Q3 2022 Performance Summary

Capital Gearing Trust/ CG Absolute Return Fund / Capital Gearing Portfolio

- Returns of -2% CGT, -1% CGPF, -1% CGAR in Q3 and -2% CGT, -3% CGPF, -2% CGAR over the last 12 months;
- The quarter was notable for the severe bond bear market, which was particularly acute in the UK, with the Sterling Aggregate Bond Index down -14%;
- Despite this backdrop of dramatically rising interest rates, the bond holdings, which collectively comprise 55% of the portfolio, enjoyed strong relative performance, returning +1%;
- A majority of the index linked bond holdings are non-sterling denominated (20% in US TIPS and 5% collectively in Japan, Canada, Australia and Sweden). These overseas holdings benefited from strengthening currencies relative to sterling;
- The UK index linked holdings (c.12% of the portfolio) and credit holdings (14% of the portfolio) both benefited from being short duration, and so were not significantly impacted by rising interest rates;
- The most significant additions during the quarter came during the gilt market selloff, with purchases of c.4% of gilt positions, mostly buying index linked 2024s and 2028s but purchasing as long as the 2050s;
- Additions were also made in the credit portfolios, as sterling credit spreads have widened significantly, likely due to technical factors as pension funds sold a wide range of assets to raise collateral for derivative positions;
- Exposure to the Japanese Yen increased 2.5% in the quarter. Whilst the Yen is almost as weak as GBP, it has not experienced problematic inflation and at current levels Yen assets look attractively priced. Initial additions were made to short bonds and Japanese equities;
- After several quarters of strong outperformance, risk assets (c.37% of the portfolio) had a relatively weak third quarter, returning -4%, in line with the MSCI UK All Cap but 2% behind the Investment Trust Index;
- The risk asset weakness was entirely attributable to the property holdings (12% of the portfolio) that fell by 13% in the period, as rising bond yields undermined property valuations;
- Fortunately we steadily reduced property over the last year, although with hindsight should have sold more aggressively over the summer;
- Non-property risk assets collectively delivered a positive return in the quarter, with another strong performance from the energy holdings;
- Discounts have notably widened for conventional investment trusts. We sold many of the conventional ETF holdings and rotated into a range of interesting discount opportunities, without increasing our aggregate exposure to conventional equities; and
- The portfolio remains defensive overall, with an objective of capital preservation and inflation protection.

Real Return Fund

- The unhedged share class returned 1% in Q3 and the GBP hedged share class returned -6%, in line with indices;
- There was a global bond bear market in the period, and the US 2-year interest rate rose by 1.1% to 4% as central banks battled against increasingly entrenched inflation;
- US CPI sits at 8.3%, Euro area CPI at 9.1% and UK CPI at 9.9% - in each jurisdiction core CPI is close to or above 5%;

- Despite the increased experience of inflation, expectations as reflected in breakevens fell in the period – in the US from 2.3% to 2.2%, and Euro breakevens remain flat at around 2%;
- It is possible that the liquidity preference for nominal bonds during a bear market is artificially depressing breakevens, as otherwise it is hard to rationalise low and falling breakevens given the inflationary backdrop;
- The Federal Reserve has led global central banks, increasing interest rates twice in the period to 3.25%, and indicating further rate rises to come;
- The combination of rising nominal interest rates and flat or falling breakevens resulted in rapidly rising real interest rates, which are now strongly positive at all maturities in the US and approaching 2% real for 20-year bonds;
- These high real interest rates appear to offer attractive risk adjusted returns compared to many other asset classes;
- The fund's overweight position to US TIPS proved both a blessing (currency strength) and a curse (weak domestic bond market), which effectively cancelled each other out;
- During the period the fund sold c.2% of short TIPS and reinvested the proceeds into the Canadian Dollar (c.1%) and Japanese Yen (c.1%); and
- Other than these changes, the portfolio remained largely unchanged, with duration remaining at c.8.5 years with longer durations in the US, Canada and Australia, and shorter durations in Japan, Germany & Sweden.

Dollar Fund

- The unhedged share class returned 2% in Q3 and the GBP hedged share class returned -7%;
- Both share classes performed c.1% worse than the indices due to the longer duration of the portfolios;
- There was a global bond bear market in the period, the US 2-year interest rate rose 1.1% to 4% as central banks battled against increasingly intrenched inflation;
- US CPI sits at 8.3% with core CPI at 6.3%, significantly above the 2% inflation target;
- Despite the increased inflation concerns, 10-year US breakeven fell in the period from 2.3% to 2.2%;
- It is possible that the liquidity preference for nominal bonds during a bear market is artificially depressing breakevens, as otherwise it is hard to rationalise low and falling breakevens otherwise given the inflationary backdrop;
- The Federal Reserve has led global central banks, increasing interest rates twice in the period to 3.25%, and indicating further rate rises to come;
- The combination rising nominal interest rates and flat or falling breakevens resulted in rapidly rising real interest rates, which are now strongly positive at all maturities in the US and approached 2% real for 20-year bonds;
- These high real interest rates appear to offer attractive risk adjusted returns compared to many other asset classes;
- The portfolio remained largely unchanged, with duration remaining at c.9.7 years, about 2.5 years longer than the index.
- Given the back up in real yields and low breakevens we have considered lengthening duration but have not done so yet.

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