policy has become an essential component of its appeal to shareholders. In practice, because of its impressively consistent performance, the board has only ever had to buy back its shares in two periods. The first, shortly after the policy was introduced, demonstrated that the board was good for its promise.

The second period was the sharp market fall which followed the outbreak of the coronavirus pandemic in February 2020. Shares in Capital Gearing were not immune to the market panic that briefly sent leading stock markets down by 30% in only 30 days, but despite the disruption the board was able to step in and buy back £7.8m worth of shares. The share price quickly returned to its normal trading level around par and shareholders saw another year of positive returns.

Inflation concerns

Capital Gearing has been prominent in the last few years in highlighting the risk of higher inflation, given the policy of low interest rates, Quantitative Easing and other monetary stimulus measures. "Monetary finance of government spending" warned the managers in 2020 "will not be deemed an issue so long as inflation does not rise to problematic levels. However, this very mindset significantly increases the risk of inflation actually becoming problematic". As it has proved to become in the last 12 months...

A growing phenomenon

Shares in demand

The flip side of a trust defending a discount successfully is the ability to issue new shares without diluting existing investors if the shares trade at a premium. Capital Gearing has been one of the most active secondary issuers of shares in recent years. While the management company benefits from higher fee income, shareholders in the trust also benefit from the costs of management being spread across a wider asset base, enabling the management fees to come down in stages.

> **“Under this new policy the Company will purchase or issue shares to ensure – in normal markets conditions – that they trade as close as possible to their underlying NAV per share”.**
>
> GRAHAM MEEK, CHAIRMAN
> CAPITAL GEARING TRUST, 2015

Behind the consistency

Absolute returns

Fund managers are, rightly, judged by their performance over time and Peter Spiller's track record is exceptional for its consistency. He is the first to acknowledge that he has been fortunate in the timing of his career. The gearing that helped to deliver shareholders in Capital Gearing Trust such outstanding early returns gave him credibility and the freedom to adopt a long term strategy without the risk of losing his job during periods when returns have lagged headline market indices.

Given that for most of the last 25 years the annual returns which the trust has delivered have been single digit gains, reflecting its more defensive positioning, the rapid growth in popularity might at first sight look surprising when set against the much higher gains produced by high profile global equity trusts, such as Scottish Mortgage. Yet that is to underestimate the true value of the kind of absolute return mandate which Capital Gearing has now adopted.

Compounding is key

Equity markets in particular are both cyclical and volatile, which means that when stock markets fall sharply, as they do periodically, a trust that succeeds in avoiding losing money during these periods is exceptionally well placed to outperform over the longer term. A trust that experiences a loss in value of 50% however has then to make a 100% gain simply in order to get back what has been lost. One that has preserved its capital value and continues to compound its net asset value at a single digit rate very quickly becomes the better performer and more difficult to catch.

That has been the pattern with Capital Gearing Trust over since 2000. Its shares have grown at a steady compound rate of around 8.4 per cent per annum. Although other trusts have enjoyed more spectacular returns over shorter periods, by avoiding the drastic drawdowns that most trusts experienced during the 2000-2003, 2007-2009 and 2020 bear markets Capital Gearing is now well ahead of the majority of its peers over the longer term.

Exerting influence

Looking more closely at the breakdown of its performance, the 'risk assets' have in fact performed well compared to standard equity market indices. While the number of investment trusts in which the trust has a holding is much greater than it was in the early days, the opportunities for making significant gains from knowledgeable intervention remain, particularly where a significant discount has developed.

Holding boards of investment trusts to account – making them stick to their promises – remains a key part of that process. A board that promises to meet a discount target, but subsequently fails to do so, has long been a primary target for Capital Gearing to take action. Despite higher standards of corporate governance in general, these opportunities continue to come round at regular intervals and can produce excellent annualised returns.

New opportunities

Against that has to be set the fact, Spiller says, that for the moment at least discounts on investment trusts remain narrow by historical standards. The opportunities to profit from favourable discount movements are therefore more limited than they were back in the 1980s. Discounts tend to narrow in bull markets and widen during bear markets, so the best opportunities for outsized gains won't arise again until the next bear market.

The rapid growth in 'alternative asset' trusts over the last 15 years is however providing opportunities of a different kind. These are trusts which invest in specialist areas such as renewable energy, physical infrastructure, warehouses and shipping. These are mostly things which private investors cannot easily invest in directly but are ideally suited to the investment trust structure. The stable, long term, high single digit returns, often based on an index-linked or government guaranteed revenue stream, that a good number of these trusts offer fit well with Capital Gearing's absolute return objective.

The long run success of Capital Gearing's approach ultimately depends however on its asset allocation, which in turn rests on the ability of Spiller and his colleagues to call "the big picture" correctly. The trust's current low weighting to risk assets and high weightings to "dry powder" derives from his high conviction view that prospective returns have been low for several years, given central bank policies and the unprecedented debt burden of most developed country governments.

Inevitably not every judgment the managers have made has been proved to be correct.
The eurozone did not break up in the early 2010s, as seemed likely at one point, for example. With the benefit of hindsight the trust could have also had more money in the United States, the top performing (but richly valued) equity market for many years

It has invariably been early in calling the top of bull markets, but that is consistent with its mandate, which prioritises capital preservation over short term but riskier potential gains.

> We take the view that a commitment is a commitment and one you can't just row back on

PETER SPILLER, EXPLAINING WHY HE TARGETS TRUSTS THAT FAIL TO IMPLEMENT THEIR DISCOUNT POLICIES

The future

Experience counts

In fund management, unlike some professions, experience is an important differentiating factor. After forty years of managing Capital Gearing, Peter Spiller has as yet no plans to retire and the continued consistent performance of the trust is a testament to the value of his five decades of working in the City. While the board has naturally put in place succession plans, the underlying philosophy that drives the trust's approach is not going to change, according to the current chairwoman Jean Matterson (who succeeded Graham Meek in 2020).

What will change, although not in ways which can be precisely predicted, is the environment in which the trust will be committing its shareholders' money. In this respect the Spiller mantra has remained unchanged for years: how the trust invests will be driven by the prospective medium to long term returns on offer from the global asset classes in which it invests. Economic history, he reminds us, demonstrates that nothing in financial markets is ever cast in stone.

The way ahead

For the past few years, and particularly, in the aftermath of the global financial crisis, his judgment has been that the prospective returns from conventional government bonds and equities have been poor by historical standards, justifying the trust's relatively low weighting to risk assets and its bias to short duration investments. This phase is likely to persist as long as interest rates continue to be suppressed and deliberately held below the rate of inflation by policymakers[6].

Yet while the absolute return objective the trust now embraces mitigates against the trust returning to the high levels of gearing it enjoyed in its early years, the manager is at pains to emphasise that there is nothing to prevent it committing a much greater proportion to risk assets in future if the environment changes to a point where prospective returns become much higher, as at some point they will.

As we head into Peter Spiller's fortieth anniversary year, central bankers face a difficult challenge balancing the need for higher interest rates to combat a sudden surge in inflation against the danger of overdoing it and inducing a severe recession instead. Historical precedents are not entirely encouraging, he concedes, but it is far from impossible that they will eventually succeed.

His recent commentaries have contrasted his short term concerns with a more optimistic medium term perspective. "With luck we will eventually see an environment similar to 1982 he observed in April 2022. That is to say, inflation and interest rates high but falling, p/e ratios low and debt no longer alarming. That would be a great opportunity to replicate the returns for the next 40 years that shareholders of Capital Gearing Trust have enjoyed for the last 40".

Chairman's outlook

In the 40 years since Peter Spiller took on the management of its portfolio, Capital Gearing Trust has had to navigated its way through some extraordinary changes in the global economic and market environment. In the year he started, phenomena such as Big Bang, the fall of the Soviet Union, the independence of central banks, globalisation and the Internet, to name but a few, were all still years in the future.

It is to his great credit, and that of his colleagues, that the trust has succeeded in producing its remarkably consistent positive returns throughout these changeable and volatile times. Shareholders have every reason to be grateful for his efforts. A compound growth rate of 15% per annum with only one negative annual result over a forty year period is a tremendous record by any measure.

The objectives of the trust, as noted earlier, have evolved over those four decades, as has its shareholder base. Our objective today is to preserve and grow the real (inflation-adjusted) wealth of our investors over the medium and longer term. In a world of surging inflation and negative real yields, like the one we see today, there is no guarantee that we can continue to achieve positive absolute returns every single year.

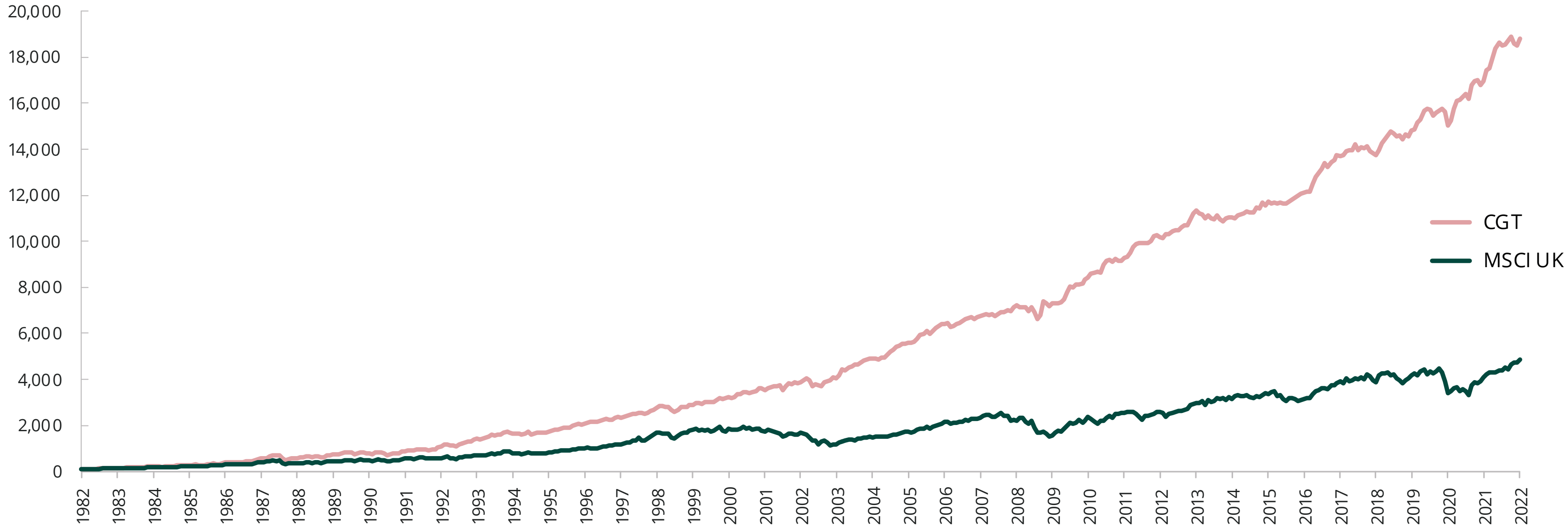
However that is our ambition and we will certainly be stretching every sinew to achieve it. While we can take heart from the trust's impressive track record, the manager knows as well as anyone that we cannot afford to sit on our hands. Every day brings a new challenge. Covid and the war in Ukraine war are two examples of hugely influential developments that nobody was even thinking about three years ago.

Jean Matterson
May 2022

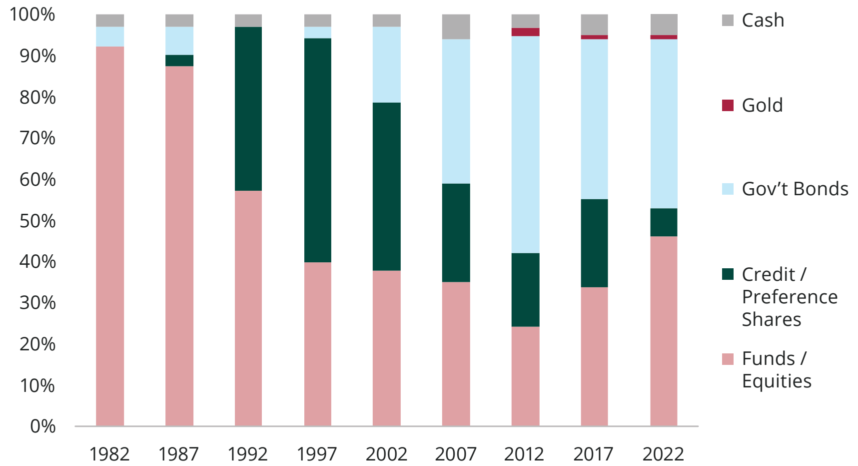
[6] *A policy known as 'financial repression'.*

40 years in numbers

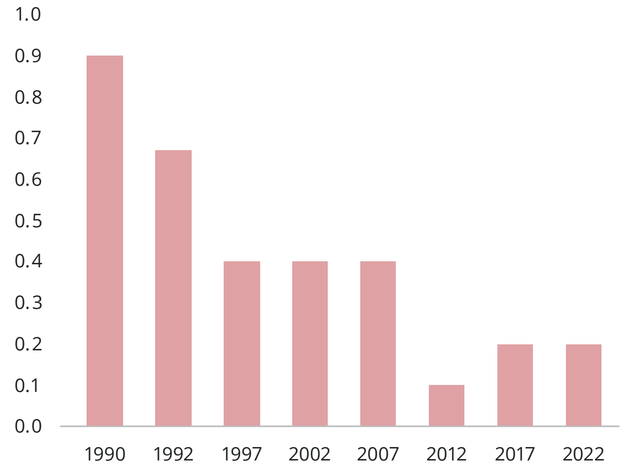
NAV Total Return History (Rebased) Apr 1982 to Mar 2022



Asset Allocation 1982 to 2022



Equity Beta 1990 to 2022



Source: Morningstar, CGT Annual Accounts, CGAM analysis.

cgam

> “We have relied on you to hold our coats whilst we fish in riskier waters, safe in the knowledge that we can get our coats back when the markets get chilly”

EXCERPT FROM A LETTER SENT TO US BY
A CAPITAL GEARING TRUST INVESTOR

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