

# Fourth Quarter Report

December 2020



Dollar Fund

Real Return Fund

Absolute Return Fund

Capital Gearing Portfolio Fund

 **CG** Asset Management

# General Commentary

December 2020

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Demographic changes are slow, measured in years and even decades rather than months. But they are powerful. Charles Goodhart and Manoj Pradhan have written an excellent book, *The Great Demographic Reversal*, whose broad thesis is that demography has been a force for low inflation and low nominal and real interest rates for three decades; but that all those downward pressures will be reversed in the coming decades.

The most dramatic shift has been in China. Its policy changes and admittance into the WTO in 1997 more than doubled the workforce available to produce tradeable goods. On top of that, its Working Age Population (WAP) increased by 240 million over the period, four times the growth in WAP in Europe and the US. The fall of the Berlin Wall added another 200 million of WAP from Eastern Europe. And the trends in Western Europe and the US were favourable too, with the number of children falling faster than the rise in retirees so that the ratio of dependents to the WAP improved. With world trade growing at twice the rate of GDP, globalisation crushed the bargaining power of labour, leading to low inflation, greater inequality and good corporate profits. The deflationary effects allowed monetary policy to be accommodative and, as a result, nominal interest rates to fall to historically unknown levels and debt to explode. Asset prices were inflated.

This sweet spot is souring. In the coming decades there will be an absolute decline in the WAP in China, much of North Asia, Japan, Germany, Italy, Spain, and Poland; the US and the UK will see lower rates of growth. There are reasons to doubt that India and Africa can play the role of China in coming decades. Meanwhile the number of retirees will increase rapidly. Goodhart and Pradhan's thesis is that this combination will see the savings rate contract and the "savings glut" disappear, leading to higher interest rates. This is because workers consume less than

# General Commentary

December 2020

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they produce, pensioners the reverse. With even higher conviction, they believe that the improved bargaining power of labour will lead to higher real wages and higher inflation.

One frequent objection to this thesis is to point to the example of Japan where a falling WAP has not yet led to rising inflation. The most important rebuttal, among several, is that the dynamics determining both inflation and real interest rates are worldwide, not local. The rest of the world was “overflowing with labour” as Japan’s was ebbing. Interestingly, a recent paper from the Fed by Michael Kiley also discusses the importance of international rather than country specific factors in determining interest rates. The same can be said for inflation.

The book argues that, with ex-ante savings falling faster than investment, long term equilibrium will require higher real interest rates. But it is worth quoting parts of a passage on the next few years:

*Inflation will rise considerably above the level of nominal interest rates that our political masters can tolerate. The excessive debt, amongst non-financial corporates and governments will get inflated away.*

*The negative real interest rates that may well be necessary to equilibrate the system, as real growth slows in the face of a reversal of globalisation and falling working populations, will happen. Even if central banks feel uncomfortable with such higher inflation, they will be aware that the continuing high levels of debt make our economies still very fragile... Only when indebtedness has been restored to viable levels can an assault on inflation be mounted.*

The final point that comes out of the study is that growth will be in short supply. Broadly, growth in GDP is the product of productivity and growth in WAP. Productivity in Japan was among the best of any

advanced economies in the last decade, but the contraction in its WAP meant that growth was modest; similar outcomes will prevail in the remainder going forward. Growth is likely to be lower and a considerable headwind for corporate profits.

So, if Goodhart and Pradhan are correct, the coming years will be characterised by elevated inflation, poor growth, and corporate profits that are constrained by the greater power of labour relative to capital. On the other hand, the debt trap will push real interest rates even lower for an extended period. It will be an interesting and challenging environment for investors to navigate.

Peter Spiller

# Dollar Fund

December 2020

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Since the start of the year, and largely in response to the Democrats regaining control of the Senate, moves in the treasury market have been dramatic. 2Y real yields have fallen by around 35 bps. Nominal yields remain firmly anchored at the lower bound: the moves can all be ascribed to rising inflation expectations. In addition, the market now appears to be predicting interest rate rises between 2023 and 2026. The spread between 5Y and 2Y real yield is around 50 bps. As recently as November it was below 10 bps. This means that the market is factoring in several rate rises over that period. Given that breakevens beyond 1 year are essentially flat over the entire length of the curve, and are below a level associated with the Federal Reserve hitting its inflation target, the market is implicitly saying that the Fed is going to raise rates for a reason *other than elevated inflation*.

We judge this – in the purely literal sense – to be incredible. Investors will recall that in August 2020 at the Jackson Hole symposium, Fed Chair Jerome Powell set out a framework for the Fed’s accommodation which said that the Fed would not raise rates until BOTH the economy had reached full employment AND inflation was above target AND likely to remain above target for some time. The Fed has explicitly told the market that it will not take action until these objectives are reached. We are left with three possibilities. First, that the Fed has said one thing but means another. Second, that something has changed since Jackson Hole. Third, and this is a conclusion that is reached with some trepidation, that the market is simply wrong.

It is true that historically the market has successfully called the Fed’s bluff over a number of consecutive years. However, in every instance this related to the

Fed’s actions being more dovish than their rhetoric, not the other way round.

Since Jackson Hole, a new Summary of Economic Projections was released by the Fed. This is a summary of committee member forecasts for various economic indicators including GDP growth, inflation and unemployment. This showed a decrease in unemployment forecasts in 2023 from 4% to 3.7%. In addition it is forecast that there would be no increase in rates until PCE reached a 12 month average of 2.3% (consistent with a CPI of c. 2.75%). Lael Brainard, a Fed governor generally regarded as a centrist, gave a speech on 13 January which, in our assessment, strongly reinforced the Jackson Hole narrative. *Inter alia*, she said that “lifting the lives of working people is at the heart of economic policy making” and that whereas previously monetary policy sought to “minimize deviations from maximum employment” it now sought to “eliminate shortfalls” altogether. She went on to say that the current headline unemployment rate of 6.7% was closer to 10%, once recent changes in participation were taken into account. She also stressed that unemployment is likely to be above 20% in the bottom wage quartile – the very cohort that the Fed is most keen to help.

Taken together, we are forced to conclude that the market is reading the situation incorrectly. Fortunately we are in a position to exploit this situation, the fund has been significantly overweight the front end of the curve, to partially offset our overweight to the long end of the curve. We are taking this opportunity to sell the front end and add to the belly. These switches pick up around 60bps in yield for minimal increase in duration, in a low return world that extra return is worth having.

Fund Information as at:  
31st Dec 2020

Fund price:  
£167.69

Status:  
Open

## Investment objective

To achieve real returns through long only investment in Treasury Inflation Protected Securities (US government index linked bonds).

### Fund information

Fund size	£1,014m
Class size	£290m
Dividend Yield	< 2%
Management fee	0.25%
Total Expense Ratio	0.34%

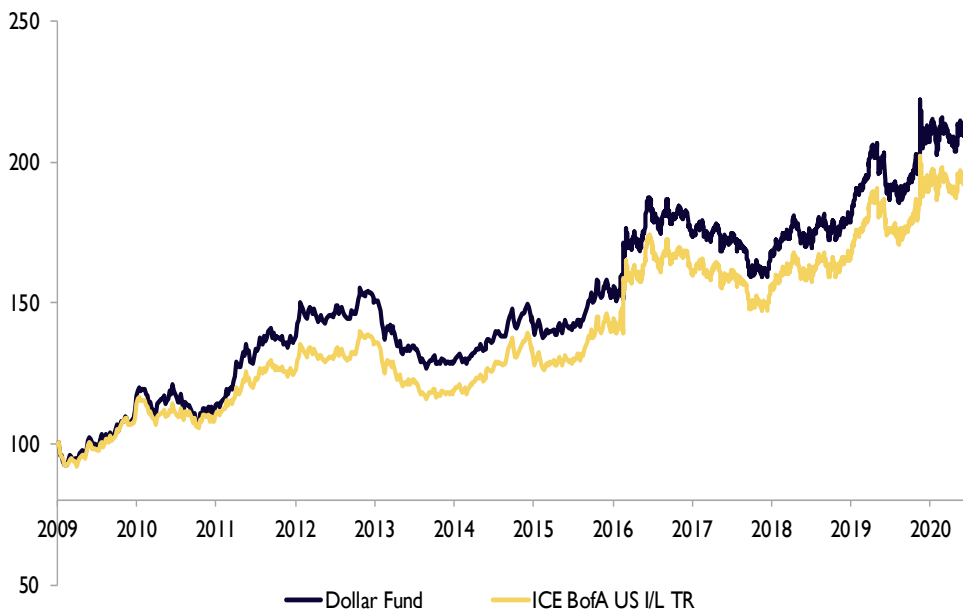
### Return history (total returns)

1 month	-1.5%	2020	8.6%
3 month	-4.2%	2019	4.9%
6 month	-5.3%	2018	-6.3%
Year to date	8.6%	2017	24.2%
1 year	8.6%	2016	5.6%

### Largest holdings

US I/L 1.00% 15/02/46	4.9%
US I/L 0.75% 15/02/45	4.8%
US I/L 1.375% 15/02/44	4.1%
US I/L 0.25% 15/02/50	3.3%
US I/L 1.00% 15/02/48	3.0%

### Performance since inception (total return)



### Credit ratings

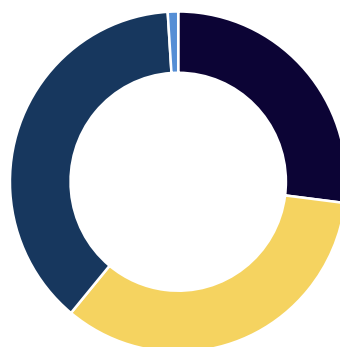
AAA	100%
AA	0%
A	0%
BBB	0%
BB and below	0%

### Characteristics

Number of bonds	45
Yield to maturity (real)	-1.1%
Average Maturity	10.9 Yrs
Average coupon (real)	0.9%
Composite rating	AAA

### Maturity analysis

10 + Yrs	34%
5 - 10 Yrs	25%
0 - 5 Yrs	38%
Cash	3%



### Duration history

31 Dec 20	10.2
30 Sep 20	10.3
30 Sep 19	8.9
30 Sep 18	7.4
30 Sep 17	6.8
30 Sep 16	5.9

Fund Information as at:

31st Dec 2020

Fund price:

£107.27

Status:

Open

## Investment objective

To achieve real returns through long only investment in Treasury Inflation Protected Securities (US government index linked bonds). All US dollar currency exposure is hedged back to Pound Sterling.

## Fund information

Fund size	£1,014m
Hedged class size	£725m
Dividend Yield	< 2%
Management fee	0.25%
Total Expense Ratio	0.34%

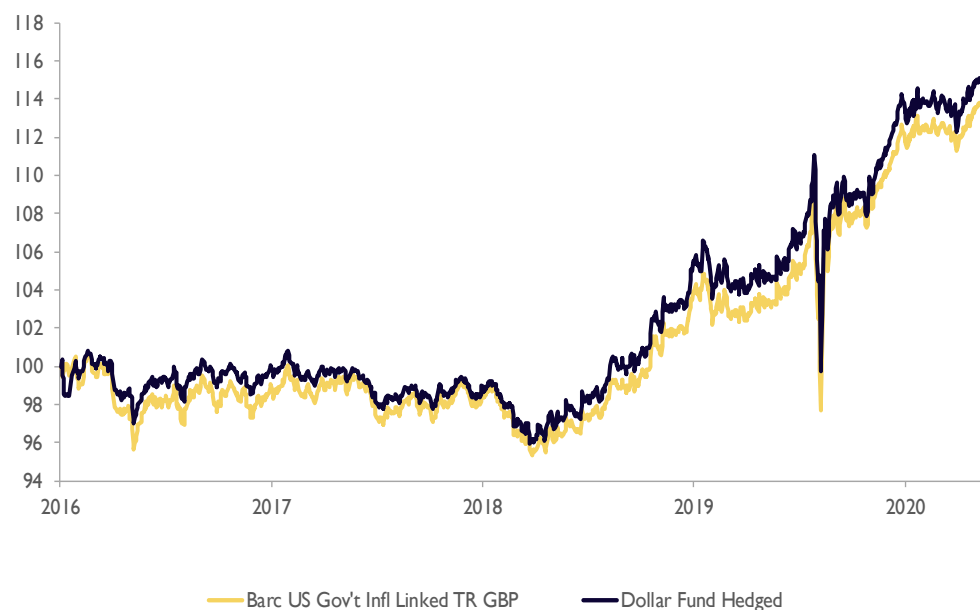
## Return history (total returns)

1 month	0.8%	2020	10.5%
3 month	1.3%	2019	7.4%
6 month	4.7%	2018	-2.6%
Year to date	10.5%	2017	1.4%
1 year	10.5%	2016	-1.5%

## Largest holdings

US I/L 1.00% 15/02/46	4.9%
US I/L 0.75% 15/02/45	4.8%
US I/L 1.375% 15/02/44	4.1%
US I/L 0.25% 15/02/50	3.3%
US I/L 1.00% 15/02/48	3.0%

## Performance since inception (total return)



## Credit ratings

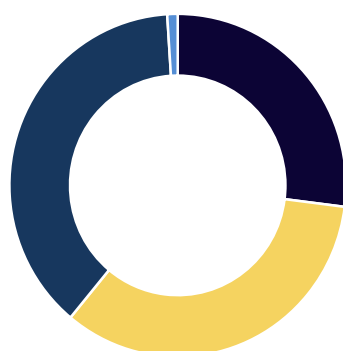
AAA	100%
AA	0%
A	0%
BBB	0%
BB and below	0%

## Characteristics

Number of bonds	45
Yield to maturity (real)	-1.1%
Average Maturity	10.9 Yrs
Average coupon (real)	0.9%
Composite rating	AAA

## Maturity analysis

10 + Yrs	34%
5 - 10 Yrs	25%
0 - 5 Yrs	38%
Cash	3%



## Duration history

31 Dec 20	10.2
30 Sep 20	10.3
30 Sep 19	8.9
30 Sep 18	7.4
30 Sep 17	6.8
30 Sep 16	5.9

# Real Return Fund

December 2020

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2020 was a successful year for the Real Return fund. It delivered returns of 8% performing robustly against a volatile backdrop. Changes to the asset allocation were modest, although the weighting to US TIPS was reduced from 76% at the beginning of the year to 72% by the end. Offsetting this decrease in TIPS was an increased investment in Japan and to a lesser extent additions were made in Sweden.

There has been a lot written about Sweden recently, mostly focusing on the less restrictive strategy the country adopted in combating the coronavirus pandemic. The highly politicised nature of that debate tends to result in more heat than light. Given the complex tradeoffs it is unclear whether a settled view will ever emerge on those policy choices.

There is one sphere in which the outcomes have been clearer. Sweden was one of the best performing advanced economies in 2020 and appears well placed to continue its growth in the coming years. Ultimately much of this results from a level of social and political cohesion in Sweden that is the envy of the world. This cohesion positively impacts a range of factors that also, theoretically, impact exchange rates – productivity, relative prices, fiscal balance, trade balance and real interest rates. The Riksbank (Sweden's central bank) hiked rates in late 2019 and did not drop them throughout the crisis. Not surprisingly the Swedish krona was the strongest developed market currency in 2020.

Sweden represents 1% of the index and 5% of this fund. The low weighting in the index reflects the fact Sweden does not issue much debt. According to Eurostat in June 2020 Swedish debt to GDP was 37% and rising slowly. By comparison Italy, France and Spain had respective debt to GDP levels of 149%, 114% &

110% in June and all were rising rapidly. These weak Eurozone sovereign credits make up respectively 8%, 12% and 3% of the index. The weightings in debt indices is based on the size on the outstanding debt stock of each issuer. This risks creating a structural bias towards weaker credits. We seek to avoid this, your fund does not hold the debt of Italy, France or Spain.

Given the good news surrounding Sweden it is worth considering why the krona is not an established safe haven currency, in a basket alongside the Swiss franc and Singapore dollar? We suspect it is because the Riksbank has a long history of targeting a weaker exchange rate in order to ensure Swedish exporting industries remain competitive relative to Germany. True to form after the krona's surge in 2020 in the Riksbank recently announced a plan to revamp its foreign reserve programme. This initiative brought the krona's rise to a juddering halt.

This intervention is frustrating in the short term, however we are confident that value will prevail in the long term. If the Riksbank is successful in suppressing the krona at levels lower than economic fundamentals justify, then it is likely to result in rising inflation in Sweden. The joy of investing in inflation linked bonds is that we are indifferent in how the real exchange rate corrects. The correction could be via higher relative inflation for which we are compensated in the price of our bonds. Or it could be through a strengthening of the krona if the Riksbank is unsuccessful. We don't mind if we get our return through higher bond prices at the same exchange rate, or via the strengthening of the exchange rate.

As Peter is keen on saying it is easy to push a ping pong ball underwater but it is harder to keep it down there for too long.



Fund Information as at:  
**31st Dec 2020**

Fund price:  
**£205.43**

Status:  
**Open**

## Investment objective

To achieve real returns through long only investment into a global portfolio of government index linked bonds outside the United Kingdom.

## Fund information

Fund size	£463m
Dividend Yield	< 3%
Management fee	0.30%
Total Expense Ratio	0.39%

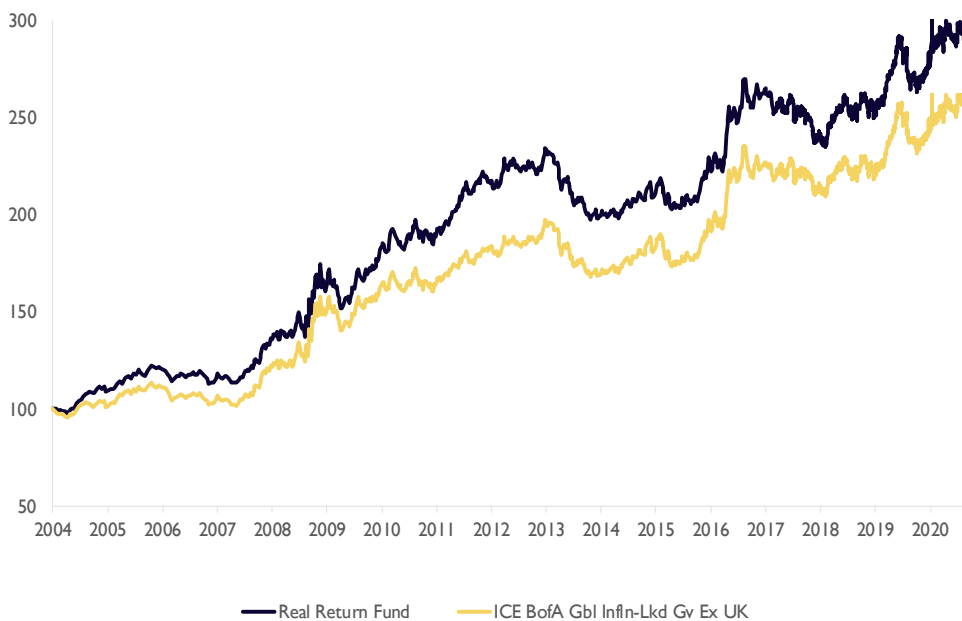
## Return history (total returns)

1 month	-0.9%	2020	8.0%
3 month	-3.0%	2019	2.6%
6 month	-3.8%	2018	3.6%
Year to date	8.0%	2017	-4.4%
1 year	8.0%	2016	22.9%

## Largest holdings

US I/L 2.00% 15/01/26	4.9%
US I/L 2.375% 15/01/27	4.6%
German I/L 0.1% 15/04/23	4.1%
US I/L 2.375% 15/01/25	4.0%
US I/L 1.00% 15/02/46	3.4%

## Performance since inception (total return)



## Credit ratings

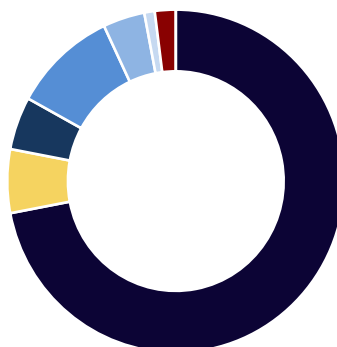
AAA	100%
AA	0%
A	0%
BBB	0%
BB and below	0%

## Characteristics

Number of bonds	56
Yield to maturity (real)	-1.1%
Av Maturity	9.6 Yrs
Average coupon (real)	1.3
Composite rating	AAA

## Asset allocation

USA	72%
Sweden	6%
Germany	10%
Canada	4%
Denmark	1%
Japan	5%
Australia	2%
Cash	0%



## Duration history

31 Dec 20	9.1
30 Sept 20	8.6
30 Sep 19	7.6
30 Sep 18	6.4
30 Sep 17	6.2
30 Sep 16	5.6

# Absolute Return Fund

December 2020

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This fund's objective is to deliver absolute returns, that is to say to deliver positive sterling returns in excess of inflation regardless of the performance of any reference equity or bond index. To flesh this objective out a little, it could be broken down into two sub goals, to

1. preserve capital over any 12 month period; and to
2. deliver returns well in excess of inflation over the longer term.

There is an inherent tension between these sub goals. Short term capital preservation can most easily be achieved by purging all risk from the portfolio. However this approach would render the second sub goal impossible to achieve, particularly in the current environment where safe haven assets have yields significantly lower than inflation. Managing this dilemma is central to our role as investment advisor.

Our style of investment management has always been philosophically closer to the tortoise than to the hare; changes that appear meaningful to us seem glacial to others. That said from the tortoise eye view 2020 did mark a meaningful break from our historic asset allocation. The portfolio started 2020 with risk assets<sup>1</sup> making up about a third of the portfolio. Today risk assets are close to half the portfolio. Offsetting this increase has been a decrease in our cash holdings. Does this change mark a de-emphasis of capital preservation and an increased focus on higher longer term returns? The short answer is no, but the longer answer is a bit more nuanced.

The change is most easily defended by reference to the attractive equity prices available in the spring and summer in the aftermath of a savage bear market. Our cash holdings provided us with optionality to invest into equities when the terms were unusually attractive. That said today many equity markets have fully rebounded and are sitting at all time highs. Certain

markets seem to us to be screaming bubble risk; the poster child being Tesla and the backdrop is a mania of Special Purpose Acquisition Company listings in the US. These latter day speculation vehicles are very reminiscent of those launched during the south sea bubble. As a result of this froth we are now actively reducing conventional equity positions, our weighting is close to its historic low level of 20%.

The reason that the risk asset holdings remain elevated is substantially explained by the increase in alternative property companies which have different dynamics to the conventional equity market. These companies are mainly in the UK and Europe and focus on beds and sheds rather than conventional property companies that focus on offices and shops. The underlying assets held by these companies typically have credit like dynamics, albeit with higher yields and better collateral than is available in the credit market. After a number of near death experiences during the global financial crisis, most property companies have much lower leverage so are much more solid. However there is a catch. Property equities behave like property in the long term but can behave like equities in the short term, particularly in a bear market when correlations go to one.

In summary we do not believe that the changes to asset allocation in the last year have fundamentally altered the risk we most care about, that of permanent capital loss. In this environment we would like to invest into high quality government bonds with yields greater than inflation but those opportunities do not exist. We believe that alternative property currently offers a compelling risk adjusted return relative to other asset classes. As a result we have orientated the portfolio towards this area even though it could result in slightly higher short term equity correlation.

1 listed collectives where the underlying asset classes include equities, property, infrastructure and other alternative assets.

Fund Information as at:

31st Dec 2020

Fund price:

£131.85

Status:

Open

## Investment objective

To achieve absolute returns through asset allocation across equities, bonds and commodities. In most cases bond investments are made directly and equity investments via collective funds such as ETFs and listed closed ended funds.

### Fund information

Fund size	£565m
Dividend Yield	< 1.5%
Management fee	0.35%
Total Expense ratio	0.44%
Comparator Index	GBP SONIA

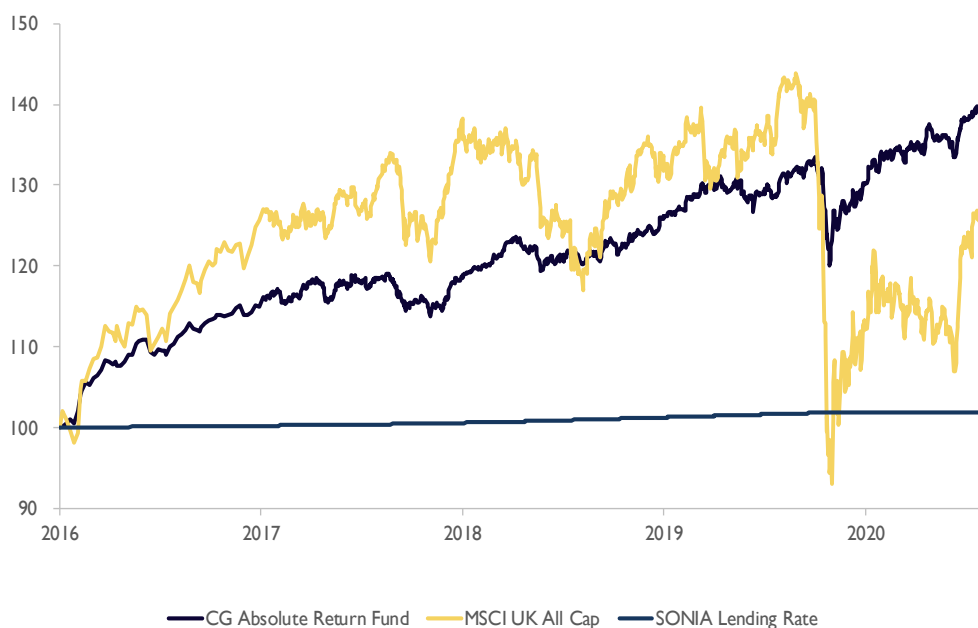
### Return history (total returns)

1 month	1.0%	2020	7.2%
3 month	3.0%	2019	8.2%
6 month	4.5%	2018	1.5%
Year to date	7.2%	2017	6.3%
1 year	7.2%	2016	n/a

### Largest fund/equity holdings

Vanguard FTSE Japan ETF	5.4%
Vanguard FTSE 100 ETF	3.3%
Ishares FTSE 100 ETF	2.8%
Vonovia	2.6%
Tritax Big Box REIT	2.0%

### Performance since inception (total return)



### Largest bond holdings

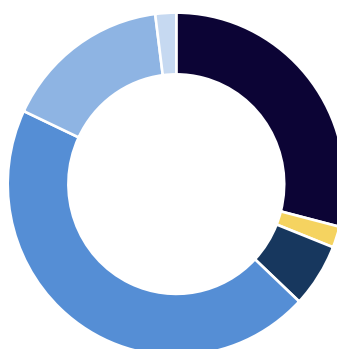
UK I/L 0.125% 22/03/24	1.9%
US I/L 1.00% 15/02/46	1.6%
JP I/L 0.10% 10/03/29	1.5%
US I/L 1.375% 15/02/44	1.5%
JP I/L 0.10% 10/03/28	1.3%

### Currency exposure

GBP	52%
USD	26%
SEK	5%
EUR	6%
JPY	9%
Other	2%

### Asset allocation

Index Linked Gov't Bonds	29%
Conventional Gov't Bonds	2%
Pref Shares / Corp Debt	6%
Funds / Equities	45%
Cash	16%
Gold	2%



### Fund/equity breakdown

Equities	20%
Property	19%
Loans	3%
Infrastructure	3%

# Capital Gearing Portfolio Fund

December 2020

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With the fund a few months away from its 20th anniversary and having closed out a tumultuous year, it seems like an opportune time to review how well it has performed over the longer term. The fund has outperformed UK equities over 1, 3, 5 and 10 years. Since inception the total return has compounded at 7.9% annually turning £10,000 in £42,560. Over the same period UK equities have returned 4.6% annually and that same £10,000 investment would be worth 45% less – £23,400. Often the fund seems to be plodding, but over time this tortoise is able to outrun the hare: *the race is not to the swift, nor the battle to the strong*. So much for the outperformance part, what about capital preservation? Its largest drawdown has been 4.9% compared with 25.5% for UK equities.

Turning to 2020, the return for the year was 7.3% with positive contributions from all asset classes. Index linked bonds returned 9.8%, risk assets 8.7%, gold 20% and the rest – “dry powder” – providing a modest positive return. Drilling into the risk assets in detail, the fund’s equities returned 18.8% materially outperforming the UK All share -9.7% and the MSCI World index 13.0%. At a regional level that outperformance continued too with our UK equities returning 3.4%, US equities 61.4% vs 18.4%, European equities 29.3% vs. 4.3%, and Asia ex-Japan 62.2% vs. 21.6%. Our Japanese equities did not outperform, but then all the fund’s Japanese equities are held in ETFs. In keeping with recent years stock selection was excellent but asset allocation less good as the fund maintained its underweight to the US market which continued its extraordinary run.

Throughout its history the fund has sought to exploit investment company discounts. After a number of years where discount opportunities were scarce, 2020 was a reminder how profitable this can be. The company purchased a c. 2% weighting in Pershing Square Holdings on discounts up to 40% in the teeth of the

March sell off. A combination of strong underlying performance and discount tightening contributed to a near 80% return for the year. The fund took advantage of its December inclusion into the FTSE 100 – and associated index buying – to materially reduce the position. In the spring the fund also built a position in Gabelli Value Plus+. This investment returned 62% as the underlying performed well and the discount tightened. Shareholders voted to wind-up the trust and return cash but this has been blocked by an associate of the manager, with the power to block the liquidation. Such a move is incredibly shortsighted; we can think of no better way to tarnish a manager’s reputation in the London market than pursuing such a *dog in the manger strategy*. We are hopeful that common sense will prevail. If not the board has set out an approach which will return significant amounts of capital to shareholders at NAV. Two other discount situations, Witan Pacific and Gulf Investment Fund, which had been built in anticipation of liquidity events, matured profitably. More generally the fund was active in around 25 discount situations in equity trusts.

Among the other classes of risk assets, property returned 6.1%. The single strongest contributor was German residential property which returned 26.1%. Infrastructure returned 9.2% and private equity/hedge funds 41.1%, this latter had a low weighting so was immaterial to overall returns. The only negative contributors were loan funds (-22%) and Junk Bonds (-1%) however the low weightings to these sectors (1.8% and 2% respectively) meant they were not major drag on performance.

The fund has had a positive start to the year and, mid-way through January, is up 2.6% year to date. While there are a number of positions within the fund which offer the prospect for good returns, equity markets and bond markets in general look stretched; the future may prove more challenging than the past.

Fund Information as at:

31st dec 2020

Share prices:

P shares £36,228  
V shares £176.19

Status:

Hard Closed

## Investment objective

To achieve absolute returns through asset allocation across equities, bonds and commodities. Equity investments are made in quoted closed ended trusts and other collective investment vehicles.

## Fund information

Fund size	£439m
Dividend Yield	< 1%
Management fee	0.90%
Total Expense Ratio	0.99%
Comparator Index	3m Libor

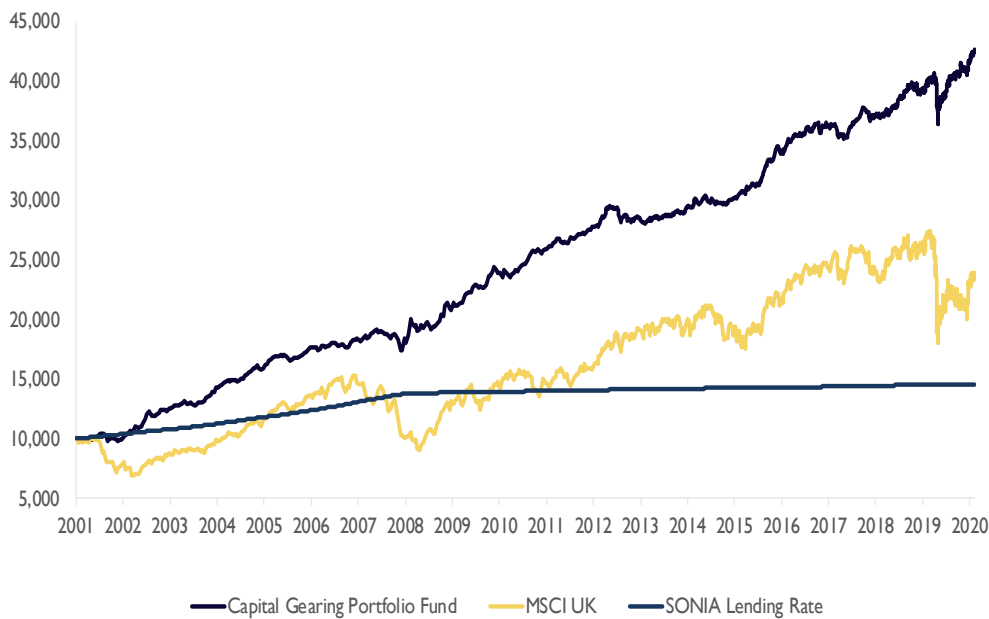
## Return history

1 month	1.6%	2020	7.3%
3 month	4.1%	2019	7.7%
6 month	5.8%	2018	1.5%
Year to date	7.3%	2017	4.9%
1 year	7.3%	2016	13.3%

## Largest fund/equity holdings

Vanguard FTSE Japan ETF	4.8%
North Atlantic Smaller Co	4.3%
Vonovia	2.5%
Wisdomtree Physical Gold	2.0%
Grainger	1.7%

## Performance since inception (total return, P Shares)



## Largest bond holdings

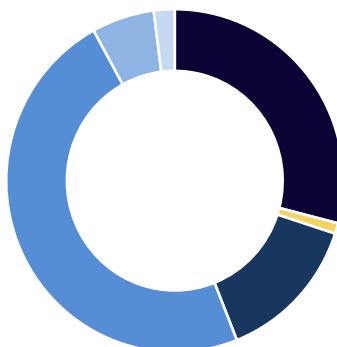
UK I/L 0.125% 22/03/24	3.0%
US I/L 2.375% 15/01/27	2.0%
US I/L 1.375% 15/02/44	1.9%
JP I/L 0.10% 10/03/29	1.8%
US I/L 1.75% 15/01/28	1.8%

## Currency exposure

GBP	52%
USD	27%
SEK	5%
EUR	6%
JPY	8%
Other	2%

## Asset allocation

Index Linked Gov't Bonds	30%
Conventional Gov't Bonds	0%
Pref Shares / Corp Debt	14%
Funds / Equities	47%
Cash	7%
Gold	2%



## Fund/equity breakdown

Equities	20%
Property	20%
Loans	5%
Infrastructure	2%

# Thoughtful Investing

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