CG INSIGHTS

Quarterly Perspectives from CG Asset Management

THIRD QUARTER 2025

cgam

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What were you thinking?

The AI arms race is creating a bubble of historic proportions

At its 2000 peak, Sun Microsystems was valued at $200bn+. By 2002, it had fallen by more than 90%. Shareholders were furious. However, its pugnacious CEO, Scott Mcnealy, fired back saying that it was the investors who were the problem **"At 10 times revenues... do you realise how ridiculous those basic assumptions were. What were you thinking?".**

Whilst the AI arms race differs meaningfully from the dot com boom, viewed through the lens of the share of the S&P 500 trading at >10 times revenues it looks very significantly worse. **As far as we can tell there has never been a period when more than 30% of the S&P 500 by market capitalisation has traded at >10 times revenues.** Nowhere close.

Our concern is this high sales multiple reflects a high PE multiple on peak profit. Nvidia is a phenomenon, however chip design/manufacture is a cyclical industry and at 25x revenues investors are assuming the cycle can only go one way. The software giants, including Microsoft and Meta have historically enjoyed hugely cash generative business models. The AI arms race is changing this: in 2025 the hyperscalers will invest capex of $300bn to $400bn, a significant share of their prodigious cashflow. **In the process they are transforming from digital monopolists into infrastructure providers who directly compete with each other.**

In 2000, Vodafone correctly identified that mobile telephony was the future and it spent aggressively to secure 3G spectrum licenses and on building out its physical infrastructure. 25 years later it remains core to the digital infrastructure of the internet age. However, its share price is down 80% from its peak and Vodafone is viewed as an ex-growth utility. Google and Meta, two companies that barely existed in 2000 used the infrastructure created by Vodafone and Sun Microsystems to build extraordinarily profitable applications. **It is possible that the hyperscalers will dominate all AI profit pools, however it seems more likely that they are building the infrastructure that will allow new digital competitors to thrive.** What are we thinking? That this arms race will end badly.

S&P 500% by value trading at greater than 10x sales multiple

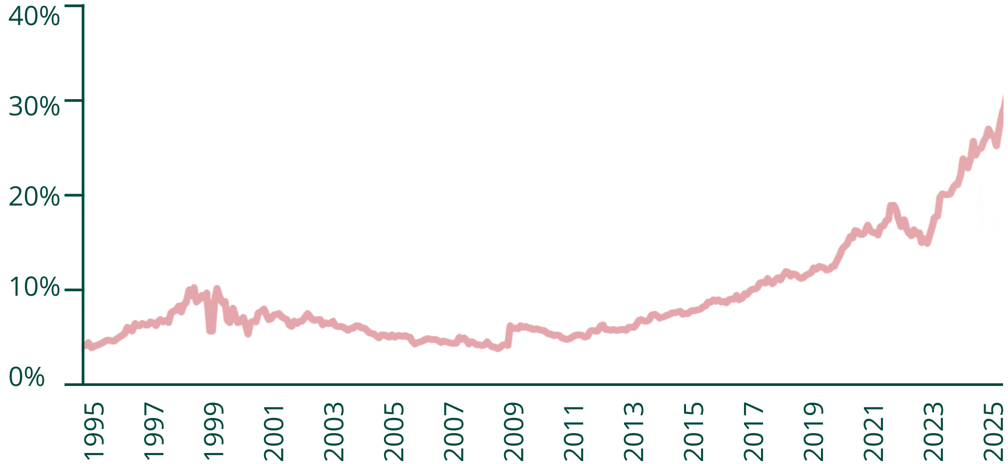

Chart takeaway: Based on a multiple of sales the S&P 500 is the most expensive it has ever been. By a long way.

Our Investment Judgement

1. The AI bubble is quite narrow in terms of number of stocks, however in value terms it is large enough that its unwinding will cause significant macro economic and financial damage.
2. Adjacent markets from cryptocurrency to meme stocks suggest a more speculative investor psychology motivated by fear of missing out.
3. As bond yields rise there are increasingly attractive alternatives to a US dominated equity market.

AT ITS 2000 PEAK SUN MICROSYSTEMS WAS VALUED AT $200BN+. BY 2002 IT HAD FALLEN BY MORE THAN **90%**

THERE HAS NEVER BEEN A PERIOD WHEN MORE THAN **30%** ... OF THE S&P 500 HAS TRADED AT >10 TIMES REVENUES.

Unhappy families

Debt sustainability is now the single most pressing issue

Leo Tolstoy's Anna Karenina opened with the observation that all happy families resemble one another, but every unhappy family is unhappy in its own way. In global bond markets, the rising yield environment of recent years has conveyed increasingly unhappy domestic situations. **In response to a global inflation shock, central banks raised policy rates in lock step. But now that the initial shock has dissipated, the paths of domestic policy rates have differed in response to different domestic unhappiness.**

In Europe, weak domestic demand led the ECB to cut interest rates rapidly to engineer a soft landing. In the UK, supply constraints from lack of investment and an inflexible labour market have meant that BoE efforts to cut rates may be short lived. In the US, despite concerted efforts to interfere with central bank independence, the FOMC has balanced the impacts of the inflation shock from tariffs against deteriorating payrolls data to continue cautiously with rate cuts. In Japan, weak economic performance and a highly publicised crisis of confidence in government institutions make it unclear whether the BoJ will be able to continue its process of policy rate normalisation.

What is striking about global bond markets is that despite these varied domestic complaints, the yield curves of the major developed market issuers have all steepened simultaneously. The increasingly more pressing issue for government bond yields is ballooning government debt, and the lack of political consensus in favour of fiscal consolidation. The coordinated yield curve steepening reflects the fact that Treasuries, gilts, JGBs and OATs are competitors in a global market for safe assets which is facing unrelenting supply to finance deficits from all major issuers. Unfortunately, fiscal profligacy is not a free lunch. In the immediate term, if the domestic polity refuses to take the pain, government bondholders will have to. Perhaps unhappy families have their similarities too.

Long end term premia are rising across developed markets [1]

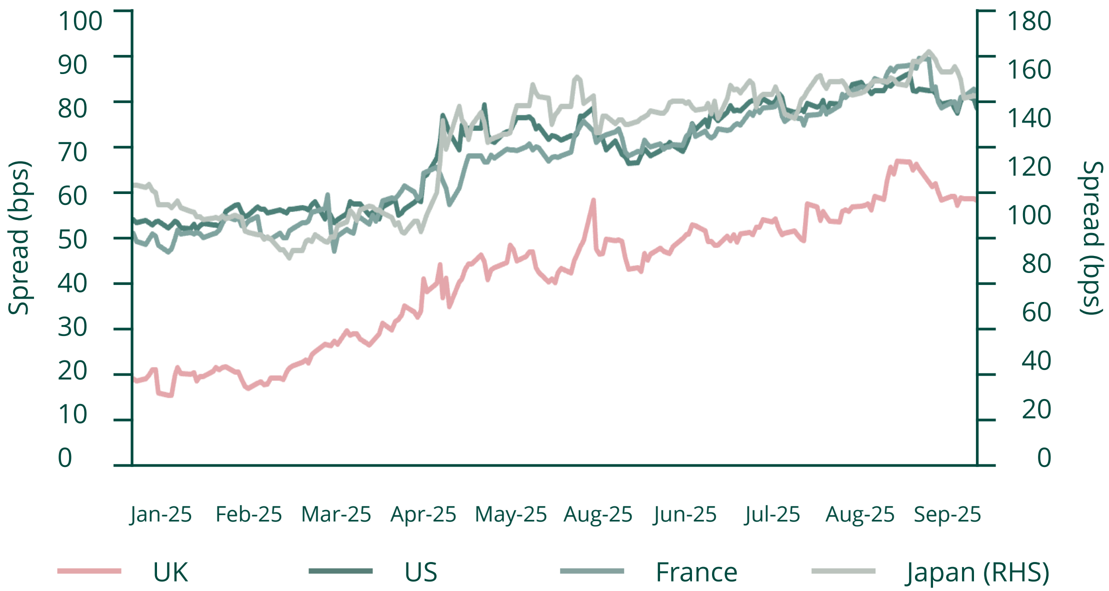

Chart takeaway: This year, the long end of the yield curve has steepened across major markets.

Our Investment Judgement

1. We are concerned about the ongoing increase in supply of government debt. This issue faces all major sovereign issuers.

2. This trend suggests that inflation will be more persistent and the yield curves in these major markets could steepen further.

3. There are several implications. First, these conditions favour index-linked government bonds over conventionals. Secondly, they reinforce our judgement to underweight the long end of the curve in favour of the belly.

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1) Long end term premia are measured by the 10s30s spread. This is calculated as the yield on the benchmark 30-year government bond less the yield on the benchmark 10-year government bond. Source: Bloomberg Finance LP.

The Rising Sun

Why we are fans of Japanese investment trusts

In a market of escalating volatility, risk-seeking and euphoria, Japanese equities present an attractive case. Despite tariff uncertainty, **the Topix has outperformed the S&P 500 by 10% this year** (in sterling terms), supported by improving fundamentals, and continues to offer value with a P/E ratio of 17 compared to the 27x for the S&P 500.

Critics would argue that the Japanese market has proved perennially cheap. **However, structural shifts in the macroeconomic backdrop and to corporate reforms have changed the game.** The economy has now exited deflation, and corporate reforms, such as share repurchases and capital distributions, have begun to improve shareholder returns as companies are showing increasing alignment with their investors.

For example, in 2024 ¥16.8 trillion was pledged to buybacks, which is up 75% on the 2023 number.

Investment trusts offer a fantastic way to get exposure to Japanese equities. **First, 4 out of the 6 managers have beaten the index over the last 10 years. Second, discounts remain wide. Third, improved governance indicates that these discounts can narrow.**

Two recent examples of governance have been particularly admirable: Baillie Gifford Japan and Fidelity Japan. The former has bought back 13% of its shares over the course of last year (at an average discount of 12%), providing remarkable returns for shareholders. The latter, having consistently underperformed, has rolled into AVI Japan, one of the top performers in the sector (with an annual tender), providing a satisfactory exit opportunity for investors.

With US CAPE (CG's preferred valuation metric) being a shade under 40, at its second highest level in recorded history and with the Yen being at historic lows against other major currencies, Japanese Investment Trusts are an appealing alternative in a global equity markets dominated by frothy US valuations.

PE ratios of the Japanese and US market over the last decade

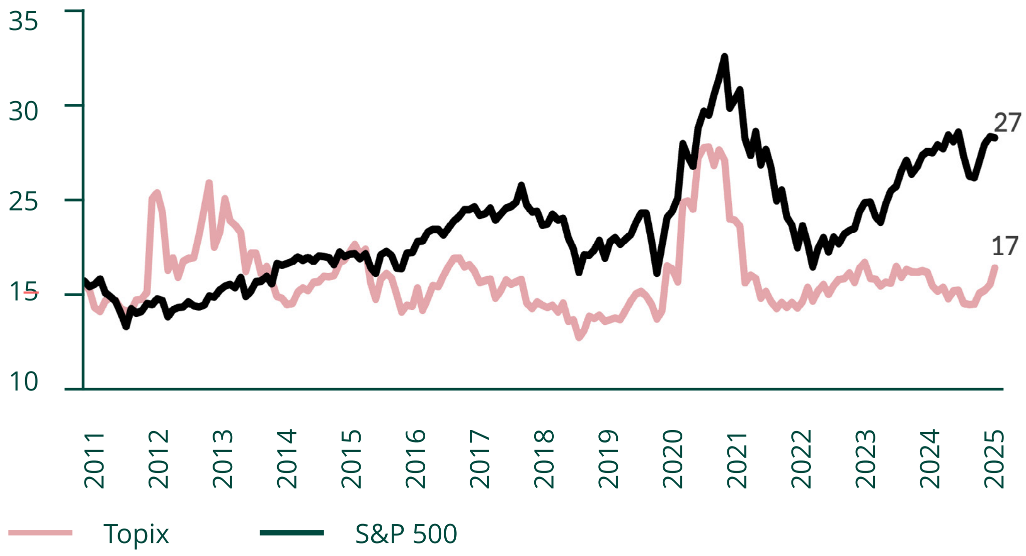


Chart takeaway: A growing dislocation has emerged between the two markets as investors have continued to chase the AI bubble that currently dominates the US market. In summary, Japanese equities look relatively attractive against an uncertain global backdrop.

Our Investment Judgement

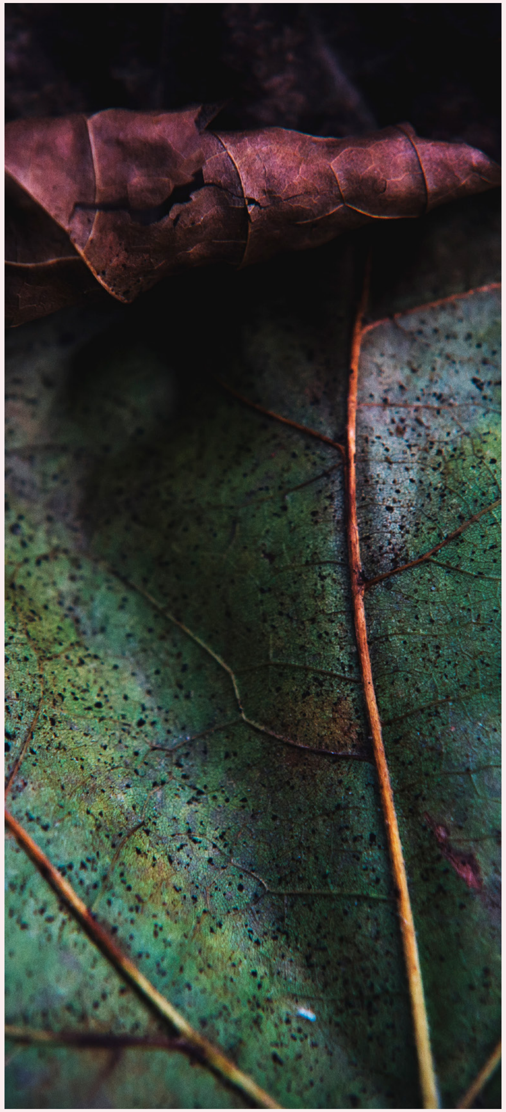
1. We believe equity valuations are stretched, and that Japan remains inexpensive relative to other equity markets.
2. Discounts on Japanese investment trusts are wider than those of peers in other regions, despite recent examples of improved governance.
3. Around 20% of our conventional equity allocation is in the Japanese market, with a preference for exploiting the discount opportunities offered by investment trusts.

THE TOPIX HAS OUTPERFORMED THE S&P 500 BY **10%** THIS YEAR (IN STERLING TERMS)

4/6 JAPENESE INVESTMENT TRUSTS HAVE BEATEN THE INDEX OVER THE LAST 10 YEARS

Source: GMO; Numis; Bloomberg LP

Recent changes to multi-asset portfolio positioning



PORTFOLIO CATEGORY

MANAGED LIQUIDITY RESERVE (34%) [1]

ASSET CLASSES

Cash, Treasury Bills & Short Duration Government Bonds
Short investment grade credit
Preference shares

CHANGES IN PORTFOLIO POSITIONING

- Managed liquidity reserve is unchanged over the period.
- Corporate bonds remain at 11% of the portfolio with limited opportunities to increase allocation as credit spreads remain tight

PORTFOLIO CATEGORY

↑ INFLATION-LINKED BONDS (39%) [1]

ASSET CLASSES

Sovereign inflation linked bonds
UK, US and other developed markets

CHANGES IN PORTFOLIO POSITIONING

- Allocation to inflation-linked bonds has increased by 1% over the period
- We have added a further 6% to UK index linked gilts this quarter (21% of the portfolio), favouring allocation to the belly of the yield curve, consequently duration of UKTIs has reduced to 6.8 years
- US index-linked bonds have reduced from 22% to 18% of the portfolio with two key changes of note over the quarter
  - We have realised profits on dollar hedges placed on ~5% of the portfolio invested in short dated TIPS
  - Duration on the remaining TIPS has been extended to 8 years by reallocating shorter TIPS to the belly of the yield curve

PORTFOLIO CATEGORY

↓ RISK ASSETS (27%) [1]

ASSET CLASSES

Investment Trusts
ETFs
Non-investment grade credit
Gold

CHANGES IN PORTFOLIO POSITIONING

- Risk assets were reduced by 1% over the quarter against a backdrop of frothy US markets and realisations from several investment trust holdings
- These included our largest Japanese investment trust position, Fidelity Japan Value which was the subject of a merger and a tender from India Capital Growth
- Proceeds from renewable infrastructure sales were invested into INPP, HICL and 3I Infrastructure, core infrastructure has increased to 4% of the portfolio

1) Data refers to Capital Gearing Trust. Weighting to index-linked bonds in CG Absolute Return Fund is 35% (with 38% in managed liquiduty reserve).

Asset Valuations and Investor Behaviour Summary

PORTFOLIO CATEGORY	UK	US	JAPAN	EUROPE	CG VIEW
INVESTMENT TRUST DISCOUNTS	ATTRACTIVE				Discounts remain attractive alongside a variety of engagement opportunities and a backdrop of increasing corporate activity for both conventional and alternative trusts
EQUITY MARKETS	FAIR	UNATTRACTIVE	FAIR	FAIR	CAPE: UK (20), US (38), Japan (24), Europe (25), US equity markets valuations are at extreme levels with elevated risks of a significant correction
SHORT GOVERNMENT BONDS	FAIR	FAIR	UNATTRACTIVE	UNATTRACTIVE	UK T-Bills offer a 4.1% return and short JGBs are attractive, specifically when hedged back to GBP
LONG INDEX LINKED BONDS	ATTRACTIVE	ATTRACTIVE	UNATTRACTIVE	UNATTRACTIVE	Both the US and UK index-linked bonds look attractive, particularly at the belly of the curve
CURRENCY	BASE CURRENCY	FAIR	ATTRACTIVE	UNATTRACTIVE	Yen is still attractive but faces near-term headwinds from potential tariffs, weak growth and stronger competition from Europe and China
CREDIT	UNATTRACTIVE	UNATTRACTIVE			Credit spreads remain historically narrow, particularly in the US where the macroeconomic outlook is weakening
INVESTOR BEHAVIOUR	FAIR	UNATTRACTIVE	ATTRACTIVE	FAIR	Investor sentiment has been reinvigorated in the US with valuations close to record highs. This is despite the backdrop of policy uncertainty and a concerning economic outlook. Shareholder engagement and corporate reforms in Japan have proved constructive

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