Third Quarter Report

September 2020

Dollar Fund

Real Return Fund

Absolute Return Fund

Capital Gearing Portfolio Fund

General Commentary

September 2020

Modern Monetary Theory (MMT), whose high priestess is the former Chief Economist for the Democrats on the US Senate Budget Committee, Stephanie Kelton, has not yet been broadly accepted in academia, but is influential in shifting the framework in which politicians and voters operate. Briefly the theory has two planks.

The first is that every adult should be employed, if necessary by the state, on good wages ($15 per hour versus the current Federal minimum wage of $7.50) if they are unable to find private work for more.

The second and much the more important theory is that the State should make up for any shortfall in demand that leads to unused capacity and should do so with printed money. The only constraint on the level of state spending is inflation. That threat is controlled by the imposition of taxes to reduce private expenditure. Although taxes also provide an opportunity to promote equality or other desirable goals such as deterring the use of tobacco. Interestingly, the nature of government expenditure is not important. Some Keynesian economists have emphasized investment that would enhance productivity in the medium term, but for MMT there is much more emphasis on "work valued by the community".

The approach taken by MMT sounds very different from any in the past, but in fact the outcome is not notably different from a traditional Keynesian diagnosis. Each seeks to determine the level of output gap and to close that gap, with appropriate lags, by increasing government spending or reducing taxes, so that the economy moves into a position of equilibrium. That is defined by as full employment as possible without inducing inflation. The definition of full employment, though, is not the same. Traditionally, the limit has been, at least in concept, the Non-accelerating Inflationary Rate of Unemployment (NAIRU). While variable and difficult to assess, that notion has been central to measuring the output gap.

General Commentary

September 2020

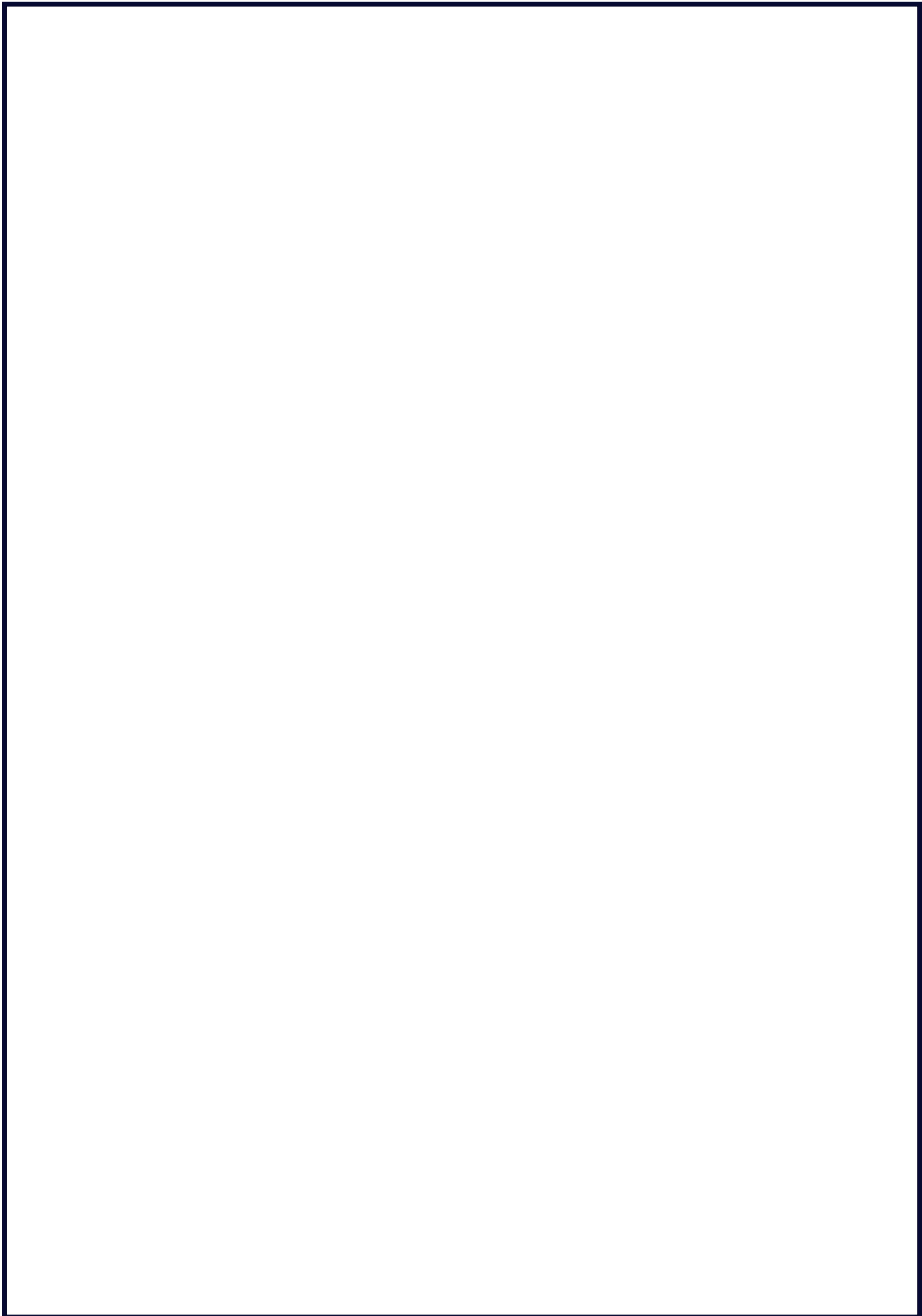
However the experience of the last decade, with a shallower Phillips Curve and weaker bargaining power for labour, has suggested that the NAIRU is lower than in earlier years. MMT goes much further and rejects the concept altogether. The state would employ every willing adult on good wages, allowing private employers to bid for labour at a, presumably substantial, premium to those wages.

The point is not that such a policy is like to be adopted any time soon, but the idea that the NAIRU is unnecessarily harsh on the remaining unemployed is becoming mainstream. There is an echo of that idea in Chairman Powell's speech at Jackson Hole; at least in the dramatic change of weight given to the targets of inflation and employment. Previously the first target was pre-eminent, the assumption being that an elevated rate of inflation is itself negative for employment. Now, not only are jobs the major concern, but also Powell minimized the idea that the Federal Reserve should anticipate future problems.

Like most central banks (particularly the ECB) the Fed is supportive of greater fiscal stimulus. That is historically rare. Budget deficits are at peacetime highs everywhere, but the enthusiasm for austere policies, to reduce them in the coming years is Augustinian – virtue but not yet.

Indeed, the output gap at the centre of the MMT analysis is likely to imply sustained large deficits. With no recent experience of problematic inflation, there is little resistance. So MMT, while remaining not quite respectable, may well provide a good description of and guide to policy developments over the next few years.

Peter Spiller 14th October 2020



Dollar Fund

September 2020

"I guess I should warn you, if I turn out to be particularly clear, you've probably misunderstood what I said". These words of Alan Greenspan, attributed to a 1988 speech typified the then prevailing approach to central bank communication. Specifically that communication should be avoided but where absolutely necessary should more closely resemble a Zen Koan than a Torahic Commandment. Starting in the Ben Bernanke era, and continuing since, the Fed has adopted an approach of greater communication. Janet Yellen's innovation *inter alia* was to introduce a "Statement on Longer-Run Goals and Monetary Policy Strategy". Jerome Powell has gone one step further. The Fed has published the most recent iteration of this document showing additions and ~~striking through deletions~~. In addition the margin is enriched with explanatory annotations in the style of the hip-hop lyric site "Rap Genius". Whatever criticisms might be laid at the door of the current Federal Reserve, poor communication is not one of them.

What can an investor in US TIPS glean from this transparency? First, the Fed now places a much greater emphasis on employment than inflation (indeed the order of words has been turned around such that employment appears ahead of inflation in the document). Maximum employment is also described as a "broad based and inclusive goal". Chairman Powell's remarks at Jackson Hole clarify that this means paying particular attention to unemployment among low income workers – those worst hit by the Corona Virus pandemic. Second, the statement formally codifies the Fed's view that its inflation target of 2% is an average – meaning that it can allow an overshoot of the inflation target to persist to make up for historic periods of below target inflation. Third, lest there be any doubt about the dovish intent of the Fed, the statement of the September meeting is very clear: the Fed will not raise rates until both maximum employment is reached AND inflation is "on track to moderately exceed 2% for some time".

With interest rates held at the effective lower bound[1], and the Taylor rule pointing to the economy requiring negative nominal rates, it is no surprise that Chairman Powell is also prepared to "use our full range of tools to support the economy"[2]. Market commentary around the possibility of yield curve control – a policy which was used effectively after the second world war – has resulted in the treasury market trading as if yield curve control had already been enacted. The Fed has gone one better than Hank Paulson[3]: the market has reacted fully to a bazooka which the Fed hasn't yet acquired.

Our response to this environment has been to lengthen duration to 10.3 years, 1.6 years greater than the index and underweight the belly of the curve relative to the wings. The real yield curve is reasonably steep with 5s30s trading at 98bps. If the Fed is determined to anchor (PCE) inflation expectations at 2% then the 30 year (CPI) inflation breakeven of 186bps looks excellent value. Turning to the front end of the curve, in the context of core CPI of 1.7% today, a 5 year breakeven of 157bps is certainly undemanding[4]. If the Fed can achieve its inflation target and anchor short real rates at c. -2%, long real rates could easily reach -1% - implying a real capital gain of 20% on long dated TIPS from here.

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1 Fed speak for zero
2 Fed speak for QE
3 "If you've got a bazooka, and people know you've got it, you may not have to take it out."
4 It is worth remembering that that the Fed's target is 2% PCE which equates to CPI (the measure of inflation used in the TIPS market) of c. 2.35%

CG AM

Dollar Fund

Fund Information as at:
30th Sept 2020

Fund price:
£177.46

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	£960m
Class size	£306m
Dividend Yield	< 2%
Management fee	0.25%
Total Expense Ratio	0.34%

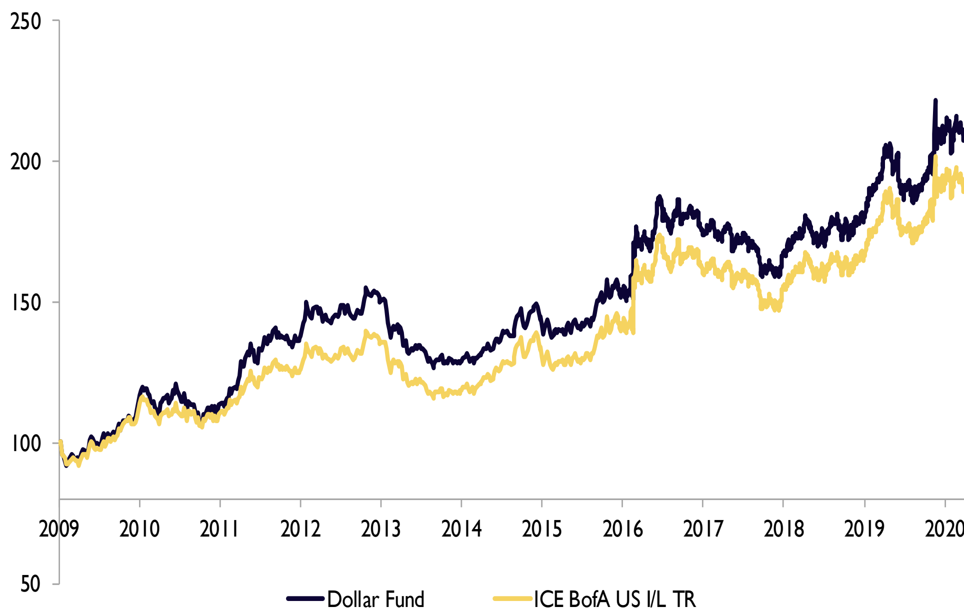
Return history (total returns)

1 month	3.6%	2019	4.9%
3 month	-1.1%	2018	4.9%
6 month	3.2%	2017	-6.3%
Year to date	13.3%	2016	24.2%
1 year	5.9%	2015	5.6%

Largest holdings

US I/L 0.75% 15/02/45	5.3%
US I/L 1.00% 15/02/46	5.1%
US I/L 1.375% 15/02/44	4.3%
US I/L 0.25% 15/02/50	3.3%
US I/L 0.125% 15/04/21	3.1%

Performance since inception (total return)



Credit ratings

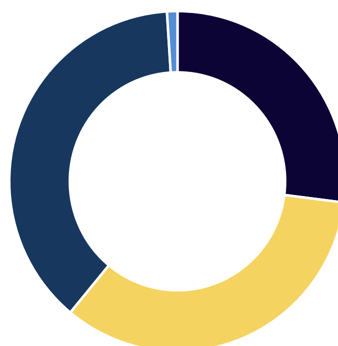
AAA	100%
AA	0%
A	0%
BBB	0%
BB and below	0%

Characteristics

Number of bonds	44
Yield to maturity (real)	-0.9%
Average Maturity	11.1 Yrs
Average coupon (real)	1.0%
Composite rating	AAA

Maturity analysis

10 + Yrs	33%
5 - 10 Yrs	27%
0 - 5 Yrs	37%
Cash	3%



Duration history

30 Sept 20	10.3
30 Sep 19	8.9
30 Sep 18	7.4
30 Sep 17	6.8
30 Sep 16	5.9
30 Sep 15	5.4

CGAM

Dollar Fund (GBP Hedged)

Fund Information as at: **30th Sept 2020**

Fund price: **£107.33**

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	£960m
Hedged class size	£653m
Dividend Yield	< 2%
Management fee	0.25%
Total Expense Ratio	0.34%

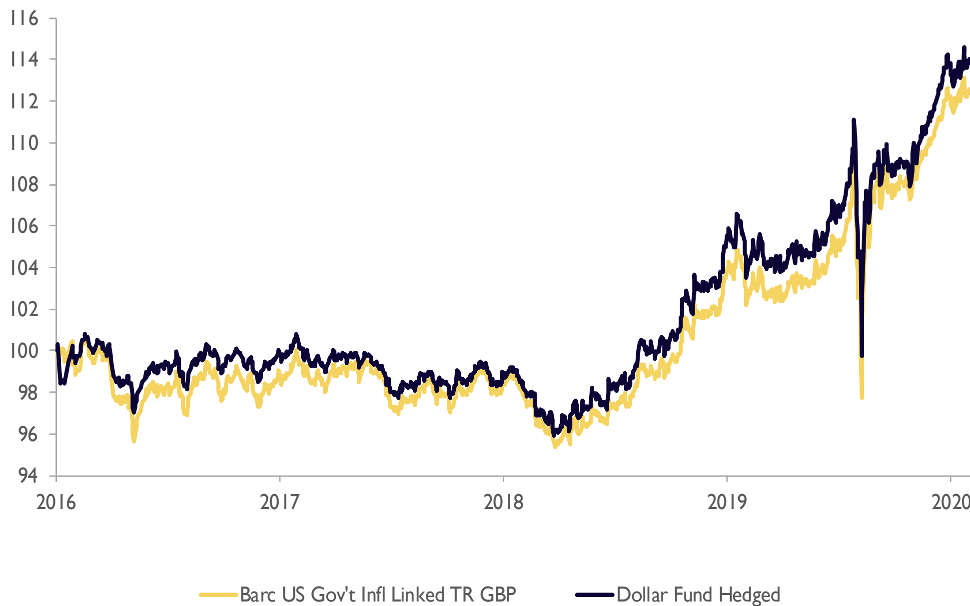
Return history (total returns)

1 month	0.5%	2019	7.4%
3 month	3.4%	2018	-2.6%
6 month	7.5%	2017	1.4%
Year to date	9.2%	2016	-1.5%
1 year	9.3%	2015	n/a

Largest holdings

US I/L 0.75% 15/02/45	5.3%
US I/L 1.00% 15/02/46	5.1%
US I/L 1.375% 15/02/44	4.3%
US I/L 0.25% 15/02/50	3.3%
US I/L 0.125% 15/04/21	3.1%

Performance since inception (total return)



Credit ratings

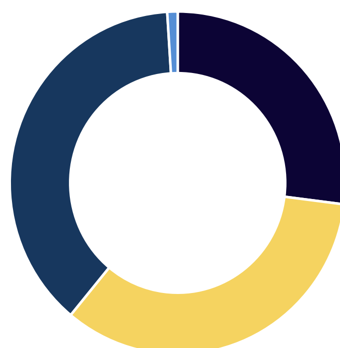
AAA	100%
AA	0%
A	0%
BBB	0%
BB and below	0%

Characteristics

Number of bonds	44
Yield to maturity (real)	-0.9%
Average Maturity	11.1 Yrs
Average coupon (real)	1.0%
Composite rating	AAA

Maturity analysis

10 + Yrs	33%
5 - 10 Yrs	27%
0 - 5 Yrs	37%
Cash	3%



Duration history

30 Sept 20	10.3
30 Sep 19	8.9
30 Sep 18	7.4
30 Sep 17	6.8
30 Sep 16	5.9
30 Sep 15	5.4

Real Return Fund

September 2020

Japan is a powerful intellectual challenge to the argument that today's excessive debt levels will result in an inflationary future. The economic issues created by the bursting of Japan's asset bubble in 1990 foreshadowed the issues faced in the West after the 2008 great financial crisis (GFC). Europe is just now experiencing a declining working age population, a phenomenon that first occurred in Japan 30 years ago. If Japan is the canary in the coal mine, then the next three decades will have a distinctly disinflationary tone.

We do not believe economic outcomes are deterministic. The future in the Anglo-Saxon West is likely to be more inflationary precisely because of the example set by Japan. Japanese banks failed to properly recapitalize post 1990 so funding to the corporate sector dried up. This resulted in plunging capital expenditure and a culture of cash hording as businesses attempted to de-gear by retaining profits. In contrast in America, post the GFC, loss recognition and bank recapitalisation was much more effective and corporate lending has boomed. In Europe, via the ECB PELTRO program, banks have access to effectively unlimited financing at -1% per annum. Yes, banks get paid by the ECB to make corporate loans!

In the monetary realm Japan has acted as a laboratory for policy innovation, allowing Western central banks to adopt and implement unconventional measures far earlier and more aggressively. Japan was experimenting with QE in 2001 and had introduced negative nominal interest rates, yield curve control and an inflation overshoot commitment by 2016. The West experienced its financial crisis 18 years later than Japan but adopted its monetary innovations almost contemporaneously.

In the fiscal realm the Japanese government responded to the 1990 slump with a program of deficit funded public works and increased investment in healthcare and social security for its aging population. Following the economic orthodoxy of the period the Japanese government attempted to raise taxes in 1997 and repeatedly over the following decades in an attempt to shrink the resulting deficits. The economic contractions caused by tax rises caused debt as a % of GDP to rise. This example provides "proof" to policy makers in the West that fiscal orthodoxy should be jettisoned. There is no meaningful political constituency anywhere in the West arguing for balanced books.

The final important differences are demographic, cultural and political. Perhaps the main explanation for the long subdued spending by Japanese consumers is the thrift of its aging population. This conservatism is expressed politically by the stability of the LDP, which has been in government for all but 5 years since its foundation in 1955. Anglo-Saxon countries do not face the same demographic declines and their consumers can be relied upon to keep spending, not least because for many everything they earn has to go on paying the rent and buying essentials. Western culture wars are, in part, motivated by an intergenerational conflict which has no political expression in Japan. Youth culture in Japan is vibrant (in print/fashion/music) but most young Japanese accept that the interests of elderly voters dominate politics.

This could all imply, after a short period of Covid induced savings, that private spending will bounce back in a way that never occurred in Japan post 1990. History is replete with examples of indebted countries suffering inflationary impulses due to private spending surges combined with government deficit spending and stimulative monetary policies. In theory these inflationary impulses can be managed by raising taxes and interest rates but in practice that could be impossible in politically polarised Anglo-Saxon countries. Western policy makers see Japan as an example to be avoid at all costs and as a result will probably avoid its fate. It remains to be seen whether a more inflationary path will deliver better outcomes for its citizens.

CG AM

Real Return Fund

Fund Information as at:

30th Sept 2020

Fund price:

£215.11

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	£494m
Dividend Yield	< 3%
Management fee	0.30%
Total Expense Ratio	0.39%

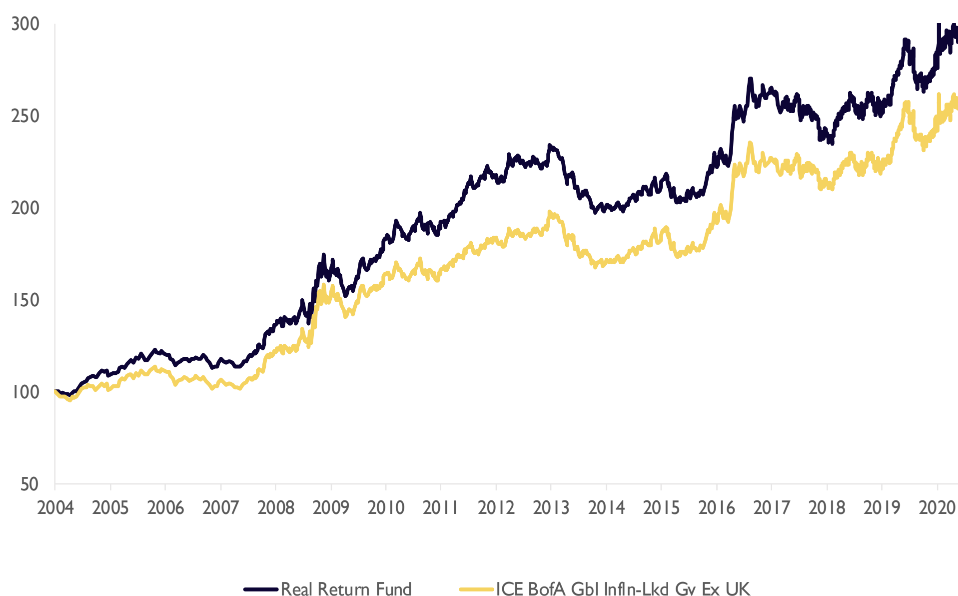
Return history (total returns)

1 month	2.9%	2019	2.6%
3 month	-0.9%	2018	3.6%
6 month	4.0%	2017	-4.4%
Year to date	11.3%	2016	22.9%
1 year	4.7%	2015	2.5%

Largest holdings

US I/L 2.00% 15/01/26	7.5%
US I/L 2.375% 15/01/27	5.0%
US I/L 2.375% 15/01/25	4.4%
German I/L 0.1% 15/04/23	4.4%
US I/L 1.00% 15/02/46	3.4%

Performance since inception (total return)



Credit ratings

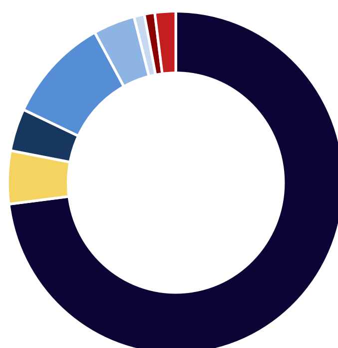
AAA	100%
AA	0%
A	0%
BBB	0%
BB and below	0%

Characteristics

Number of bonds	55
Yield to maturity (real)	-0.9%
Av Maturity	9.2 Yrs
Average coupon (real)	1.4
Composite rating	AAA

Asset allocation

USA	73%
Sweden	5%
Germany	10%
Canada	4%
Denmark	1%
Japan	4%
Australia	1%
Cash	2%



Duration history

30 Sept 20	8.6
30 Sept 19	7.6
30 Sep 18	6.4
30 Sep 17	6.2
30 Sep 16	5.6
30 Sep 15	5.4

Absolute Return Fund

September 2020

For the last 40 years it has been relatively straightforward to deliver decent risk adjusted returns: buy a portfolio of equities, alongside a portfolio of long dated government bonds, rebalance periodically. The government bonds were negatively correlated to the equities and provided a valuable running yield to boot. Those days are over: the yields on government bonds are paltry – if indeed they are positive at all – and the effective lower bound means that the capital gains available from bonds in times of stress are limited. Worse, for much of this year, long bonds, gold and fashionable growth stocks have been positively correlated as the market discounted the cashflows associated with each asset using the same negative real interest rates.

Equities are, by historical standards, very expensive in the US; though they look good value in other markets, notably the UK and Japan. Credit spreads are exceptionally tight; the clamour for yield has become a cacophany as central bank actions flatten both yield curves and efficient frontiers.

While nominal bonds are unlikely to serve their historic role in a portfolio as effectively as they have done in the past, index-linked bonds have the potential to deliver strong capital gains and, as the UK has shown, real yields can become strongly negative and aren't constrained by an effective lower bound. So while the value on offer in US TIPS has undoubtedly diminished they continue to play a useful portfolio role and could yet deliver further capital gains. Japanese index-linked bonds are a new addition to the portfolios. The yen looks cheap and the bonds, unique among G7 countries, offer positive real yields. Gold's weighting has increased from 1% at the start of the year to 2.5% today: gold behaves much like a long dated index-linked bond but tends over the short term to be negatively correlated to the US dollar so it provides a useful counterpoint to our TIPS holdings.

With index-linked bonds and credit yielding so little, we must look elsewhere for returns. We have been attracted to long-lease UK property which has characteristics of both. We recently participated in a placing by Supermarket REIT. As the name suggests, this owns a portfolio of supermarkets on long leases principally let to Sainsburys and Tesco. The portfolio has a yield of 5%, index-linked, with a lease term of 16 years. Consequently around 70% of the NPV of the portfolio relates to an index-linked cashflow where the obligor is one of the major UK supermarkets. The headline spread to index-linked gilts is an attractive 7.5%. There is a prevailing view that, come the end of the leases, these portfolios will be over-rented which will serve to reduce the returns: that juicy spread will not then be all it seems today. Ultimately the residual value, and therefore future rents, will relate to land prices. The portfolio is largely situated on the edge of prosperous towns around the British Isles. This is a crowded island so while the possibility of over-renting gives us cause for concern, the long term prospects for these assets seems well underpinned.

These, and other similar assets are being introduced to the portfolio, part as replacement for index-linked bonds, part as replacement for corporate credit. This approach is not without risk. While we expect these securities to have low correlation to equities, in times of crisis these correlations will rise to one. To compensate for increasing risk in this element of the portfolio we expect to run the portfolio with higher cash balances. Taken together our portfolios will prove somewhat more volatile than in the past, however the higher cash balances should ensure the fund is well placed to exploit such volatility.

CG AM

CG Absolute Return Fund

Fund Information as at: **30th Sept 2020**

Fund price: **£129.75**

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	£472m
Dividend Yield	< 1.5%
Management fee	0.35%
Total Expense ratio	0.44%
Comparator Index	GBP SONIA

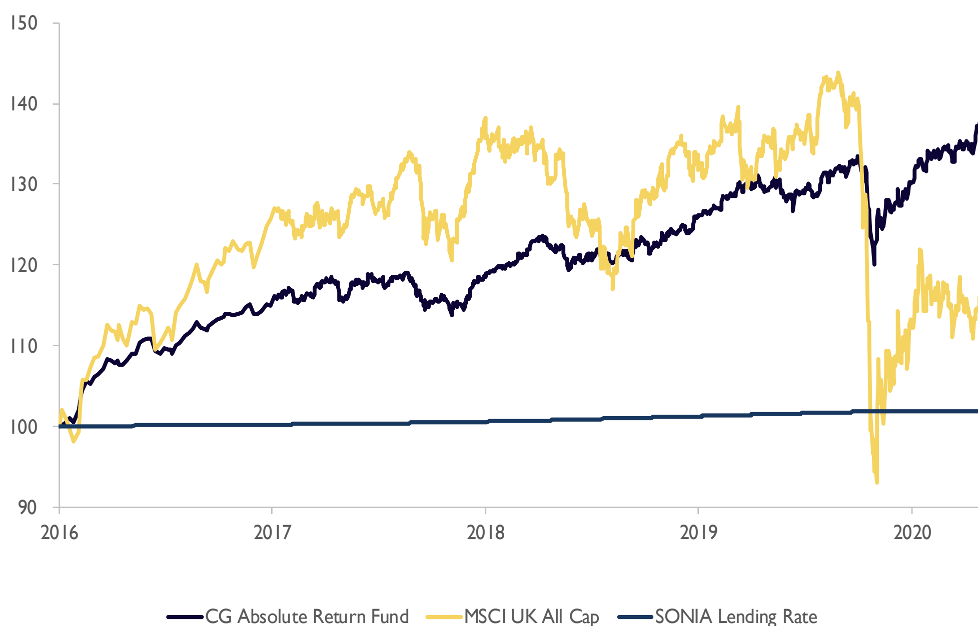
Return history (total returns)

1 month	0.9%	2019	8.2%
3 month	1.4%	2018	1.5%
6 month	7.8%	2017	6.3%
Year to date	4.1%	2016	n/a
1 year	4.0%	2015	n/a

Largest fund/equity holdings

Vanguard FTSE Japan ETF	5.6%
Vanguard FTSE 100 ETF	3.5%
Ishares FTSE 100 ETF	2.7%
Wisdomtree Physical Gold ETF	2.5%
Vonovia	2.4%

Performance since inception (total return)



Largest bond holdings

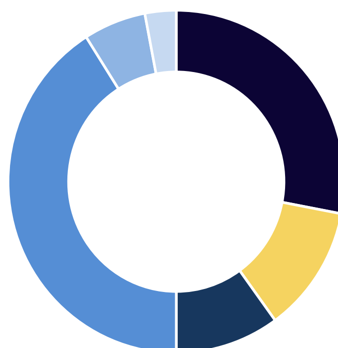
UK I/L 0.125% 22/03/24	2.5%
JP I/L 0.10% 10/03/29	1.8%
US I/L 1.375% 15/02/44	1.6%
US I/L 0.75% 15/02/45	1.5%
JP I/L 0.10% 10/03/28	1.4%

Currency exposure

GBP	51%
USD	27%
SEK	5%
EUR	6%
JPY	9%
Other	2%

Asset allocation

Index Linked Gov't Bonds	30%
Conventional Gov't Bonds	9%
Pref Shares / Corp Debt	9%
Funds / Equities	40%
Cash	10%
Gold	2%



Fund/equity breakdown

Equities	20%
Property	16%
Loans	3%
Infrastructure	1%

Capital Gearing Portfolio Fund

September 2020

The fund has returned 2% in the quarter and 3% year to date, which compares to the MSCI UK index of -5% in the quarter and -22% year to date.

Within the risk asset portfolio, the period was dominated by an unusual number of large primary and secondary placings. This activity was concentrated in alternative property ("sheds and beds") and renewable infrastructure. The Absolute Return fund report lays out some of our thinking as to attractions of these types of assets. The single most exciting secondary placing was in Secure Income REIT plc (SIR) which occurred in July. Notwithstanding the name, this vehicle has had a torrid crisis due to its position as a major landlord to, amongst other tenants, Travelodge and Merlin Entertainments (Legoland, Alton Towers, Warwick Castle etc). These underlying tenants have experienced severe short term impacts from the Covid crisis. This challenging backdrop was exacerbated by a weak market dynamic as a large institution, widely considered to be a forced seller, struggled to build a book in a secondary placing process. Unsurprisingly the share price was very weak.

So what is it about this opportunity that is attractive? Firstly an excellent management team who we trust to guide SIR through the Covid crisis. Secondly, a portfolio containing irreplaceable and strategically valuable properties. Thirdly, and most importantly, compelling value. The fund acquired its holding at a price barely higher than the combined value of SIR's cash and its portfolio of private hospitals (which are trading extremely well). We are always excited to find opportunities with significant upside if we are lucky and limited downside if we are wrong. This holding is now the second largest in the property portfolio and is a top ten equity holding.

Other primary or secondary placings the fund has participated in recently include Supermarket REIT plc, Greencoat UK Wind plc, Greencoat Renewables plc, HICL Infrastructure plc, SDCL Secure Energy Efficiency Income Trust plc and Urban Logistics REIT plc. We have been reading a lot of circulars!

The other area of addition has been in the index linked portfolio, which has increased to a c.29% weighting. The purchases have been in Japan, Sweden and Australia diversifying away a little from our historic concentration in US TIPS. In an unexpected development Japan is now offers the highest real yields in our investment universe. It is rare and pleasing to acquire a safe haven asset offering a positive real yield. Within our TIPS holdings, which still make up 20% of the portfolio, we have lengthened average duration to more than 11 years. Real yields on TIPS have significantly reduced over the last 12 months but these instruments remain central to our defensive asset allocation. By holding a smaller portfolio of longer duration TIPS we hope to benefit from their negative correlation with equities whilst diversifying our overseas currency exposure to include more Yen, Swedish Krona and Australian Dollar.

Offsetting the equity and bond purchases made over the last 6 months has been a reduction in cash (and cash equivalent) levels. Before the Covid crisis the fund held more than 20% cash/ cash equivalents, today this level c.7%. This is still relatively high compared to history but closer to "normal" levels. With equity and bond markets simultaneously trading at elevated levels, attempting to construct a portfolio with the potential for reasonable returns and with robust downside protection has never felt more like walking a tightrope. Nevertheless we remain hopeful that our portfolio will deliver above average returns, adjusted for its carefully considered and controlled risks.

CG AM

Capital Gearing Portfolio Fund

Fund Information as at:

30th Sept 2020

Share prices:

P shares £35,124
V shares £170.83

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	£435m
Dividend Yield	< 1%
Management fee	0.90%
Total Expense Ratio	0.99%
Comparator Index	3m Libor

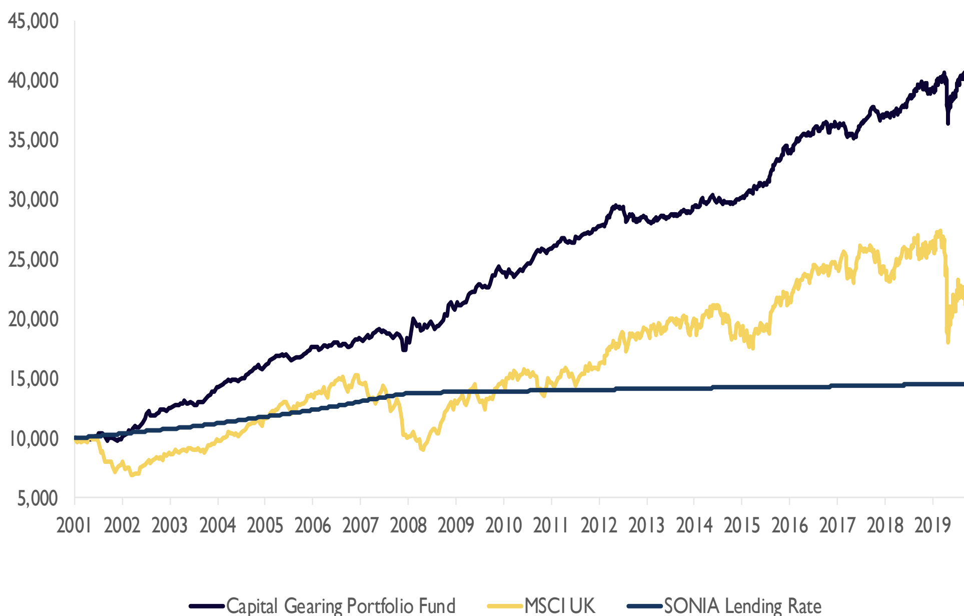
Return history

1 month	0.9%	2019	7.7%
3 month	1.7%	2018	1.5%
6 month	7.7%	2017	4.9%
Year to date	3.1%	2016	13.3%
1 year	3.3%	2015	4.0%

Largest fund/equity holdings

Vanguard FTSE Japan ETF	4.3%
North Atlantic Smaller Co	3.6%
Wisdomtree Physical Gold ETF	2.5%
Vonovia	2.4%
Pershing Square Holdings	2.1%

Performance since inception (total return, P Shares)



Largest bond holdings

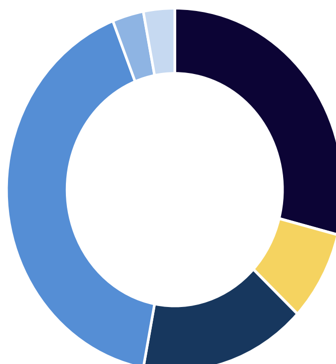
UK I/L 0.125% 22/03/24	3.1%
US I/L 2.375% 15/01/27	2.1%
UK I/L 1.75% 15/01/28	1.9%
JP I/L 0.10% 10/03/29	1.7%
US I/L 1.375% 15/02/44	1.6%

Currency exposure

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

Asset allocation

Index Linked Gov't Bonds	29%
Conventional Gov't Bonds	8%
Pref Shares / Corp Debt	16%
Funds / Equities	41%
Cash	3%
Gold	3%



Fund/equity breakdown

Equities	18%
Property	17%
Loans	5%
Infrastructure	1%

Thoughtful Investing

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