CG Portfolio Fund

Q1 2023 Report

- Quarter in Review
- Dollar Fund
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- Capital Gearing Portfolio Fund

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Pity the Engine

One foot on the accelerator, the other on the brake

March was a tumultuous month. After a year of steady central bank tightening, we witnessed the canary in the coalmine in the form of the failure of Silicon Valley Bank. The ripples have since been felt across the wider American banking sector and more recently in Europe. Amidst the tumult, inflation remains stubbornly high and the UK, US and Euro-area continue to face prolonged inflation. Labour markets remain tight, unemployment remains low, and workforce participation has returned to pre-pandemic levels. The corporate bankruptcies predicted are yet to emerge. These indicators suggest that, despite strains in financial markets, economies continue to operate at levels of output beyond full employment. As long as this persists, so too will inflation.

The key question is how best to move forward from this set of economic circumstances. In answering this question, it is important to acknowledge the wave of changes to the intellectual orthodoxy on how best to manage economies through the cycle.

At the turn of the 20th century, classical economic theory prevailed. This was best encapsulated by Jean-Baptiste Say, who posited that an economy's output should adjust toward full employment levels without the need for government intervention. However, the experience of debt deflation during the Great Depression led to the rise of demand-side economics. The best-known proponent, John Maynard Keynes, argued that another Great Depression could be avoided through appropriately stimulative fiscal policy to boost aggregate demand. The latter part of the century then saw the rise of monetarism. Initially, in Milton Friedman's era, inflation was primarily managed through changing the size of the money supply. This approach has since given way to inflation targeting through policy rates, although recent experience of quantitative easing suggests that money supply remains an important tool to manage inflation. We could characterise this most recent era as "Friedman lite".

The culmination of this experience suggests that there are two effective demand-side policy responses to manage inflation: tighter monetary policy by central banks, and tighter fiscal policy by governments.

Perhaps appropriately, given the rise of the regime of independent central bank inflation targeting, responses to the most recent bout of inflation have focused on monetary policy. Policy shifts have been twofold. In the first instance, there have been substantial increases to policy rates. In the US, the tightening has been the most extreme, with a cumulative 475 basis point increase to the Federal Reserve's target range over the past 12 months. More recently, central banks have begun to reduce the size of their balance sheets through quantitative tightening. The intention was to increase the effective interest rate by reducing money supply. An unanticipated consequence, which we have witnessed during the recent episode, has been to tighten liquidity in the financial system.

Surprisingly to us, fiscal policy has received comparatively little attention as a response to the current economic episode. This is notable given how frequently Keynesian demand-side justifications were used for the elevated levels of government spending in response to the Covid pandemic. The US provides the most stark examples in the form of the Bipartisan Infrastructure Law, the CHIPS Act and, lastly, the ironically-named Inflation Reduction Act. These three pieces of legislation together represent around $3 trillion in US government expenditure, designed to stimulate economic activity. The impact of this package has been to bolster the US economy's embedded inflationary pressures at the same time as the Federal Reserve has sought to combat them.

The result of this combination of tight monetary policy and loose fiscal policy is that monetary policy transmission has been delayed and very uneven. The more traditional mechanisms through which interest rate rises impact the economy – household and corporate demand – appear largely unaffected by recent rate rises. Commentators continue to note the “surprising resilience” of both of these groups. But is it really surprising? Instead, monetary policy appears to be transmitting primarily through financial market asset prices, as demonstrated by last October’s LDI episode in the UK, and by the recent failure of Silicon Valley Bank. Should this continue, the banking sector may finish central banks’ work for them, through a sharp contraction in lending to the real economy.

This contradiction in policy stance has begun to express itself in another macroeconomic problem: elevated national debt. In assessing the appropriate response to debt, understanding its composition is important. A relatively high share of public debt, as is the case in both the US and the UK, will incentivise an era of financial repression, where nominal interest rates increase, but do not match the rate of inflation, allowing the value of the debt burden to fall in nominal terms. This enables governments to continue to run deficits, as long as they do not exceed the rate of increase to nominal GDP, with the effect of deleveraging in real terms.

So, where to from here? Despite the appearance of a fully employed economy, recent events have highlighted the first cracks in the financial system. Policymakers, faced with a heightened trade-off between financial stability and price stability, face an unenviable task. It is extremely difficult to tell where in the cycle the economy presently sits, and we will only know with the benefit of hindsight. Anthony Barber is understood to have enacted his package of “Barber Boom” policies under the impression that UK economy faced a negative output gap, only subsequently to find out that in fact the opposite was the case. And central banks have shown a revealed preference for stimulative policy as insurance against a downturn (recall: the “Fed Put”). However, irrespective of where we sit in the economic cycle, our view remains that monetary and fiscal policy will always work better when working together.

Peter Spiller
Emma Moriarty
March 2023

Q1 2023 Report
Dollar Fund

Fund information as at:	Fund price:	Status:
31st March 2023	*£167.84*	*Open*

Investment objective

To achieve long-term capital appreciation and income growth via long-only investments in US Government Index Linked Bonds. The Fund is actively managed, without reference to a benchmark.

Fund information

Fund Size	£821m
Class Size	£338m
Dividend Yield	< 2%
Management Fee < £1bn	0.25%
Management Fee > £1bn	0.15%
Total Expense Ratio	0.34%

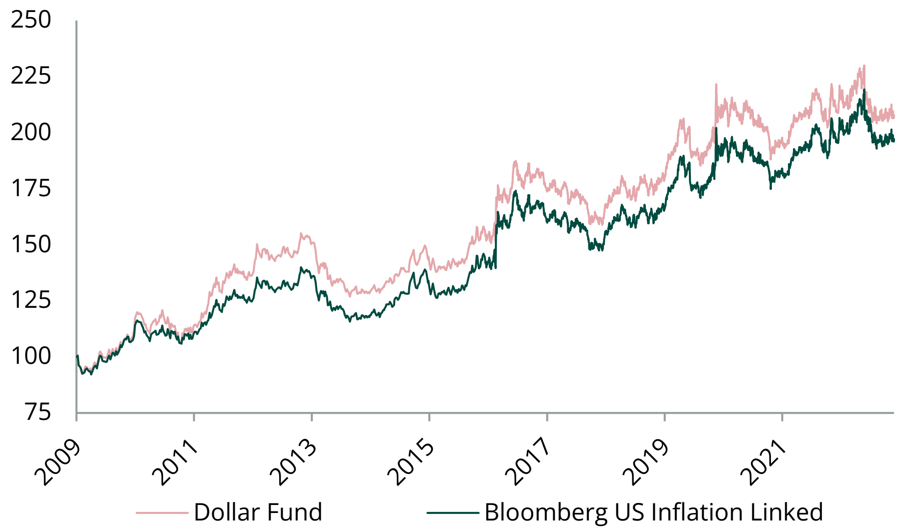
Return history (total returns)

1 month	0.8%	2022	-4.1%
3 months	1.1%	2021	6.0%
6 months	-3.5%	2020	8.6%
Year to date	1.1%	2019	4.9%
1 year	-2.2%	2018	4.9%

Largest holdings

US I/L 0.75% 15/02/45	6.7%
US I/L 1.375% 15/02/44	6.4%
US I/L 0.625% 15/02/43	6.2%
US I/L 1.00% 15/02/46	5.8%
US I/L 0.75% 15/02/42	5.5%

Performance since inception (total return)



Credit ratings

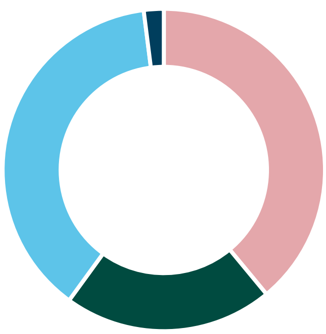
AAA	100%
AA	0%
A	0%
BBB	0%
BB and below	0%

Characteristics

Number of bonds	40
Yield to Maturity (real)	1.3%
Average Maturity	10.9 Yrs
Average coupon (real)	1.0%
Composite rating	AAA

Maturity analysis

10+ Years	39%
5-10 Years	21%
0-5 Years	38%
Cash	2%



Duration history

31 Mar 23	9.8
30 Sep 22	9.7
30 Sep 21	8.5
30 Sep 20	10.3
30 Sep 19	8.9
30 Sep 18	7.4

Dollar Fund

When Alan Blinder was Vice Chair of the Federal Reserve under Alan Greenspan, he asked Paul Volcker just how monetary policy could bring inflation down. His reply was characteristically blunt, "through bankruptcies". Tightening, in his view, should squeeze the life out of inflation. The seizure of Silicon Valley Bank and demise of Credit Suisse is an apt reminder of this interpretation.

Following an era of capital largesse, perhaps a prescription of Schumpeterian purge is appropriate. The medicine being spooned out is rather different: the Fed is extending loans to banks against their treasury portfolios, far in excess of their market values, the FDIC is increasing moral hazard by guaranteeing deposits in smaller banks, and the federal budget deficit is accelerating ahead of the next presidential election. All of these elements serve to prolong the underlying inflationary dynamic in the US economy.

Such agreeable intervention delays the necessary purge or policy that could contain core inflationary forces, whose persistence increases the longer the Fed allows it to run above target. A Cleveland Fed study finds that the pain exacted in steering inflation back to 2% could require unemployment levels as high as 7.4%[1] over 1-2 years, from 3.6% in February. However, monetary policy and fiscal policy are already at odds with one another. Were unemployment to rise dramatically and with an upcoming election, it is likely the fiscal response would prevent monetary policy from operating as effectively.

The Fed's current framework views inflation across three buckets: goods, housing services, and non-housing services. Goods inflation has declined as expected. Housing services is forecast to decline this year but has thus far actually accelerated. Lastly, non-housing services (56% of the PCE core index) has also continued to increase. It is this final majority which represents the imbalances in the labour market that is "likely to take a substantial period to get down". Thus far, whilst headline CPI has eased to 6% YoY, core inflation has reaccelerated to 5.5% YoY. As Chair Powell put it, "a long way to go and is likely to be bumpy". Consequently, the target rate was raised by 25bps to between 4.75-5% in March, a slower cadence than what was expected before the banking crisis, with the Fed anticipating that "tighter financial conditions would work in the same direction" noting that official forecasts for the coming year have been revised for slower economic growth (0.4%), lower unemployment (4.5%) and higher core inflation (3.5%).

Recent implosions have demonstrated the fragility of the economy with such elevated debt levels, and as a "higher for longer" regime transmits through the system, the Fed has a narrower window to pursue the policy required to remedy labour market imbalances. This points to a much higher probability of structurally higher inflation in the future. Given this outlook, and their low starting breakevens, TIPS should outperform their nominal peers over their life. Even in a "hard landing" recessionary scenario, where inflation falls rapidly to target, TIPS should perform reasonably well as real yields fall in sympathy with nominal yields.

It was a strong quarter for the fund, which is up 1.1% against 0.6% for the US Inflation-Linked Index. Over 12 months the fund returned -2.2%, much of this being attributable to a longer duration than the index, built in response to values emerging in earlier quarters. Sterling strength meant the hedged share class returned 3.6% over the period versus 3.1% for the benchmark. We continue to believe that the outlook is a period of persistent above target inflation, which will lead to significant capital gains for the owners of TIPS from both higher inflation accruals and expanding breakevens

Market yields suggest that investors believe policymakers have largely finished raising interest rates, with banks acting at the behest of the Fed to finish the job, but to borrow Gregory Hess's response to Blinder, if "inflation is like a cancer" that spreads, then each day becomes crucial in the fight for remission. Delaying the necessary remedy could cost an arm or leg later.

Hassan Raza
March 2023

[1]Verbrugge and Zaman, Working Paper 23-06, Cleveland Fed (Jan 23).

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Q1 2023 Report
Dollar Fund (GBP Hedged)

Fund information as at:	Fund price:	Status:
31st March 2023	*£95.83*	*Open*

Investment objective

To achieve long-term capital appreciation and income growth via long-only investments in US Government Index Linked Bonds. The Fund is actively managed, without reference to a benchmark.

All US dollar currency exposure is hedged back to Pounds Sterling for the Dollar Fund Hedged share class.

Fund information

Fund Size	£821m
Hedged Class Size	£397m
Dividend Yield	< 2%
Management Fee < £1bn	0.25%
Management Fee > £1bn	0.15%
Total Expense Ratio	0.34%

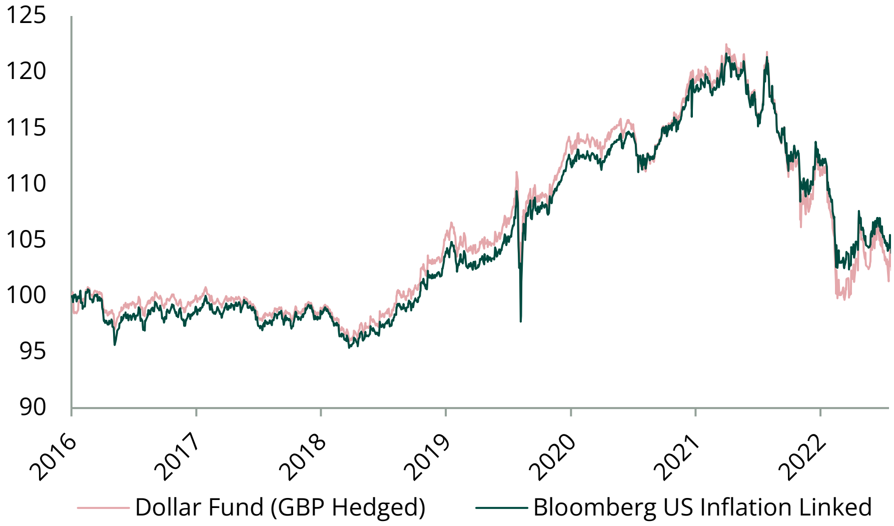
Return history (total returns)

1 month	2.9%	2022	-15.8%
3 months	3.6%	2021	5.2%
6 months	6.3%	2020	10.5%
Year to date	3.6%	2019	7.4%
1 year	-9.5%	2018	-2.6%

Largest holdings

US I/L 0.75% 15/02/45	6.7%
US I/L 1.375% 15/02/44	6.4%
US I/L 0.625% 15/02/43	6.2%
US I/L 1.00% 15/02/46	5.8%
US I/L 0.75% 15/02/42	5.5%

Performance since inception (total return)



Credit ratings

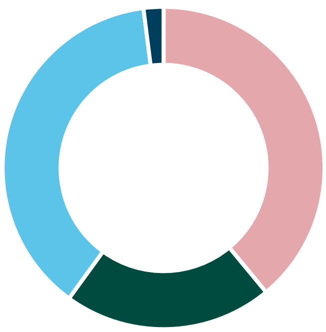
AAA	100%
AA	0%
A	0%
BBB	0%
BB and below	0%

Characteristics

Number of bonds	40
Yield to Maturity (real)	1.3%
Average Maturity	10.9 Yrs
Average coupon (real)	1.0%
Composite rating	AAA

Maturity analysis

10+ Years	39%
5-10 Years	21%
0-5 Years	38%
Cash	2%



Duration history

31 Mar 23	9.8
30 Sep 22	9.7
30 Sep 21	8.5
30 Sep 20	10.3
30 Sep 19	8.9
30 Sep 18	7.4

Q1 2023 Report
Real Return Fund (GBP Hedged)

Fund information as at:	Fund price:	Status:
31st March 2023	*£94.13*	*Open*

Investment objective

To achieve long-term real returns by investing in high-quality international Index Linked Bonds (ex. United Kingdom), including but not limited to Australia, Canada, Denmark, Japan and the United States. The Fund is actively managed, without reference to a benchmark.

All currency exposure is hedged back to Pounds Sterling for the Real Return Fund Hedged share class.

Fund information

Fund Size	£561m
Class Size	£131m
Dividend Yield	< 2%
Management Fee < £500m	0.30%
Management Fee > £500m	0.20%
Total Expense Ratio	0.39%

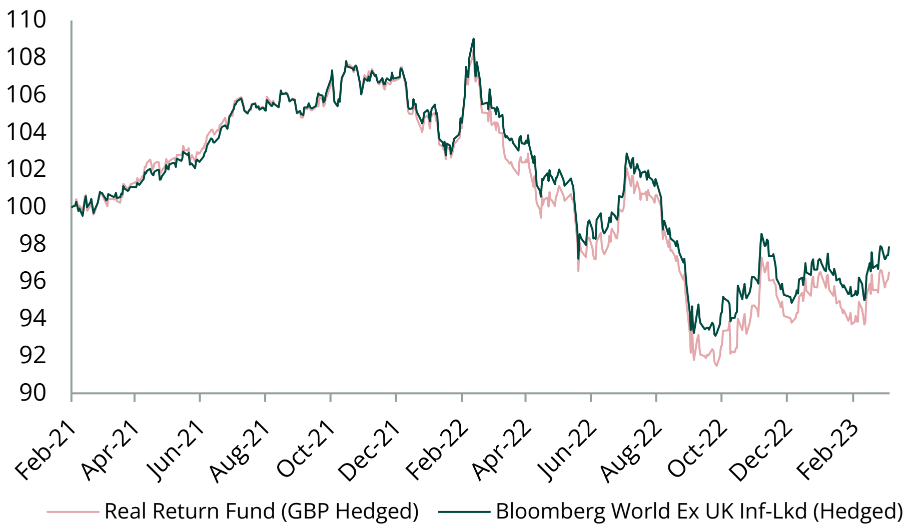
Return history (total returns)

1 month	2.5%	2022	-12.8%
3 months	2.9%	2021	N/A
6 months	5.1%	2020	N/A
Year to date	2.9%	2019	N/A
1 year	-7.6%	2018	N/A

Largest holdings

US I/L 1.375% 15/02/44	5.4%
US I/L 0.625% 15/02/43	4.9%
US I/L 0.75% 15/02/45	4.3%
US I/L 2.375% 15/01/27	4.0%
US I/L 2.00% 15/01/26	3.8%

Performance since inception (total return)



Credit ratings

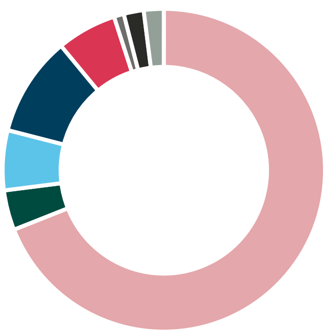
AAA	100%
AA	0%
A	0%
BBB	0%
BB and below	0%

Characteristics

Number of bonds	59
Yield to Maturity (real)	0.8%
Average Maturity	9.6 Yrs
Average coupon (real)	1.0%
Composite rating	AAA

Asset allocation

USA	70%
Sweden	4%
Japan	6%
Germany	10%
Canada	6%
Denmark	1%
Australia	2%
Cash	1%



Duration history

31 Mar 23	8.7
30 Sep 22	8.5
30 Sep 21	8.6
30 Sep 20	8.6
30 Sep 19	7.6
30 Sep 18	6.4

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Q1 2023 Report
Real Return Fund

Fund information as at:	Fund price:	Status:
31st March 2023	*£201.21*	*Open*

Investment objective

To achieve long-term real returns by investing in high-quality international Index Linked Bonds (ex. United Kingdom), including but not limited to Australia, Canada, Denmark, Japan and the United States. The Fund is actively managed, without reference to a benchmark.

Fund information

Fund Size	£561m
Class Size	£429m
Dividend Yield	< 2%
Management Fee < £500m	0.30%
Management Fee > £500m	0.20%
Total Expense Ratio	0.39%

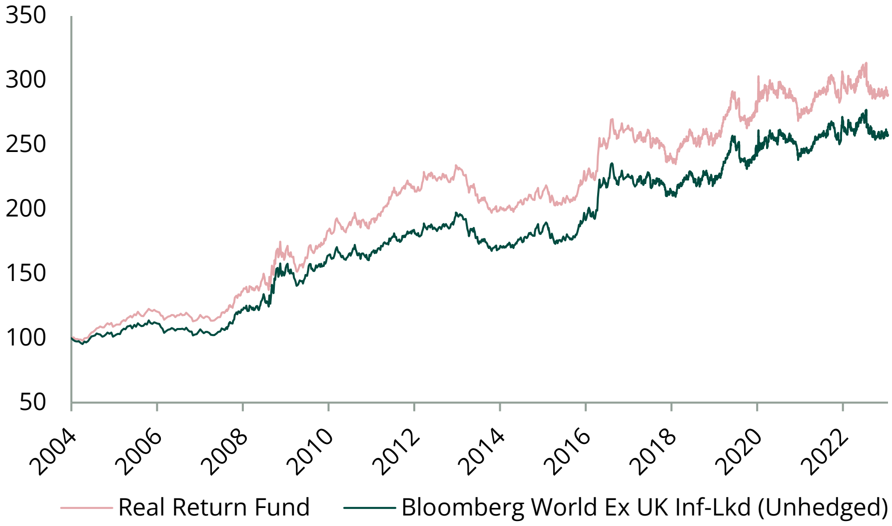
Return history (total returns)

1 month	0.8%	2022	-3.4%
3 months	0.4%	2021	4.1%
6 months	-2.6%	2020	8.0%
Year to date	0.4%	2019	2.6%
1 year	-2.3%	2018	3.5%

Largest holdings

US I/L 1.375% 15/02/44	5.4%
US I/L 0.625% 15/02/43	4.9%
US I/L 0.75% 15/02/45	4.3%
US I/L 2.375% 15/01/27	4.0%
US I/L 2.00% 15/01/26	3.8%

Performance since inception (total return)



Credit ratings

AAA	100%
AA	0%
A	0%
BBB	0%
BB and below	0%

Characteristics

Number of bonds	59
Yield to Maturity (real)	0.8%
Average Maturity	9.6 Yrs
Average coupon (real)	1.0%
Composite rating	AAA

Asset allocation

USA	70%
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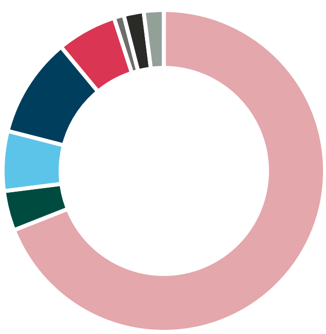


Duration history

31 Mar 23	8.7
30 Sep 22	8.5
30 Sep 21	8.6
30 Sep 20	8.6
30 Sep 19	7.6
30 Sep 18	6.4

Real Return Fund

"To finish first, first you must finish" is a phrase beloved of ocean sailors, Scalextric racers and latterly investors in bank shares. Nowhere is the adage more relevant than fixed income investing given the capped upside and 100% downside. Creditworthiness is the first and most important consideration for the Real Return Fund. John Pierpoint Morgan is reputed to have said, "A man I do not trust could not get money from me on all the bonds in Christendom" pithily drawing the distinction between ability and willingness to pay. He clearly set great store in the latter, as do we. Though, as lenders to governments, we are tasked with assessing the character of nations rather than individuals.

We have written before about the Copernican Principle[1] which predicts the longevity of disparate things (the Berlin Wall, the length of runs of Broadway shows etc.) based solely on how long they have already existed. We think it can be sensibly applied to sovereign defaults; countries that have never defaulted in the past are less likely to default in the future. As we wrote at the time:

> *"[The Copernican Principle] can be described as naïve, but it's very naivety reveals a deeper truth – things that have endured for a long time must have some fundamental quality which means they are likely to endure further".*

In the case of countries, it is the political structures and social institutions which tend to endure and give rise to creditworthiness or profligacy, as the case might be.

There are further generalisations we can make. For countries that are monetarily sovereign – that borrow in their own currency *whose supply they control* – there are three principal risks to the government bond investor: inflation, war and revolution. The first we mitigate by investing solely in inflation protected securities.

The second risk we manage by avoiding autocratic regimes. Dictators and populist rulers frequently show the same level of disdain for creditors as they do for their subjects. Unchecked by democratic institutions they are more likely to start wars which result in some combination of isolation, sanctions, defeat, reparations, inflation and default. The corollary of this rule is that countries with strong social institutions (independent judiciary, a free press, etc.) make for better credits.

Autocracies do not score well on the revolution front either. In the short-term they tend to be effective at quashing dissent, but suppression makes the fabric of society becomes ever more brittle until, eventually, it must shatter. Happy, equal societies with high living standards, long life expectancy, and moderate inequality are better prospects. After all, why go to the trouble of overthrowing your government when life is good? To this list of attributes, there is one other quality we seek in our debtors: absence of corruption. Corruption corrodes the finances of a state and make it less able to service its debts.

There are those who argue that applying ESG[2] considerations to investing is empty virtue signalling. We disagree. ESG considerations, at least as it relates to government bond investing, are indistinguishable from fundamental credit analysis. You can read more about the screens we use to define our investment universe on our website, it produces a very short list of credits we judge acceptable[3]. Add our requirement that the borrower must control the supply of the currency it borrows, and the list becomes even shorter. We hope investors in the fund take comfort from our discernment.

Chris Clothier
March 2023

[1] https://www.cgasset.com/wp-content/uploads/2022/11/We-need-to-talk-about-Bitcoin.pdf
[2] Environmental, Social & Governance
[3] https://www.cgasset.com/document/our-approach-to-esg/

Q1 2023 Report
CG Absolute Return Fund

Fund information as at:	Fund price:	Status:
31st March 2023	*£134.68*	*Open*

Investment objective

To achieve cost-effective, long-term absolute returns via a global portfolio of equities, bonds and commodities. Typically, equity investments are expressed via ETFs and listed closed end funds, and bond investments are made directly. The Fund is actively managed, without reference to a benchmark.

Fund information

Fund Size	£1,114m
Dividend Yield	< 2%
Management Fee	0.35%
Total Expense Ratio	0.45%
Comparator Index	GBP SONIA

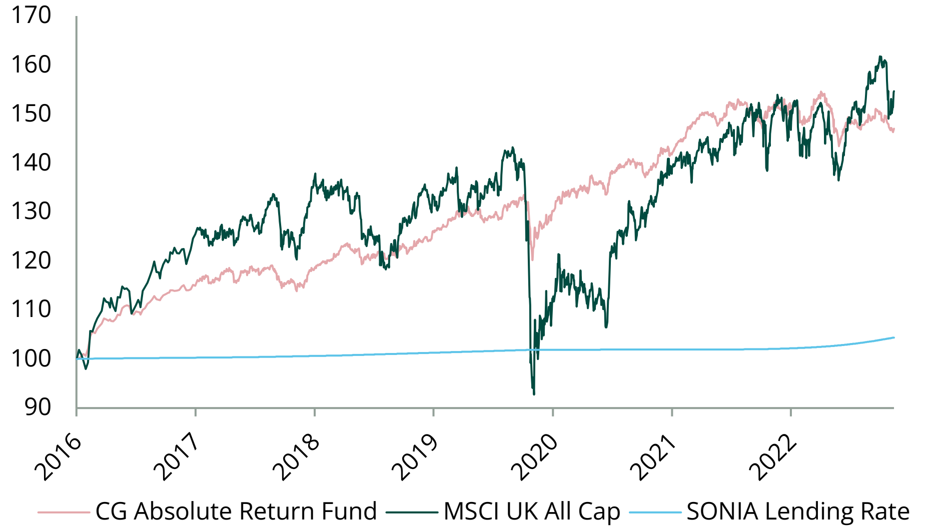
Return history (total returns)

1 month	-0.9%	2022	-2.9%
3 months	-0.6%	2021	8.9%
6 months	0.3%	2020	7.2%
Year to date	-0.6%	2019	8.2%
1 year	-3.4%	2018	1.5%

Largest fund/equity holdings

Ishares MSCI JP ESG Screened ETF	3.3%
SPDR MSCI Europe Energy ETF	2.6%
Lyxor Stoxx 600 Basic Resources	1.4%
Greencoat UK Wind	1.1%
Wisdomtree Physical Swiss Gold	1.0%

Performance since inception (total return)



Largest bond holdings

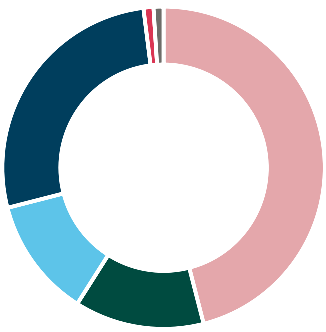
UK I/L 0.125% 22/03/24	6.1%
UK I/L 2.50% 17/07/24	5.5%
UK I/L 0.125% 22/03/29	3.7%
US I/L 1.375% 15/02/44	1.9%
US I/L 0.75% 15/02/45	1.9%

Currency exposure

GBP	53%
USD	25%
SEK	4%
EUR	5%
JPY	9%
Other	4%

Asset allocation

Index Linked Gov't Bonds	46%
Conventional Gov't Bonds	13%
Pref Shares / Corp Debt	12%
Funds / Equities	27%
Cash	1%
Gold	1%



Fund/equity breakdown

Property	4%
Equities	10%
Infrastructure	5%
Loans & Junk Bonds	3%
Energy Equity	4%
Private Equity / Hedge	1%

CG Absolute Return Fund

In Ernest Hemingway's *The Sun Also Rises*, the war veteran Mike Campbell was asked "How did you go bankrupt?". He famously replied, "Two ways. Gradually and then suddenly."

Economists conceptualise the lead up to a crisis along similar lines: a build-up of risk occurs in one area, reaches a tipping point, and transmits throughout the economy, amplified by the financial system. Implicit in the recent commentary about the US economy's surprising resilience to gradual but significant interest rate rises was the idea that there must be a sudden tipping point at which the economy would react. This point came with the failure of Silicon Valley Bank, where initial liquidity concerns escalated into a wider solvency panic after the failure of an emergency equity raise. Silicon Valley Bank was followed swiftly by the collapse of Signature Bank and Silvergate Capital in the US, and then by Credit Suisse in Europe.

Against this backdrop, we spent the quarter adjusting the portfolio to position it defensively against the risk of further sudden breakage to the financial system or real economy.

We had been enthusiastic buyers of corporate bonds at the end of 2022, but became sellers in the first quarter of 2023 as yields on the sterling corporate bond index reduced from a high of 7.2% in October 2022 to a low of 4.8% in February. While corporate bonds yields were falling, six-month UK Treasury Bill yields were rising and now stand at 4.3%. This combination of developments has allowed us to sell our lowest-yielding corporate bonds and shift these into higher-yielding and lower risk UK Treasury Bills. The extent of this has been to reduce our corporate bond holdings from 16.8% at end-2022, to 12.6% at present, with an overall yield of 6.3%. Our UK Treasury Bills now comprise 8.1% of the portfolio, with an overall yield of 4.2%.

We continue to hold the bulk of our portfolio in government index-linked bonds. Within this, the largest constituent parts remain US TIPS (19% weighting, 1.4% real yield), and UK Linkers (20.5% weighting, 0.2% real yield based on RPI which rises to approximately 1% real on a CPI-adjusted basis). Given the uncertainty around the outlook for the financial system, and the increasingly embedded inflation across the US and UK economies, the opportunity to earn a positive risk-free real yield remains difficult to overlook.

We continue to reduce the risk asset weighting in the portfolio, which is currently 27.3%. This follows from our judgment that US conventional equity valuations remain elevated and vulnerable to downward adjustment from either a rising interest rate environment or a recession. Risk assets were the main culprit of negative performance over the quarter, returning -3.0% overall. Our most notable reduction has been to the property sector, where the benefit to valuations of increased rental income from index-linked leases continues to be more than offset by the negative impact of rising capitalisation yields. The property sector now comprises only 4.0% of the portfolio.

The last year has been a very difficult investment environment and the CG Absolute Return Fund has not been immune to this. The fund returned -0.6% over the quarter and -3.4% over the past 12 months. Much of the weakness over both these periods was due to property holdings, which have seen drastic rerating and now fully discount a recessionary environment. It is disappointing to report a negative performance over any 12-month period, but we are increasingly confident in the portfolio's ability to deliver improved returns over the period ahead. The portfolio is well-diversified, with a majority allocation to high quality government and corporate bonds which offer low risk, inflation-beating returns. This is not an environment for complacency, but we are cautiously optimistic that the portfolio can withstand the challenges that we are likely to face.

Emma Moriarty
March 2023

Q1 2023 Report
Capital Gearing Portfolio Fund

Fund information as at:

31st March 2023

Share prices:

P shares £37,013
V shares £180.01

Status:

Hard Closed

Investment objective

To achieve cost-effective, long-term absolute returns via a global portfolio of equities, bonds and commodities. Typically, equity investments are expressed via ETFs and listed closed end funds, and bond investments are made directly. The Fund is actively managed, without reference to a benchmark.

Fund information

Fund Size	£348m
Dividend Yield	< 2%
Management Fee	0.75%
Total Expense Ratio	0.85%
Comparator Index	3m Libor

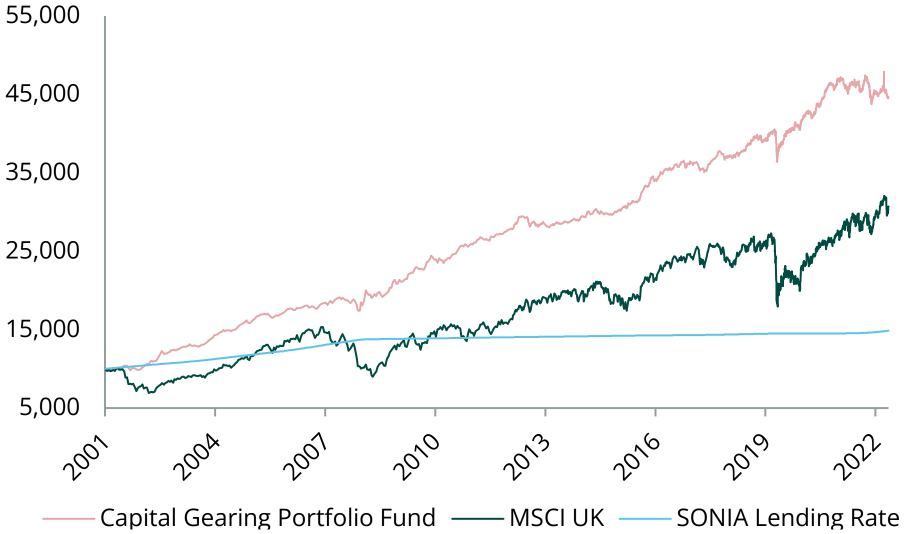
Return history (total returns)

1 month	-1.2%	2022	-4.0%
3 months	-0.9%	2021	10.3%
6 months	-0.2%	2020	7.3%
Year to date	-0.9%	2019	7.6%
1 year	-4.1%	2018	1.5%

Largest fund/equity holdings

Ishares MSCI JP ESG Screened ETF	3.7%
SPDR MSCI Europe Energy ETF	2.6%
North Atlantic Small Co's	2.3%
Lyxor Stoxx 600 Basic Resources	1.5%
Greencoat UK Wind	1.2%

Performance since inception (total return, P Shares)



Largest bond holdings

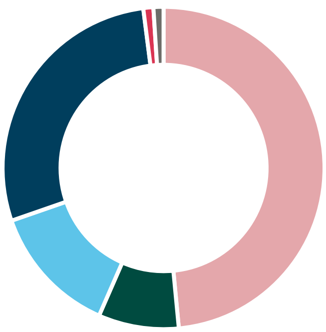
UK I/L 0.125% 22/03/24	7.3%
UK I/L 2.50% 17/07/24	5.0%
UK I/L 0.125% 22/03/29	3.5%
US I/L 2.375% 15/01/27	2.7%
US I/L 1.375% 15/02/44	2.2%

Currency exposure

GBP	53%
USD	25%
SEK	3%
EUR	5%
JPY	9%
Other	4%

Asset allocation

Index Linked Gov't Bonds	49%
Conventional Gov't Bonds	8%
Pref Shares / Corp Debt	13%
Funds / Equities	28%
Cash	1%
Gold	1%



Fund/equity breakdown

Property	4%
Equities	10%
Infrastructure	5%
Loans & Junk Bonds	4%
Energy Equity	4%
Private Equity / Hedge	1%

Capital Gearing Portfolio Fund

You don't find out who's been swimming naked until the tide goes out. Few now doubt that the tide is ebbing and that, as it does so it is revealing a range of issues across the financial system. Sadly, the receding water is revealing significant issues in the investment trust sector. The average discount to net asset value for conventional investment trusts is at the widest level it has been in a decade, with the exception of a very brief period at the peak of the Covid crisis. Even more concerningly alternative investment trusts now sit at an average discount of c.25%, significantly wider than the Covid trough and reminiscent of levels seen during the global financial crisis.

Many of these issues were foreseeable. As we wrote in our September 2021 quarterly letter, the then staggering level of issuance was a clear warning sign of troubles to come. Despite our nervousness we had no quarrel with investment trusts issuing shares at a premium, and Capital Gearing Trust was part of that issuance trend. However, investment trust directors who allowed rampant share issuance at modest premiums have a symmetric obligation to protect their shareholders at modest discounts. These obligations are largely going unmet.

Fund Manager Chris Clothier recently wrote an open letter to the boards of renewable energy infrastructure funds stressing this point. "Shrink to grow" was his call to arms!

> *"The burden falls then to the boards in the sector to take urgent action. For as long as their shares trade at discounts, trusts cannot raise additional capital, and without fresh capital our path to net zero looks more challenging. To counter this, boards must aggressively buy in their company's shares until they once again stand at premia, premia which were the norm for most of the past decade. Boards will understandably be reluctant to divert cash from new projects to buying back shares. They need to be farsighted and resolute. Shrinking now will enable them to grow faster in the future".*

This paradoxical advice builds on the central importance of trust at the heart of the financial system. Trust is won by acting with competency, integrity and goodwill; it is about making the hard decision when that is the right thing to do. There have been some alternative investment trusts that are responding to recent share price falls, including Aquila European Renewables plc, GCP Infrastructure Investments plc and Cordiant Digital Infrastructure plc. These companies are all to be commended for taking action. Frustratingly there are many more boards that have simply stood back and let significant discounts emerge. We are actively engaging with many of them and would be keen to speak with any other shareholders who share our frustration.

Recently a small discount has emerged in Capital Gearing Trust's share price, immediately prompting the board to commence share buy backs. In doing so they are honouring their shareholder obligations and pursuing a risk-free opportunity to enhance returns. Why would any board miss this opportunity to build trust? What more is there to say?

In this environment of widening discounts, the investment trust index delivered a -1.4% return in the quarter and -10% over the last year. This fund's risk asset portfolio delivered returns of -0.9% in the quarter and -4.1% over the last year. Given the risks in the current environment we continue to maintain a low weighting to risk assets, at 28% of the portfolio. We are not yet at a point that sufficient value has emerged to increase our risk asset weighting. That time will come, and it may arrive sooner if boards take their shareholder obligations more seriously.

Alastair Laing
March 2023

[1] Warren Buffett - 25th April 1994.
[2] Alternative Investment Trusts include those holding illiquid assets such as infrastructure, property, private debt and private equity.
[3] "Renewable Boards Must Power Up: An open letter to the boards of, and our fellow shareholders in, investment trusts in the renewable energy sector." March 2023. Available at www.cgasset.com.

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