CG Asset Management

Focus on absolute returns

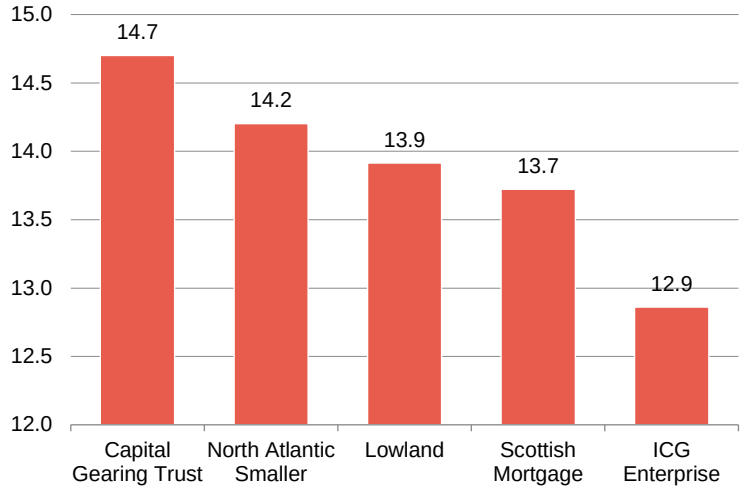
The CG Asset Management (CGAM) team's focus on medium-to-long-term absolute returns, coupled with its excellent track record has attracted a loyal following of investors. This note describes:

- CGAM's business;
- its investment approach; and
- two of its absolute return funds:
  - Capital Gearing Trust and
  - CG Absolute Return Fund.

Manager of the top-performing investment company

Since 1982, when Peter Spiller, CGAM's chief investment officer, assumed responsibility for Capital Gearing Trust, it has been the best performing of all conventional investment companies. Capital Gearing Trust's success has allowed CGAM to launch a number of open-ended, UCITS funds. One of these, CG Absolute Return Fund, has many of the same characteristics as Capital Gearing Trust, offers a liquid way of accessing this strategy and, unlike some of the other funds in CGAM's stable, it is open to new investors.

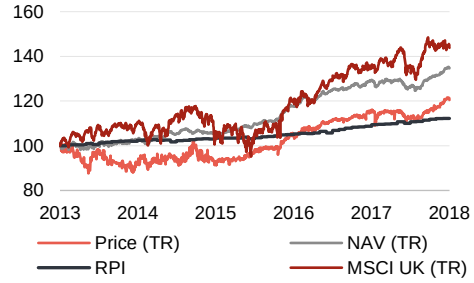
Figure 1: Annualised NAV return April 1982 to August 2018



Source: Morningstar, Marten & Co

Capital Gearing Trust

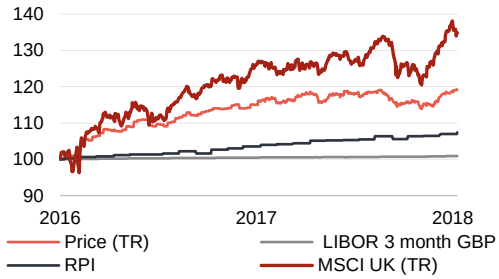
Time period 31/08/2013 to 31/08/2018



Source: Morningstar, Marten & Co

CG Absolute Return Fund

Time period 23/05/2016 to 31/08/2018



Source: Morningstar, Marten & Co

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Introducing CG Asset Management

More information is available at the CGAM website: www.cgasset.com

CG Asset Management (CGAM) was founded in 2000 but its roots go back much further than that, to 1982. This was when Peter Spiller (CGAM's chief investment officer) took on the management of Capital Gearing Trust and developed the investment approach that CGAM still uses today.

CGAM's founders set out three key principles:

- the client comes first;
- don't be greedy; and
- have fun.

Initial aim was to design funds that could be used to look after all of a client's money

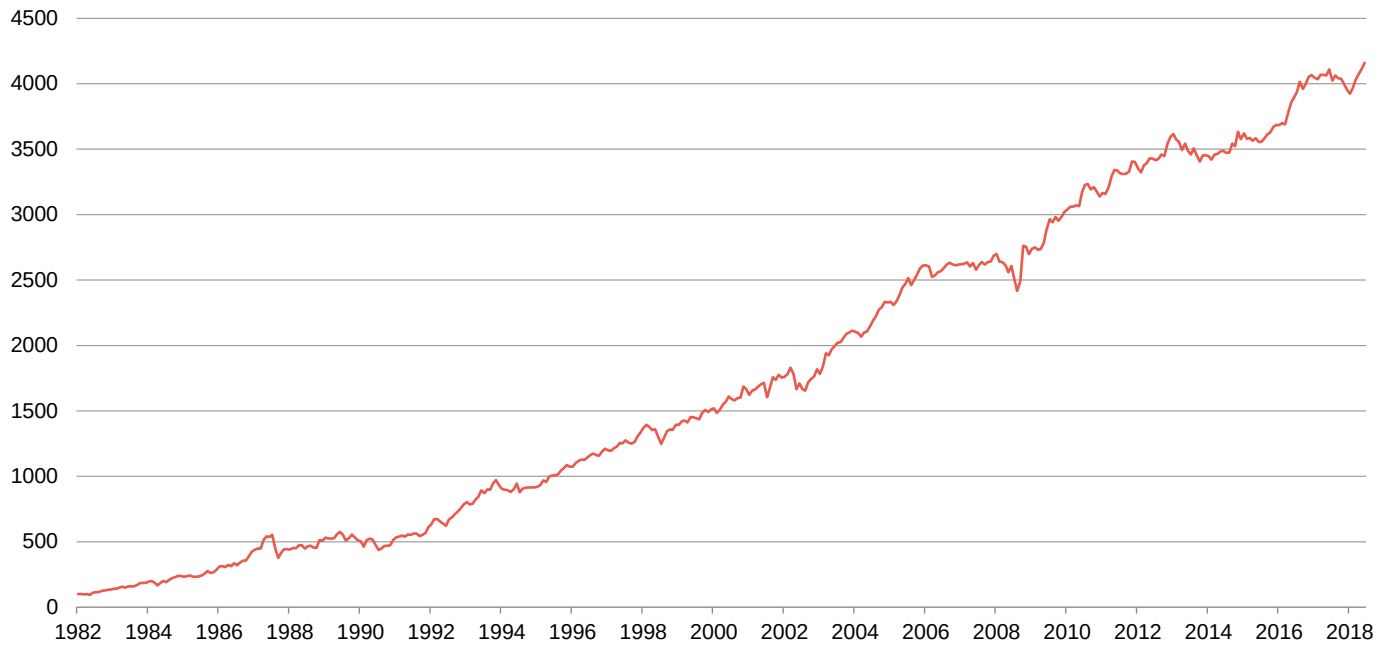
CGAM's initial aim was to design funds that could be used to look after all of a client's money, particularly where these clients share the same aims as CGAM. The founders of the business and the other employees have invested substantial portions of their own money in the funds.

To achieve this aim:

- CGAM takes a genuinely long-term view;
- has an aversion to losing money;
- has a preference for capital gains over income; and
- aims to benefit from the potential returns offered by equity markets but recognises that its funds would not participate in the latter stages of a bull market.

The success of this thinking is evident in the long-term real (after adjusting for inflation) returns generated by CGAM's flagship fund, Capital Gearing Trust. The trust was established in 1963 and listed on the London Stock Exchange in 1973 but the chart uses a start point of 1982 for Figure 2, reflecting Peter Spiller's first involvement with the fund.

Figure 2: Capital Gearing Trust relative to inflation, as represented by the UK Retail Prices Index (RPI), rebased to 100



Source: Morningstar, Marten & Co

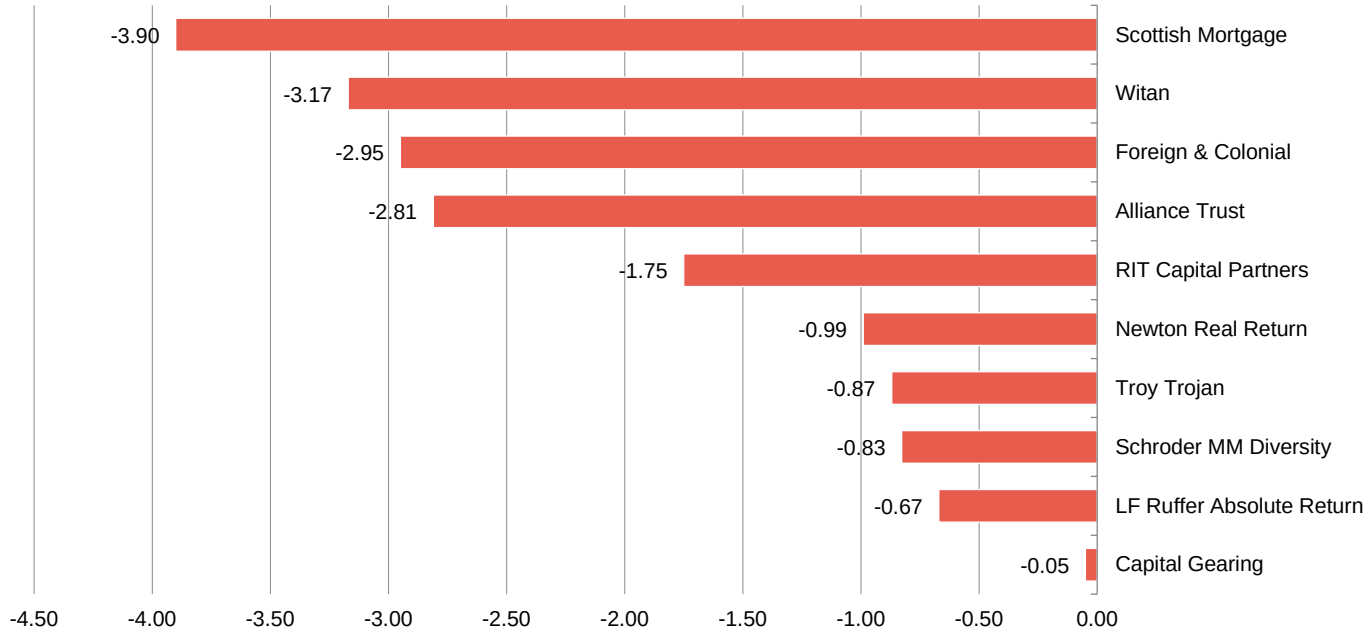
42x in real terms under one manager

Figure 2 amply demonstrates that, over the long term, Capital Gearing Trust has delivered on its objective of preserving the real wealth of its shareholders and achieving an absolute total return over the medium to longer term. In fact, an investment made in 1982 would have made 42x in real terms and 147.6x in nominal terms (versus 40.3x for the UK market or 11.3x adjusted for inflation).

Strategy has been defensive in falling markets

What is more, Capital Gearing Trust can demonstrate a strong track record of preserving investors' capital in falling markets.

Figure 3: Average percentage monthly drawdown in months where the MSCI AC World Index falls in value since February 2006



Source: Morningstar, Marten & Co

Figure 3 shows how various funds perform, on average, in months where world equity markets (as represented by the MSCI All Countries World Index in Sterling) are falling. When compared to a peer group of large global investment trusts and well-known open-ended funds with an absolute return objective, Capital Gearing is by far the most defensive, falling by less than a tenth of 1% while, at the other end of the scale, Scottish Mortgage falls by 3.9%, on average.

Focused management team managing six funds

CGAM's chief executive is Alastair Laing who has been an integral part of CGAM's management team since 2010. Peter Spiller acts as chief investment officer for the company. They are assisted by Chris Clothier. More detail on CGAM's team is provided on page 30.

CGAM manages £1.9bn across six funds; four have an absolute return objective and two invest solely in index-linked securities issued by governments (more information is available on page 30). This note focuses on CGAM's absolute return strategy, Capital Gearing Trust and CG Absolute Return Fund, a version of Capital Gearing Trust available in an, open-ended, UCITS structure.

Investment thesis

Lock in high potential returns for as long as possible – geared exposure to equities

Putting it simply, CGAM's investment thesis is that when potential returns are good, try to lock these in for as long as possible; when potential returns are poor, do the opposite.

In 1982, prospective returns across most asset classes were exceptionally good:

- inflation had purged balance sheets of excessive debt (in 1972 money, a £1 worth of debt borrowed in April 1972 could be repaid for the equivalent of 26 pence ten years later);
- real interest rates (interest rates less inflation) were high and falling;
- inflation was high and falling; and
- p/e ratios were very low.

The model (described in the next section) suggested that real returns of 16% per annum were available over the next ten years but only if they could be locked in.

In CGAM's view, 1982 was the perfect time to have more than 100% of your portfolio invested in equities because, of all asset classes, they would respond most positively to falling real interest rates. In the case of Capital Gearing Trust, this meant borrowing money to invest in equities and having an allocation to the capital shares of split capital investment companies.

All the investment decisions that CGAM makes are driven by value. As the stance that had been taken in 1982 paid off in the early eighties, the prospective returns on equities started to decline but returns on bonds still looked attractive. It therefore made sense to switch portfolios gradually into long-duration (30-year) bonds.

When, as today, prospective returns are poor, do the opposite – low equities and short duration bonds

Today in CGAM's view, prospective returns are exceptionally poor. Its model suggests returns will be zero to negative on most asset classes. The implication of this is that it makes sense to lock those returns in for as short a period as possible. Therefore, portfolios should have low exposure to equities and where bonds are held they should be short duration.

Currently, CGAM's absolute return funds reflect this stance. The managers have substantial resources available to take advantage of any market correction. They stress that, when circumstances change, so will the funds' asset allocation.

Avoid the temptation to take on additional risk to compensate for low returns

CGAM says that it is important that investors accept that returns will be unexciting when valuations are high. Many investors have a tendency to take on additional risk in an attempt to maintain returns in these environments. CGAM believes that is a recipe for disaster down the line. Some alternative asset classes do offer attractive returns, however, and the portfolios have some exposure to these areas (see page 12 and 25).

Investment process

CGAM seeks to add value both through stock selection and asset allocation. Equity exposure is achieved through investment in listed closed-ended funds and other collective investment vehicles including exchange-traded funds (ETFs). Closed-ended funds are preferred to ETFs where the managers believe that excess returns can be achieved by purchasing funds at discounts to NAV and benefitting as those discounts narrow. In current market conditions, a discount narrowing opportunity of 5% or more is considered attractive.

The managers also note that the opportunity set in listed closed-ended funds is limited. Using ETFs and other collective investment vehicles may offer access to asset classes, geographic locations and investment strategies not available to a portfolio comprised entirely of closed-ended funds.

Rates of return mean revert, markets are efficient but longer-term market timing can add value

CGAM's asset allocation model assumes that rates of return on individual asset classes mean revert over time (so if say, equities, look exceptionally expensive now, in time valuations will adjust so that they are trading in-line with long-term averages). Short-term market timing is not possible (i.e. markets are fairly efficient and investors cannot predict where valuations are going in the short term) but longer-term market timing can add value.

The model assumes that, over 10 years, rational investors should expect:

- real equity returns equal to the dividend yield on a stock plus real earnings growth plus or minus any valuation change; and
- real bond returns equal to the 10-year inflation-linked bond yield (held to maturity)

It also assumes that reversion to the mean takes place very slowly (over 20 years).

Confidence imparted by long-term track record allows managers to ride out short-term underperformance of equity markets

CGAM's approach and the asset allocation decisions it makes may lead to sub-par returns for periods of time, especially at the tail end of a bull market (when equity markets are still rising and valuation multiples expanding but CGAM has low/no exposure). This would be an uncomfortable position for most managers, given the short-termism prevalent across much of the investment industry, but CGAM's managers can point to their long-term success and ride these out.

CGAM tends not to use derivatives, complex strategies or short positions in the management of its portfolios. The managers are concerned about counterparty risk in the derivatives market. They feel that short positions are more suited to short-term tactical investment decisions.

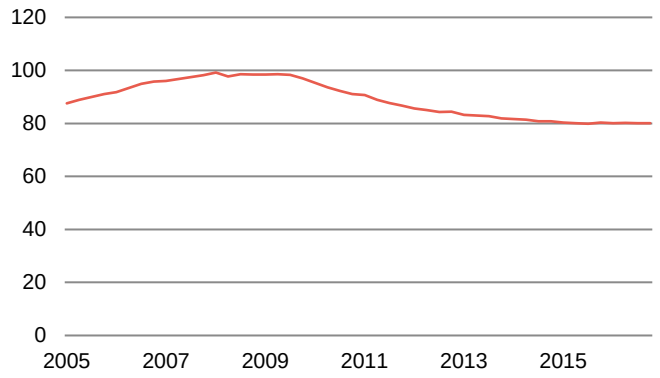
Currency exposures are considered within the context of asset allocation.

Managers' view – all asset classes offer low returns

The global financial crisis was a product of an excessive build-up of debt. The policy response to that was to impose very low interest rates on markets (through central bank rate cuts and quantitative easing). While this did act to stabilise the economy, the knock-on effect was to boost asset prices well beyond historic levels.

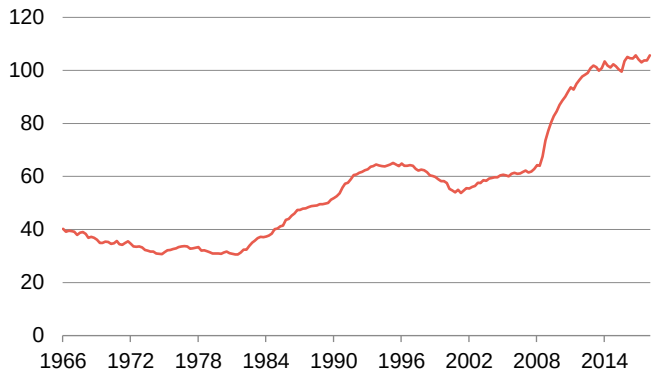
In an environment where borrowing is cheap, the process of deleveraging that should have followed the bursting of the credit bubble has been muted. Notably, debt has shifted from households to governments as is evident in Figures 4 and 5. Interest payments may be affordable now, while rates are at or near historic lows, but economies might struggle if rates normalised.

Figure 4: US household debt as a percentage of GDP



Source: International Monetary Fund

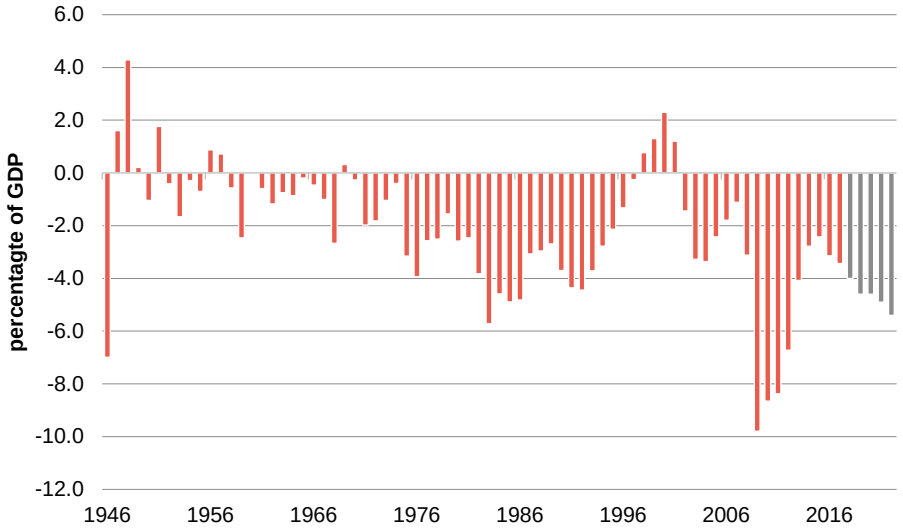
Figure 5: US federal debt as a percentage of GDP



Source: Federal Bank of St Louis

The managers look at the various options available to governments to achieve deleveraging, which encompass austerity, growing the asset side of the balance sheet (investing in infrastructure), high inflation and high levels of default, and conclude that high inflation is the most appealing to politicians seeking re-election.

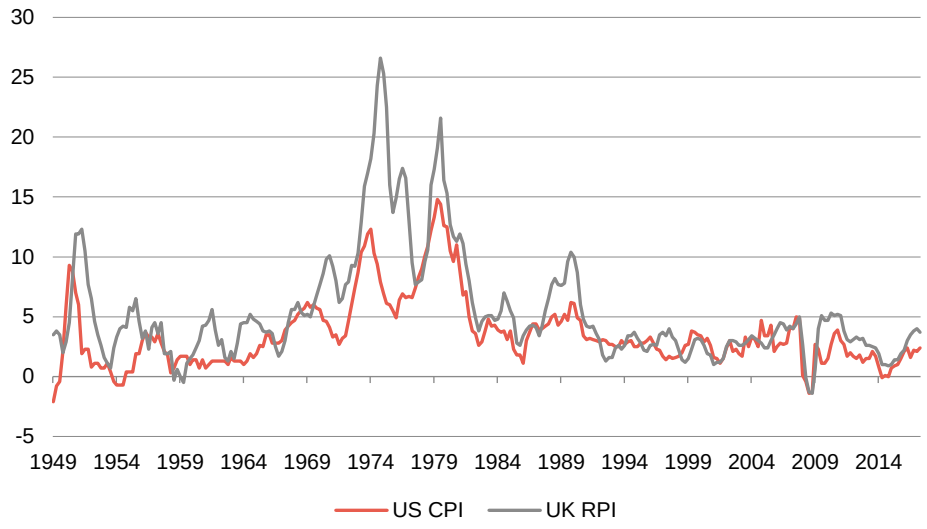
Figure 6: US post WW2 budget surplus/(deficit) as a percentage of GDP



Source: Federal Bank of St Louis, US Office of Management and Budget, and The Congressional Budget Office

The managers draw a parallel between conditions today and those of the US in the late 1960s. Then, at a time when the economy was running at full capacity, Lyndon Johnson decided to finance the Vietnam war and the introduction of Medicare and Medicaid by increasing the deficit, fearing the political consequences of increased taxes. Today, Trump's tax-cutting largesse comes at a time when the output gap (the spare capacity in the economy) in the US is low-to-zero. The difference is that Trump's deficit looks set to exceed 5.0% while LBJ's was 2.7%.

Figure 7: US and UK inflation rates since 1950



Source: Bloomberg, Marten & Co

This does not mean that the managers are expecting inflation rates equivalent to those of the mid-1970s. The rise of low-cost manufacturing in China and technological changes have been deflationary. In addition, unions have much less power than they did and this has restricted wage growth.

The managers conclude that economies are vulnerable and three scenarios seem likely:

a) a recession, assuming the business cycle turns
b) resurgent inflation, as a consequence of keeping interest rates artificially low
c) or stagflation (high inflation and a recession at the same time).

They expect that interest rates will be below the rate of inflation for some time and therefore holding cash is value destructive in real terms. Equity valuations look vulnerable in any of these three scenarios and therefore it makes sense to limit exposure to equities. Long bond prices would suffer in any scenario where inflation surged and therefore it makes sense to keep duration short.

Asset allocation

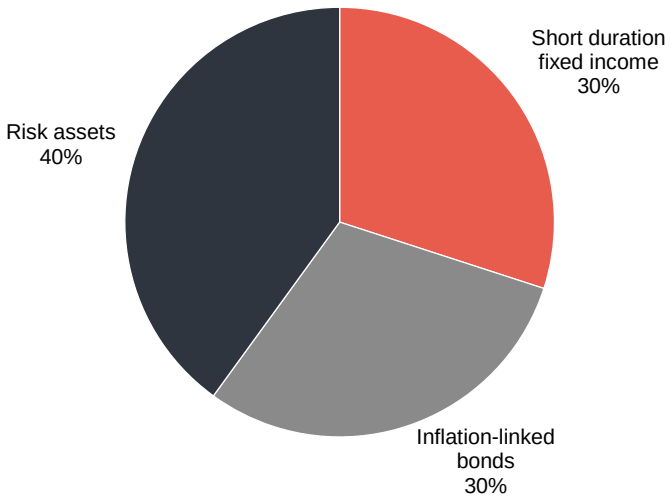
Given the views outlined above, the managers believe an optimum asset allocation should include elements of short duration fixed interest securities, longer duration inflation-linked bonds and a selection of risk assets (including equities) with defensive qualities.

Short duration fixed income offers relatively low yielding but high-quality assets that should be stable in all scenarios and can be used as ‘dry powder’ to funnel into other assets when valuations are more attractive.

Inflation linked bonds offer slightly higher yields and would increase in value in a scenario of negative real interest rates.

Figure 8 shows CGAM’s current asset allocation targets.

Figure 8: Current asset allocation targets



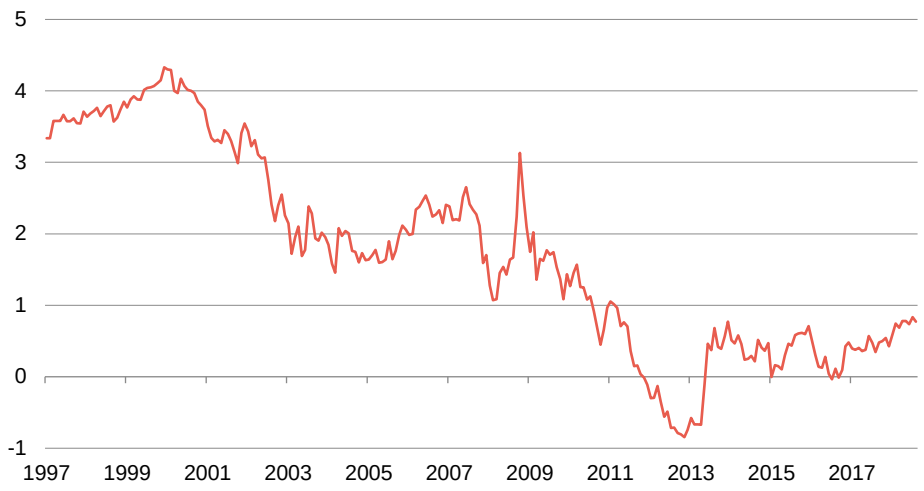
Source: CGAM

Risk assets are held with the aim of benefitting from the bull market (CGAM's risk assets have been outperforming benchmarks) but hopefully allocated to securities that will prove defensive in a bear market. Within its allocation to risk assets, CGAM has some exposure to a selection of funds providing alternative sources of income. The managers caution that the real yields on some of these funds may not be as high as advertised and their investment strategies are not without risk. Nevertheless, some still look attractive, especially when compared with returns available from other asset classes.

Why use US inflation-linked securities rather than, say gold?

The managers think that nominal bond yields may have passed their low point but real bond yields have further to go. With strongly negative real yields in the UK, it is not obvious to them that UK index-linked securities offer much upside.

Figure 9: 10-year index-linked bond yields 1997 to date



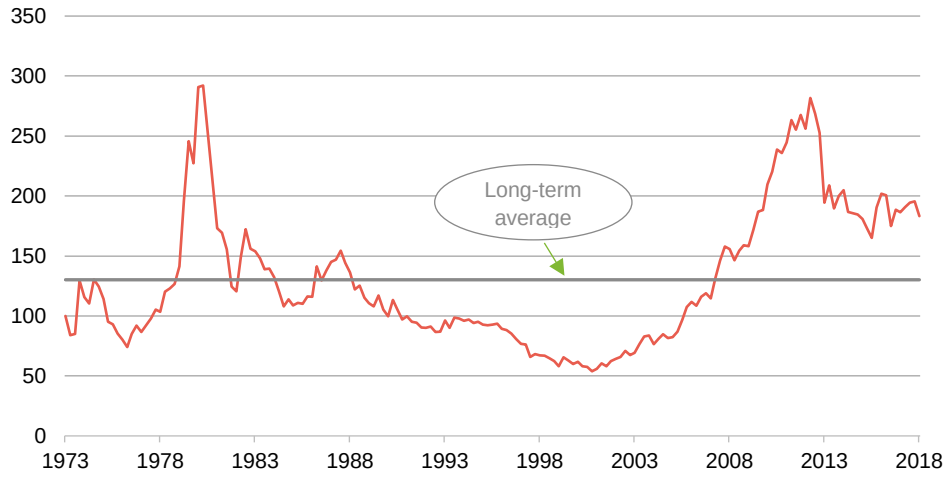
Source: Bloomberg, Marten & Co

By contrast, they believe that US inflation-linked securities (Treasury Inflation-Protected Securities or TIPS), which offer positive real returns of around 0.8%, look to offer a much a better risk/reward profile. The managers think these could hit -0.9%, implying

a considerable capital gain. The duration of the TIPs portfolios in the absolute return funds is seven years. New issuance of TIPS continues and the managers think there may be opportunities to extend the duration of the TIPS portfolio at higher yields if TIPS prices react to rising yields in conventional bond markets.

Across traditional asset classes, there is nothing that benefits from high inflation except, perhaps, gold and its price is unpredictable. The portfolios have only limited exposure to gold and this reflects the difficulty that the managers have in determining what the 'right' price for gold should be. The chart in Figure 10 shows the movement in the real price of gold (the gold price adjusted for US inflation – CPI) since the end of June 1973 (when the market was settling down following the collapse of the fixed exchange rate system used by the western world). The chart might suggest that gold is expensive.

Figure 10: The real price of gold (adjusted for US CPI) since June 1973



Source: Bloomberg, Marten & Co

Initiation | Investment companies

7 September 2018

Capital Gearing Trust

Sure and steady

Capital Gearing Trust (CGT)'s managers believe that it has built an enviable long-term track record by focusing on the preservation of its shareholders' wealth, even when adjusted for the effects of inflation. This has attracted a loyal investor base.

There will be times when the managers adopt a cautious stance and the trust lags rising equity markets. This is the situation that we find ourselves in today. The managers believe that valuations of most asset classes are stretched close to breaking point. The portfolio is positioned in short duration, liquid assets, awaiting a more favourable investment environment.

Medium to longer term absolute total returns

CGT's dual objectives are to preserve shareholders' real wealth and to achieve an absolute total return over the medium to longer term.

It aims to achieve its investment objectives through long only investment in quoted closed-ended funds and other collective investment vehicles, bonds, commodities and cash, as considered appropriate.

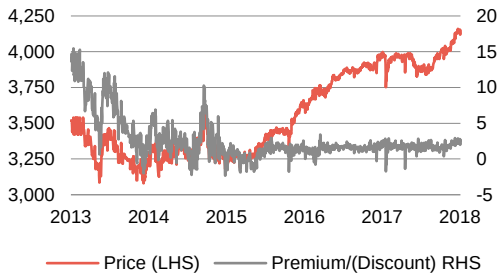
Year ended	Share price total return (%)	NAV total return (%)	RPI (%)	MSCI UK total return (%)
31/08/14	(8.5)	2.6	2.4	10.2
31/08/15	1.5	2.9	1.1	(3.4)
31/08/16	13.0	11.7	1.8	11.8
31/08/17	9.9	9.9	3.9	14.5
31/08/18	4.4	4.1	2.5	5.5

Source: Morningstar, Marten & Co

Sector	Flexible investment
Ticker	CGT LN
Base currency	GBP
Price	4,110p
NAV	4,042p
Premium/(discount)	1.7%
Yield	0.5%

Share price and premium

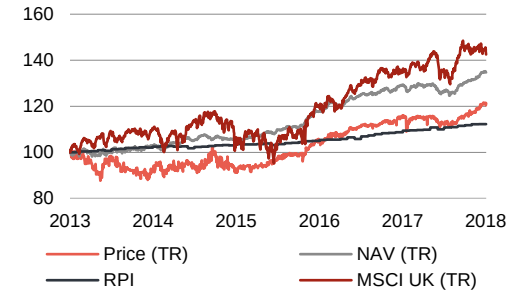
Time period 31/08/2013 to 31/08/2018



Source: Morningstar, Marten & Co

Performance over five years

Time period 31/08/2013 to 31/08/2018



Source: Morningstar, Marten & Co

Domicile	Northern Ireland
Listing date	9 February 1973
Manager	CG Asset Management Ltd
Market cap (GBP)	264.0m
Shares outstanding	6,423,869
Daily vol. (1-yr. avg.)	9,502 shares
Net cash	6.0%

Fund profile

CGT has had the same manager since 1982

Capital Gearing Trust (CGT) was incorporated in May 1963 and listed on the London Stock Exchange on 14 February 1973. Peter Spiller has been managing the trust since 1982 and has therefore been responsible for CGT's excellent long-term performance record, described on page 3. CGAM's founders and its other employees have substantial personal investments in the funds that it manages and Peter Spiller is one of the largest shareholders in CGT (see page 20). Since 2011, he has been assisted by Alastair Laing. Chris Clothier joined the team in 2015. More information on CGAM is available on page 30.

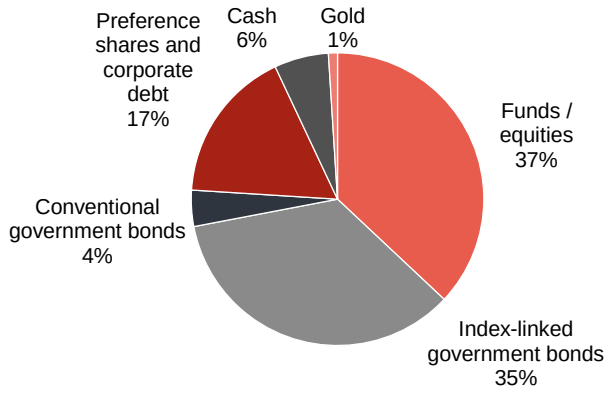
Preserve shareholders' real wealth and achieve an absolute total return over the medium to long term

CGT's dual objectives are to preserve shareholders' real wealth (in other words, ensure that the value of their investment at least matches inflation) and to achieve an absolute total return over the medium to longer term. It aims to achieve its investment objectives through a multi-asset portfolio of quoted closed-ended funds and other collective investment vehicles, bonds, commodities and cash. The managers do not short stocks or indices and the generation of capital gains is prioritised over income.

CGAM's approach to managing CGT was described on page 5. CGAM says that CGT's long-term returns have benefitted from an emphasis on cost control. More information on its fees is provided on page 19. The adoption of a zero discount mechanism (see page 19) has allowed the fund to expand over the past three years.

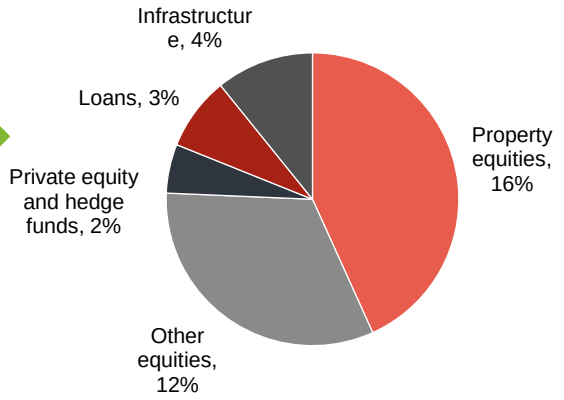
Portfolio positioning

Figure 11: Asset allocation as at 31 August 2018



Source: Capital Gearing Trust

Figure 12: Breakdown of fund/equity portfolio as at 31 August 2018

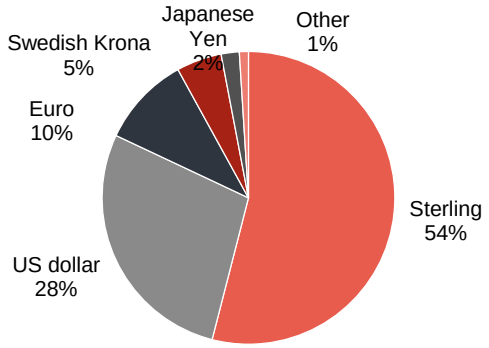


Source: Capital Gearing Trust

Substantially lower exposure to equities than competing funds

Figure 11 shows that CGT had 35% of its portfolio in index-linked government bonds as at 31 August 2018, reflecting the stance that was outlined earlier in this note (from page 6 onwards). As Figure 12 shows, just 28% of CGT's portfolio is exposed to equities (including a 16% allocation to property stocks), which is substantially less than competing funds as is evident in Figure 22 on page 18.

Figure 13: Currency exposure as at 31 August 2018



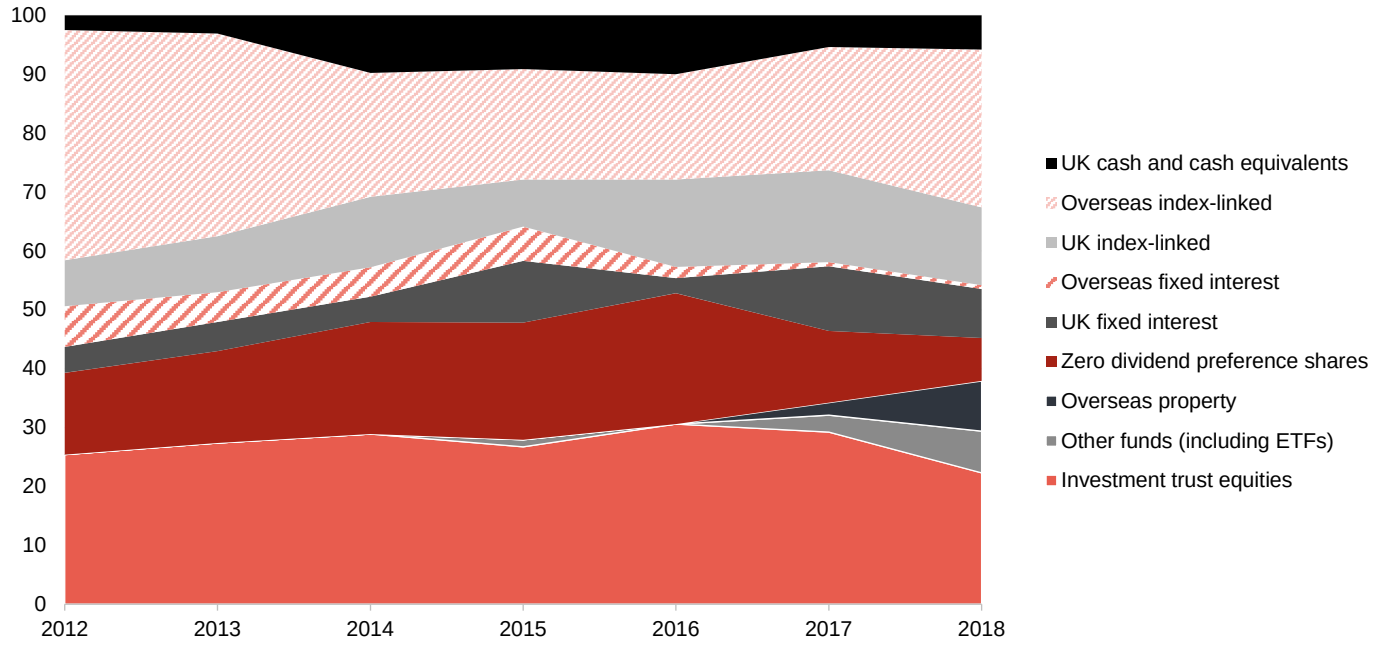
Source: Capital Gearing Trust

The historical analysis of CGT's asset allocation in Figure 14 shows that cash has been put to work. The proportion in index-linked securities dipped to a low of 26.8% in 2015 but has since expanded to 40% as at 5 April 2018.

Overseas fixed interest exposure declined, to the benefit of the allocation to UK fixed interest but the exposure to zero dividend preference shares has declined markedly as a number have matured and supply has shrunk.

In recent years, new allocations have been made to overseas property (mainly German and Scandinavian residential property) and other funds (mainly exchange traded funds – ETFs), at the expense of CGT's weighting to investment trusts. This reflects the general narrowing of discounts across the investment trust sector and hence a lack of discount narrowing opportunities that was noted on page 5. It is important to remember that the investment trust exposure is spread across a number of asset classes as is shown in Figure 12.

Figure 14: CGT asset allocation changes (annual rests) since 2012



Source: Capital Gearing Trust, Marten & Co

Within CGAM's property exposure, its bias is towards funds providing exposure to residential property in Germany and commercial property in Sweden. The thesis is that

monetary policy in Germany is too loose (being set to accommodate the wider euro area rather than the German economy). The managers also like the Swedish currency which they feel is being held at artificially low levels (two standard deviations below its long-term level relative to the euro).

In the UK, CGAM shares the consensus view that City offices and retail property look vulnerable on the downside. CGT has some exposure to student accommodation through Unite Group. The managers recently reduced the weighting in UK industrial property, selling SEGRO. The funds have some exposure to the housing sector through Grainger, Civitas and PRS REIT.

Largest holdings

Figure 15: Largest bond holdings as at 31 August 2018

	(%)
UK index-linked 0.125% 22/11/19	8.8
US index-linked 2% 15/01/26	3.6
US index-linked 0.25% 15/01/25	3.5
US index-linked 2.375% 15/01/25	2.1
US index-linked 3.875% 15/04/29	2.0
Total	**20.0**

Source: Capital Gearing Trust

Figure 16: Largest fund/equity holdings as at 31 August 2018

	(%)
Vonovia	3.0
North Atlantic Smaller Companies	2.5
Vanguard FTSE Japan ETF	2.3
Investor	2.1
Deutsche Wohnen	1.9
Total	**11.8**

Source: Capital Gearing Trust

Vonovia is a German residential property company which owns and manages around 355,000 residential units across Germany. It was established in 2015 following the merger of Deutsche Annington and GAGFAH. Deutsche Wohnen is a similar business with 160,723 units at the end of March 2018. At the date of this publication, Vonovia was trading at a discount of 6.5% to its end June 2018 EPRA NAV and Deutsche Wohnen was trading at a premium of 16.4% to its end June EPRA NAV. Investor is a Swedish conglomerate.

North Atlantic Smaller Companies is an investment trust investing mainly in small and medium sized companies in the UK and North America. It trades at a significant discount to NAV (20.9% at the time of publication), despite holding a significant proportion of its assets in treasury bills (19.6% as at 31 January 2018).

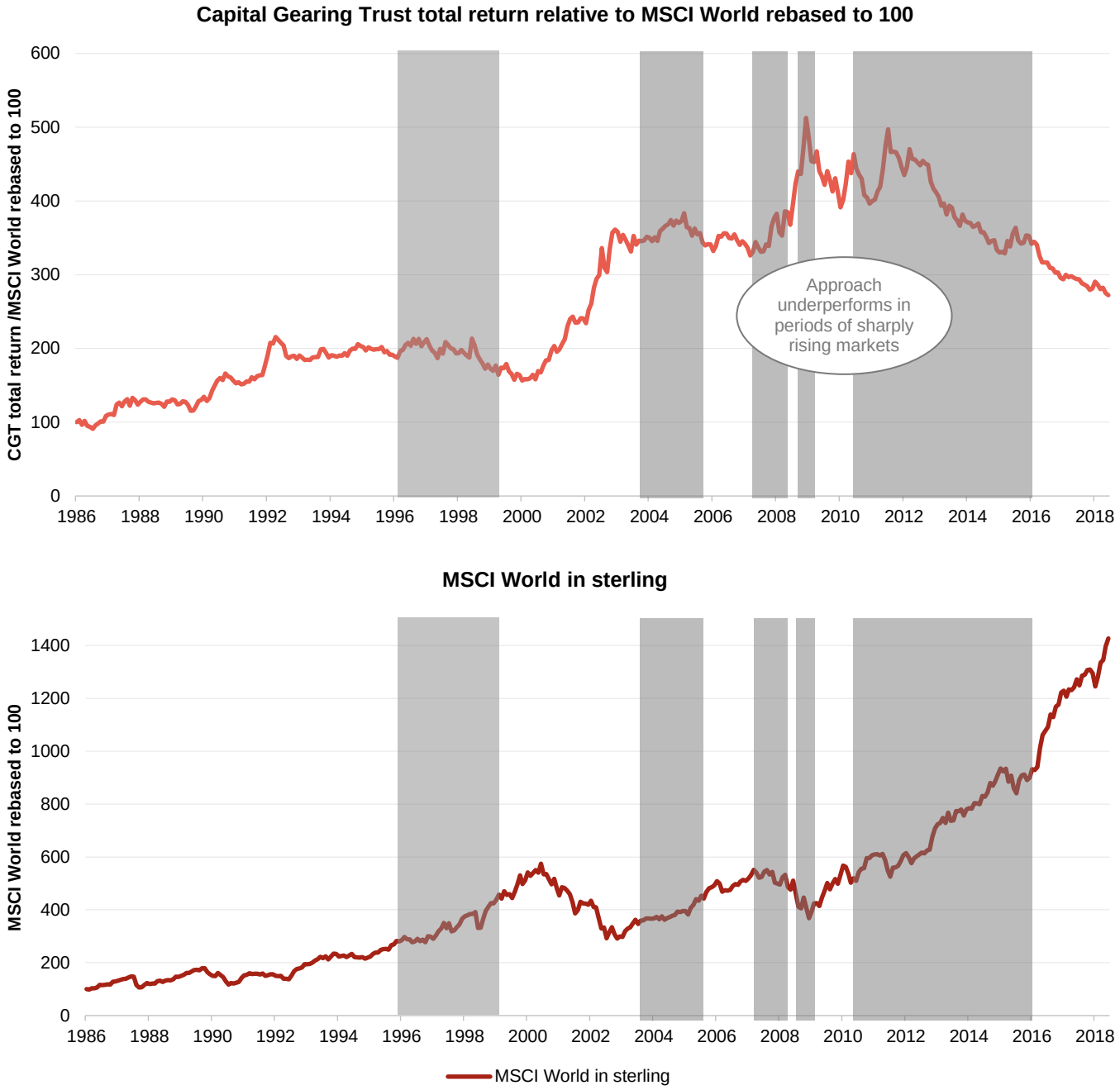
The managers say that there is a long tail of holdings but this reflects the breadth of trading opportunities available and a number of funds that are in the process of liquidating their portfolios.

Performance

2.7x the return on equity markets, as represented by the MSCI World Index in sterling, since 1986

Figure 17 shows that when equity markets are strong, as they have been since May 2012 for example, the approach can lead to relative underperformance of equity markets. Over the long term, however, CGT has outperformed equities, as represented by the MSCI World Index in sterling terms, by a considerable margin (2.7x) since that index was created in 1986.

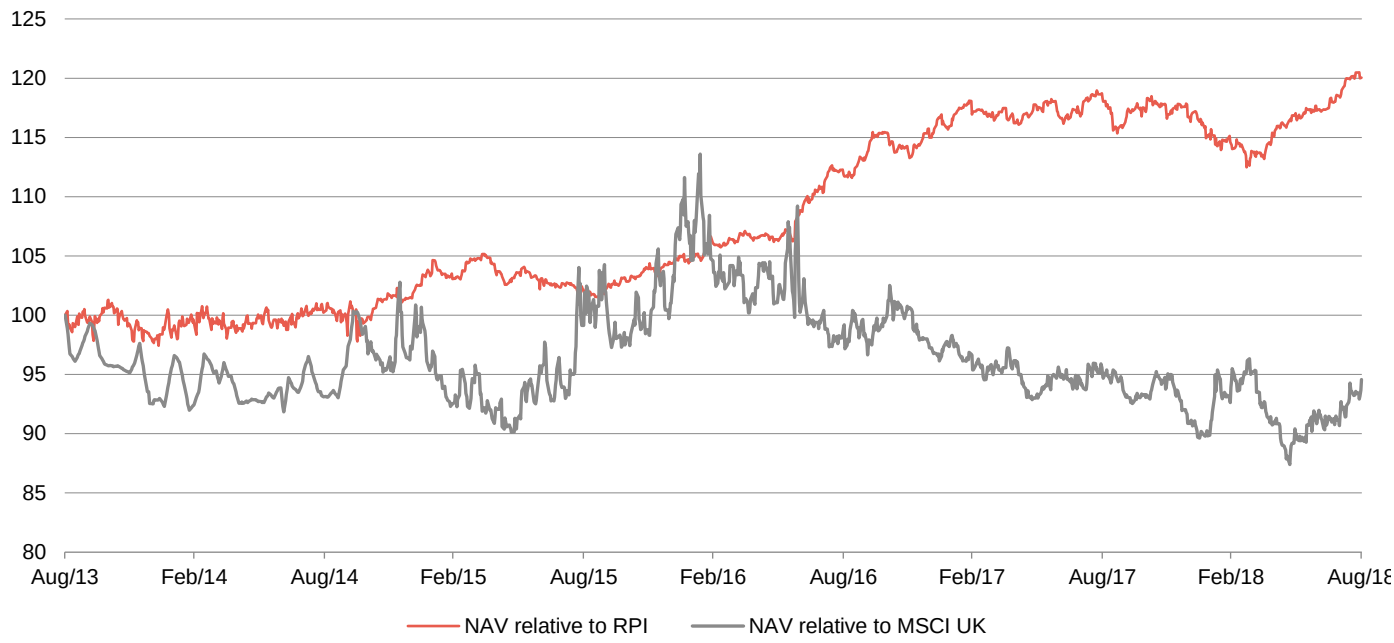
Figure 17: Capital Gearing Trust out/under performance compared to the MSCI World Index



Source: Morningstar, Marten & Co

Over the short-term (five years), as Figure 18 shows, CGT's NAV has exceeded UK inflation, as measured by RPI, but has lagged UK equity returns, as measured by the MSCI UK All Cap Index.

Figure 18: CGT NAV performance relative to both RPI and to MSCI UK over five years ended 31 August 2018



Source: Morningstar, Marten & Co

Over the first quarter of 2018, CGT found it harder to keep pace with inflation. The principal cause of this was the strength of sterling, given CGT's US dollar exposure. The manager was sanguine about this given that it represented a reversal of gains made when sterling weakened post the EU referendum, sterling has been weaker since. TIPS yields have also been rising.

Figure 19: Performance over periods ending 31 August 2018

Heading	1 month	3 months	6 months	1 year	3 years	5 years
CGT Price	1.0	3.7	7.5	4.4	29.6	20.4
CGT NAV	1.3	3.3	6.4	4.1	27.6	34.7
Retail Prices Index	0.0	0.7	2.1	2.5	8.4	12.2
MSCI UK	(1.9)	(0.9)	5.6	5.5	35.1	43.8

Source: Morningstar, Marten & Co

Peer group

Up-to-date information on CGT and its peer group is available at the QuotedData website

The AIC's flexible investment sector now has 17 members. These encompass a wide range of objectives and investment styles. CGT believes its closest listed peers are probably Personal Assets (PNL) and Ruffer Investment Company (RICA) but, in Figures 20 and 21 below, the peer group also includes RIT Capital Partners (RCP), which aims to deliver long-term capital growth while preserving shareholders' capital, and Aberdeen Diversified Income & Growth (ADIG), JP Morgan Multi-Asset Trust (MATE) and Seneca Global Income & Growth (SIGT), all of which have objectives of delivering absolute returns with low volatility, but which place greater emphasis on the provision of income, which impacts on their asset allocation decisions.

Figure 20: Peer group comparison as at 5 September 2018

Heading	Market cap (£m)	Premium/ (Discount) (%)	Yield (%)	Ongoing charge (%)
Capital Gearing Trust	264	1.7	0.5	0.77
Aberdeen Div. Income & Growth	404	1.2	4.3	0.87[1]
JPMorgan Multi-Asset	86	(4.4)	4.1	n/a
Personal Assets	903	1.3	1.4	0.89
RIT Capital Partners	3,239	9.1	1.6	1.02
Ruffer Investment Company	401	(0.3)	0.8	1.16
Seneca Global Income & Growth	85	1.8	3.7	1.43

Source: Morningstar, Marten & Co. Note: 1) forecast – see below

CGT was at the smaller end of the peer group by market cap but in recent years, following the introduction of its zero discount policy (see page 19), it has been expanding. All the funds in the peer group are trading at premiums apart from MATE, which was a new launch in 2018, and RICA, which is trading at a small discount.

In all probability, CGT is operating with the lowest prospective ongoing charges ratio of this peer group. ADIG's historic ongoing charges ratio was flattered by a period in which the manager was not charging a fee for the management of its assets and it is using a forecast rate of 0.87% on its factsheets. MATE raised less money than it would have liked and this will affect its ongoing charges ratio.

Figure 21: NAV total returns over periods ending 31 August 2018

Heading	1 month	3 months	6 months	1 year	3 years	5 years
Capital Gearing Trust	1.3	3.3	6.4	4.1	27.6	34.7
Aberdeen Div. Income & Growth	(0.9)	1.3	(0.2)	1.6	6.5	11.9
JPMorgan Multi-Asset	(0.9)	n/a	n/a	n/a	n/a	n/a
Personal Assets	(0.0)	1.4	0.8	(0.9)	22.3	27.9
RIT Capital Partners	(0.9)	(0.5)	1.1	1.2	11.9	13.8
Ruffer Investment Company	(1.0)	0.0	1.4	0.3	32.9	48.4
Seneca Global Income & Growth	1.1	2.4	4.1	6.9	32.2	57.1

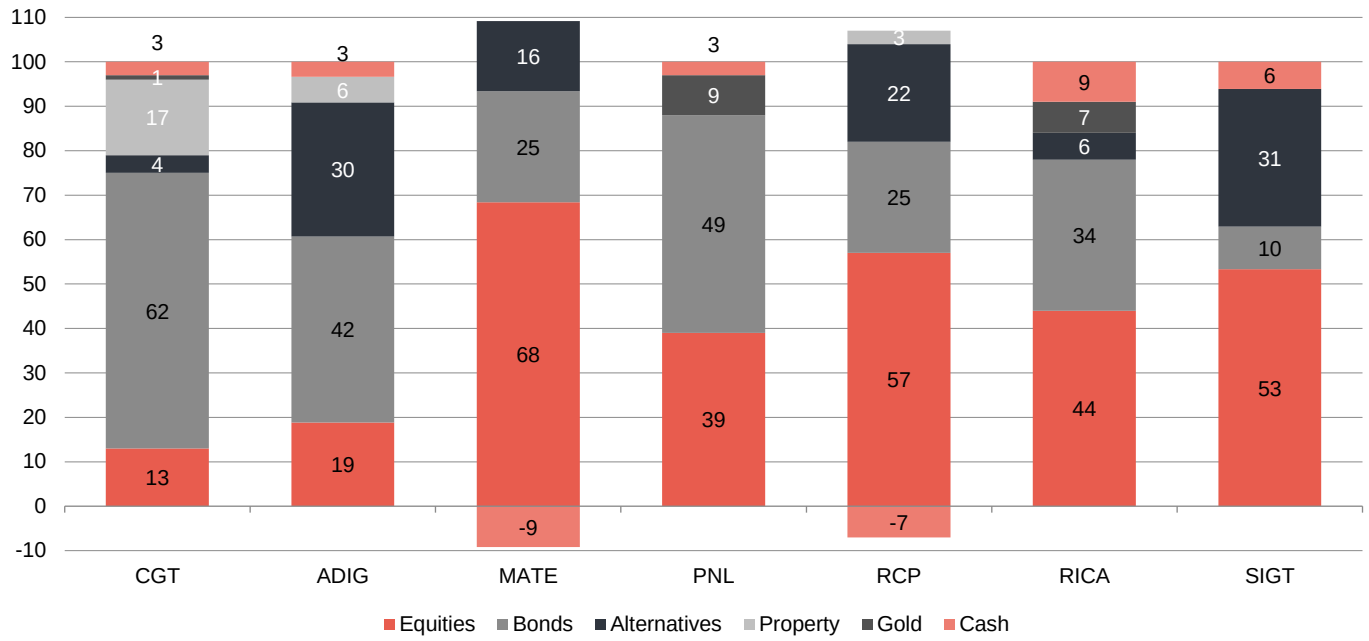
Source: Morningstar, Marten & Co

The disparity between the performance of the various funds in the peer group shown in Figure 21 can be attributed largely to their asset allocation. Figure 22 attempts to compare this. This is an inexact comparison however, as there are substantial differences in the way that the various funds break down their portfolios.

CGT has a lower exposure to equities, higher index-linked and higher property exposure compared to peers

What is clear from Figure 22 is that CGT has the lowest allocation to equities of any fund in this peer group. Our analysis showed that it also had the highest allocation to index-linked bonds. CGT's allocation to property looks to be higher than any other fund in this group. It might be worth noting however, that some part of some fund's equity allocation relates to property stocks.

Figure 22: Peer group asset allocation as at end July 2018

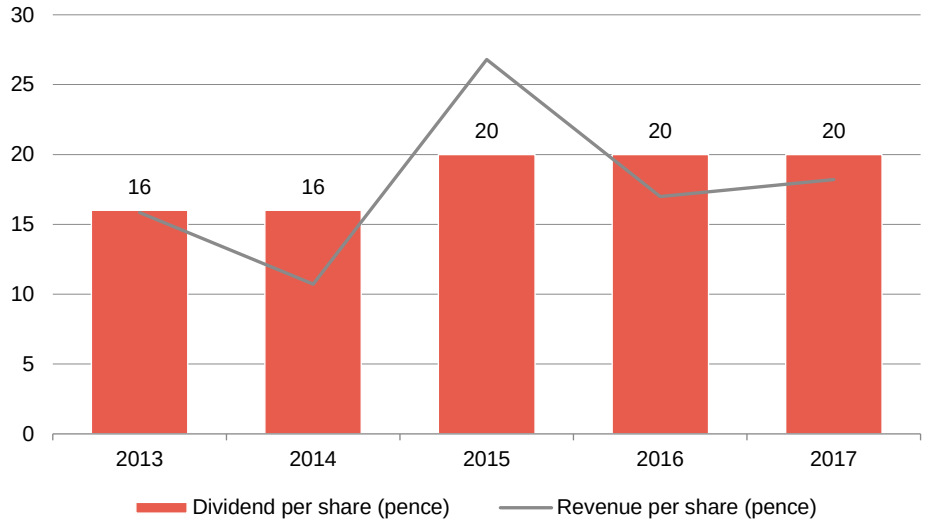


Source: Funds' own websites, Marten & Co. Note: Personal Assets data is as at 31 May 2018, RIT Capital Partners data is at 30 June 2018 and may not reflect its true exposure because of hedging within its portfolio.

Dividend

CGT is not managed to produce an income return to its shareholders. One dividend per annum is declared in order to maintain the company's investment trust status. The dividend has not been covered by earnings in recent years but the board has elected to make a small transfer from capital reserves rather than cut the dividend.

Figure 23: CGT five-year dividend history for periods ending 5 April

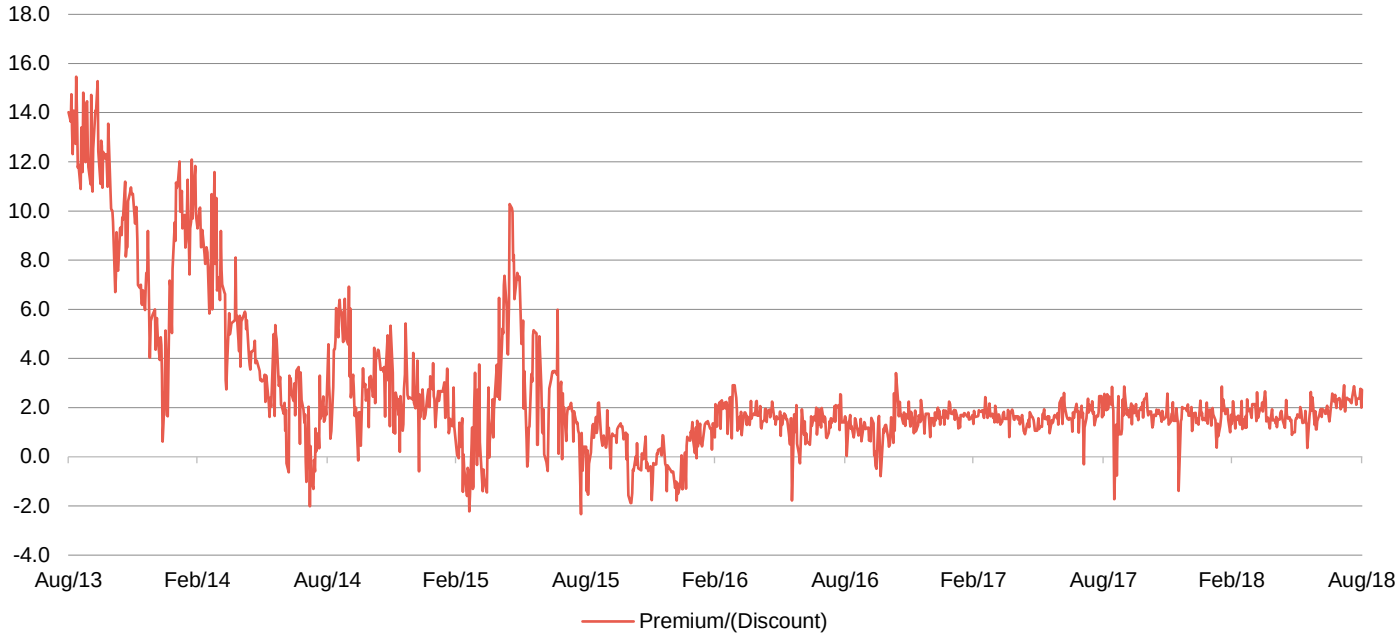


Source: Capital Gearing Trust, Marten & Co

At 5 April 2018, CGT had revenue reserves of £2.7m or 44 pence per share.

Premium

Figure 24: CGT premium/(discount) over five years ended 31 August 2018



Source: Morningstar, Marten & Co

Zero discount mechanism allowing the trust to expand

Over CGT's life it has often traded at a premium to NAV as is illustrated in Figure 24. On occasion, that premium became excessive in the board's view. The managers have the view that investors in closed ended funds should be able to turn their investment into cash at regular intervals at levels close to NAV. Where the underlying portfolio is liquid, they prefer that the fund offers a 'zero discount mechanism'. For a less liquid portfolio, they would advocate periodic liquidity opportunities such as tender offers or redemption pools. The board believes that CGT's portfolio is liquid enough to support a zero discount mechanism and implemented one with effect from 31 July 2015 (coincident with the appointment of Personal Assets Trust Administration Company Limited as the manager of the zero discount mechanism).

CGT's policy is to issue shares close to but at a premium to NAV and redeem them at close to NAV, thereby ensuring that ongoing shareholders are not disadvantaged by the costs of implementing the zero discount mechanism.

Over the year ended 31 August 2018, CGT's shares have traded within a range of a 1.7% discount to a 2.9% premium. As at 5 September 2018, the shares were trading at a premium of 1.7%.

Fees and costs

Tiered management fee and no performance fee

CGAM is entitled to receive an annual management fee of 0.6% on the first £120m of CGT's net assets and 0.45% on the balance. There is no performance fee. The management fee is calculated quarterly and paid in arrears. For accounting purposes, 40% of the management fee is allocated against revenue and 60% against capital. The management agreement is terminable on six months' notice.

Northern Trust Company acts as the company's custodian. Corporate secretarial, administrative, accounting services and the management of CGT's zero discount mechanism are provided by PATAC Limited. PATAC's fee amounted to £135,000 for the year to 5 April 2018.

CGT's ongoing charges ratio for the year ended 5 April 2018 was 0.77%, down from 0.89% for the prior year and almost half the ratio for the year ended 5 April 2008.

Capital structure

CGT has 6,423,869 ordinary shares in issue and no other classes of share capital. There are no shares held in treasury. At the AGM in July 2018, shareholders voted to allow the directors to issue up to 1,971,323 shares (1/3 of CGT's issued share capital as at 31 May 2018). Shareholders will allow 1,182,793 of these shares to be issued without pre-emption.

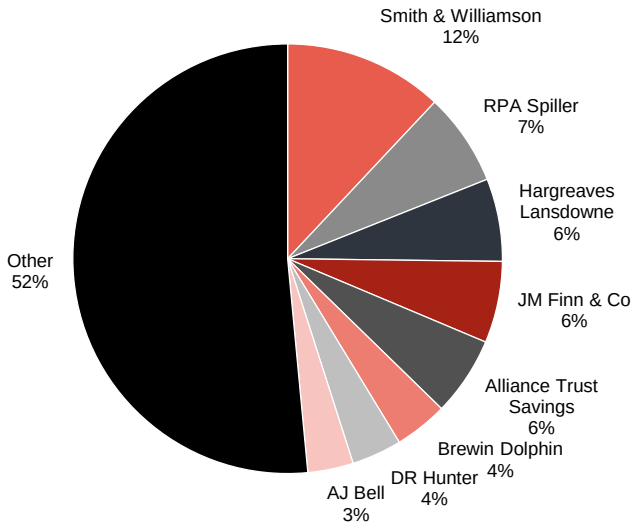
The board was also given power to buy back up to 14.99% (886,053) shares. If it does repurchase shares, these will be held in treasury for potential reissue at NAV or a premium.

The company's year end is 5 April (coincident with the end of the fiscal year in the UK) and AGMs are typically held in July. CGT has an unlimited life. There is no regular continuation vote but the zero discount mechanism allows shareholders to exit the fund at prices close to NAV and the board says that it considers the continuation of the trust at each board meeting.

CGT has the power to borrow up to a limit of 20% of net assets, subject to the approval of the board. At present, given the managers concern over asset valuations, the company has no borrowings and net cash of 6%.

Major shareholders

Figure 25: persons with a significant direct or indirect holding of shares in CGT as at 5 April 2018



Source: Capital Gearing Trust

Board

The board comprises five directors, who do not sit together on any other boards, and four of whom are independent of the manager. The company's articles of association currently limit the aggregate fees payable to the board to a total of £150,000 per annum.

The chairman has served on the company's board for more than nine years and offers himself for re-election at each AGM. The other directors stand for re-election, by rotation, on a triennial basis. There is no standing nomination committee; the full board is responsible for succession planning. The board has used a combination of both an internal process and external consultants when selecting new board members in the past.

Figure 26: The board

Director	Position	Appointed	Length of service (years)	Annual fee (GBP)	Shareholding*
Graham Meek	Chairman	2004	14	30,000	14,834
George Prescott	Chairman of the audit committee and senior independent director	2010	8	25,000	200
Alastair Laing	Co-manager	2013	5	-	11,900
Jean Matterson	Director	2015	3	22,000	9,000
Robin Archibald	Director	2015	3	22,000	920

Source: Capital Gearing Trust, Marten & Co

Graham Meek MSc has been chairman of CGT since 8 July 2015. Mr Meek is also a member of the audit committee. He is a former investment banker and stockbroker and was previously an executive director of Smith New Court Plc and chairman of SPI Lasers Plc. He was previously a non-executive director of Filtronic Plc, and of King's College Hospital NHS Foundation Trust.

George Prescott BA FCA became the company's senior independent director in 2015. Mr Prescott is a chartered accountant and, until his retirement in 2009, was deputy group chief executive of the Ecclesiastical Insurance Group. He is currently a member of the board of JP Morgan Cazenove Pension Trustee Company and Qatar Reinsurance Company Ltd. He sits on the advisory committee of The Equities Investment Fund for Charities (Charifund) and also on the board of The Charibond Charities Fixed Interest Common Investment Fund. Mr Prescott is a member of the Court and of the Finance & Investment Committee of the Worshipful Company of Coopers.

Alastair Laing CA MBA joined CGAM in 2011 and has been co-manager of the company since that time. He joined CGAM from Hg Capital LLP (a pan-European private equity fund) and previously worked with the mergers and acquisitions team at Deloitte LLP. Mr Laing was educated at Edinburgh University and was an MBA Scholar at London Business School. He is a member of the Institute of Chartered Accountants of Scotland.

Jean Matterson MCSI is a partner of Rossie House Investment Management in Edinburgh, which specialises in private client portfolio management with particular emphasis on investment trusts. She was previously with Stewart Ivory & Co Ltd for 20 years, as an investment manager and director. She is the chairman of Pacific Horizon Investment Trust Plc and a non-executive director of BlackRock Throgmorton Trust Plc.

Robin Archibald BCom CA was formerly head of corporate finance and broking of Winterflood Investment Trusts. He qualified as a chartered accountant in 1983 and subsequently worked with Samuel Montagu, SG Warburg Securities, NatWest Wood

Mackenzie and as partner and corporate financier with the corporate finance division of a Scottish accountancy firm. Since the early nineties, he has concentrated on advising and managing transactions in the UK closed-ended funds sector. He is a non-executive director and audit chairman of Albion Technology and General VCT Plc, and a non-executive director of Ediston Property Investment Company Plc, Henderson European Focus Trust Plc and Shires Income Plc.

Initiation | Open-ended investment companies

7 September 2018

CG Absolute Return Fund

On the right track

It is early in the life of CG Absolute Return Fund, especially given its long-term objective. Nevertheless, it has made a good start since launch, with a return of 22.9% against just 1% for its benchmark (3-month sterling LIBOR) and inflation of 7.8%, as measured by the UK Retail Price Index (RPI). The fund's returns lag equity markets (as represented by the MSCI United Kingdom Index) but this is unsurprising given the fund's asset allocation, which reflects the managers' caution on valuations across most asset classes.

Long-term capital growth in absolute terms

CG Absolute Return Fund's investment objective is to achieve long term capital growth in absolute terms.

It attempts to achieve this by investing in a spread of direct equities; exchange traded funds (ETFs); open ended funds; closed ended funds; and government and corporate bonds, including index-linked bonds – all listed on a recognised exchange.

Investment trusts and investment companies are used to obtain exposure to global and domestic equity markets, real estate, infrastructure, commodities and precious metals.

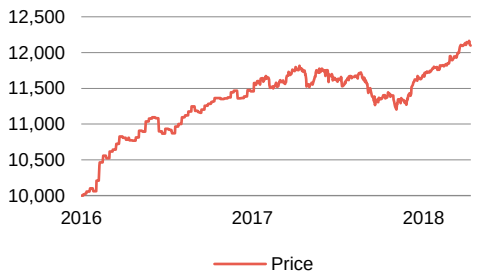
Year ended	Price total return (%)	3-month Libor (%)	RPI (%)	MSCI UK total return (%)
31/08/17	9.7	0.4	3.9	14.5
31/08/18	3.7	0.5	2.5	4.5

Source: Morningstar, Marten & Co

Sector	Absolute return
Base currency	GBP
Price	12,136p
Yield	1.2%
ISA	Yes

Share price since launch

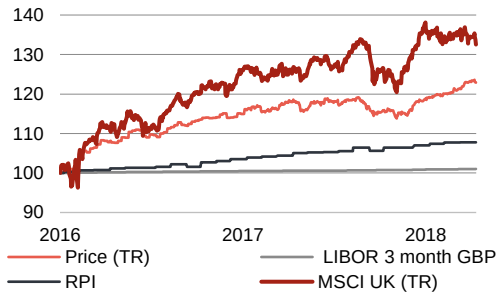
Time period 23/05/2016 to 31/08/2018



Source: Morningstar, Marten & Co

Performance since launch

Time period 23/05/2016 to 31/08/2018



Source: Morningstar, Marten & Co

Domicile	Ireland
Inception date	23 May 2016
Manager	CG Asset Management
Fund size (GBPm)	106
Ongoing charge	0.73%
Dealing frequency	Daily
Status	Open
Minimum investment	£100,000

Fund profile

More information is available from the manager's website: www.cgasset.com

CG Absolute Return Fund aims to achieve long term capital growth in absolute terms by investing in a spread of direct equities; exchange-traded funds (ETF)s; open ended funds; closed ended funds; and government and corporate bonds, including index-linked bonds – all listed on a recognised exchange.

CG Absolute Return Fund is a UCITS fund domiciled in Ireland. CGAM acts as investment manager to the fund with the same team that manages CGAM's other absolute return funds.

The only open-ended absolute return fund offered by CGAM open to new investment

The fund was established in May 2016 as the fourth fund managed by CGAM with an absolute return objective. It is the only open-ended absolute return fund offered by CGAM that is open to new investment (see page 30).

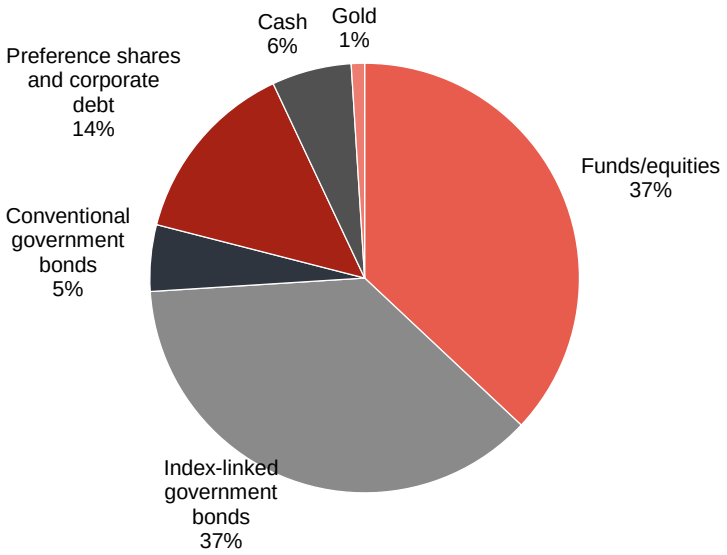
A liquid alternative to Capital Gearing Trust

CG Absolute Return's portfolio closely resembles that of CGAM's flagship investment trust, Capital Gearing Trust. As we explain on page 26, over the fund's relatively short life, it has delivered on its objectives, beaten competing funds by some margin and outperformed Capital Gearing Trust, aided by its lower fee structure.

CGAM has made modest adjustments to CG Absolute Return's portfolio relative to Capital Gearing Trust which it believes will allow CG Absolute Return to expand to a multiple of its current size, without an adverse effect on its performance. The UCITS structure offers daily dealing. CG Absolute Return is therefore a liquid alternative to Capital Gearing Trust and, in CGAM's opinion, an ideal core investment for most investors' portfolios.

Portfolio positioning

Figure 27: Asset allocation as at 31 August 2018



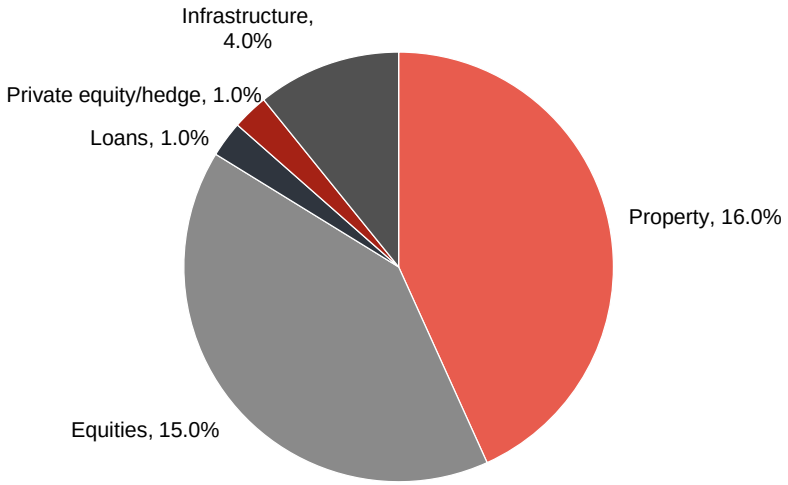
Source: CG Absolute Return Fund

Figure 27 shows that CG Absolute Return Fund had 37% of its portfolio in index-linked government bonds as at 31 August 2018, reflecting the stance that this note outlined from page 6 onwards.

CGAM favours ETFs over investment companies for CG Absolute Return Fund's portfolio

At the end of August 2018, the funds/equities exposure was 37%. This could be broken down further as in Figure 28. CG Absolute Return Fund has higher exposure to ETFs and lower exposure to listed investment companies when compared to Capital Gearing Trust (see page 12). This reflects the need to hold more liquid investments within the open-ended fund.

Figure 28: Breakdown of fund/equity portfolio as at 31 August 2018



Source: CG Absolute Return Fund, Marten & Co

Largest holdings

Figure 29: Largest bond holdings as at 31 August 2018

	(%)
UK index-linked 0.125% 22/11/19	11.4
US index-linked 2.375% 15/01/25	3.1
US index-linked 0.125% 15/07/24	2.6
US index-linked 0.25% 15/01/25	2.5
US index-linked 3.875% 15/04/29	1.9
Total	21.5

Source: CG Absolute Return Fund

Figure 30: Largest fund/equity holdings as at 31 August 2018

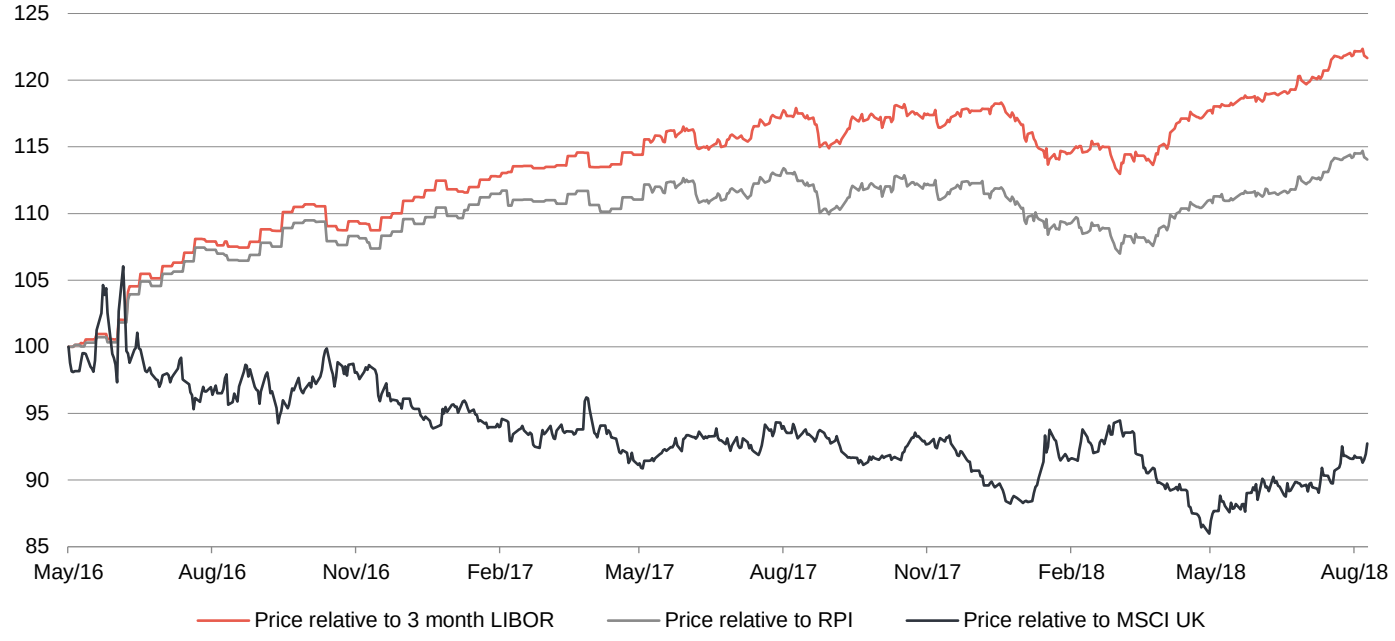
	(%)
Ishares Core FTSE 100 ETF	3.4
Vonovia	2.8
Vanguard FTSE Japan ETF	2.5
Investor	2.1
Deutsche Wohnen	1.9
Total	12.7

Source: CG Absolute Return Fund

Vonovia is a German residential property company which owns and manages around 355,000 residential units across Germany. It was established in 2015 following the merger of Deutsche Annington and GAGFAH. Deutsche Wohnen is a similar business with 160,723 units at the end of March 2018. At the date of this publication, Vonovia was trading at a discount of 6.5% to its end June 2018 EPRA NAV and Deutsche Wohnen was trading at a premium of 16.4% to its end June EPRA NAV. Investor is a Swedish conglomerate.

Performance

Figure 31: CG Absolute Return Fund relative to LIBOR, RPI and MSCI UK



Source: Morningstar, Marten & Co

It is early in the life of CG Absolute Return Fund. Nevertheless, readers may think that it is encouraging that it has outpaced both its 3-month sterling Libor benchmark and UK inflation, as measured by RPI since launch.

CG Absolute Return Fund has failed to keep pace with equity markets, as represented in Figure 31 by the MSCI UK Index. It has very low exposure to equities, this reflects the managers' views on the valuation of the asset class (see page 6 onwards).

More recently, CG Absolute Return has been held back by rising TIPS yields and stronger sterling relative to the US dollar.

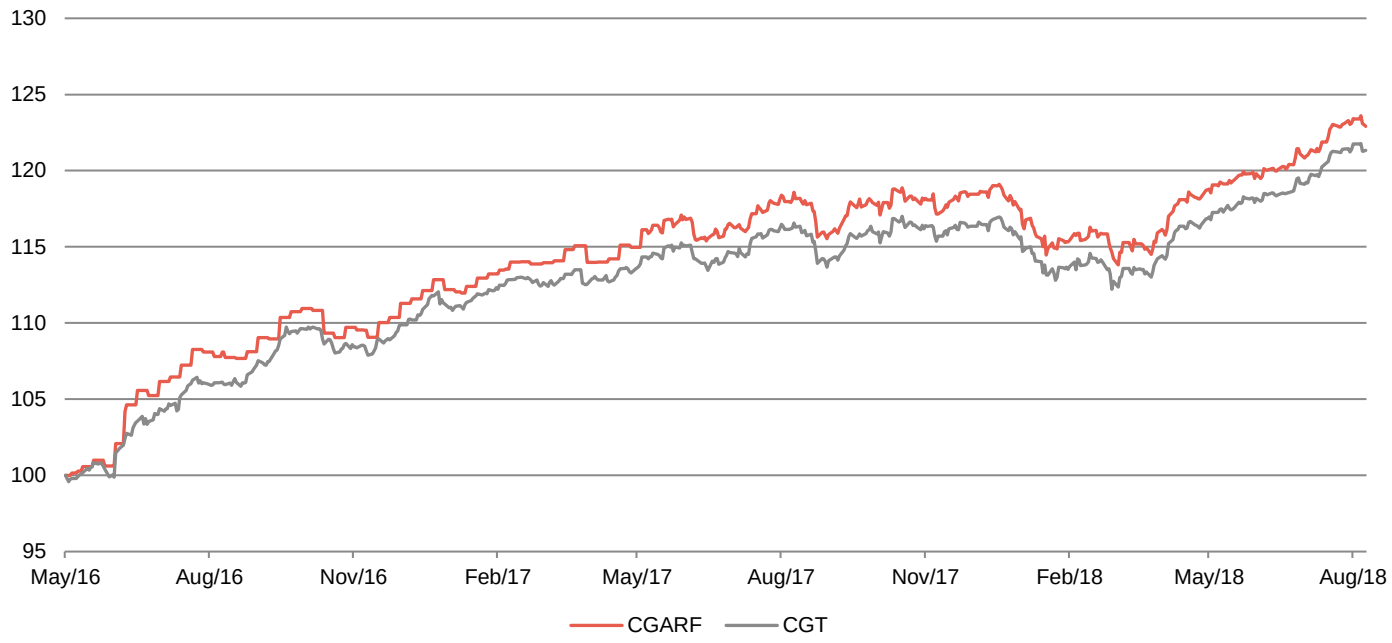
Figure 32: Returns over periods ending 31 August 2018

Heading	1 month	3 months	6 months	1 year	Since launch
CG Absolute Return Fund	1.2	3.1	6.1	3.7	22.9
3-month sterling LIBOR	0.1	0.1	0.3	0.5	1.0
UK RPI	0.0	0.7	2.1	2.5	7.8
MSCI UK	(2.8)	(1.8)	4.7	4.5	32.5

Source: Morningstar, Marten & Co

As Figure 33 shows, the returns on CG Absolute Return Fund have been similar to those of Capital Gearing Trust since the open-ended fund was launched. In fact, CG Absolute Return Fund has provided modest outperformance of Capital Gearing Trust.

Figure 33: Comparison of CG Absolute Return Fund and Capital Gearing total return performance



Source: Morningstar, Marten & Co

Peer group

There are many open-ended funds that target absolute returns or that operate with multi-asset portfolios. Figure 34 shows a select peer group of well known funds with similar objectives to CG Absolute Return Fund.

Figure 34: Cumulative NAV total returns over periods ending 31 August 2018

Heading	1 month (%)	3 months (%)	6 months (%)	1 year (%)	Since launch (%)
CG Absolute Return	1.2	3.1	6.1	3.7	22.9
Capital Gearing Trust	1.2	3.6	6.7	3.9	21.2
LF Ruffer Absolute Return	(0.9)	(1.0)	0.7	0.9	11.0
Newton Real Return	0.3	2.1	4.5	0.9	3.4
Schroder Multimanager Diversity	(1.5)	(0.9)	0.5	(1.9)	5.7
SLI GARS	(0.7)	(0.3)	(4.2)	(4.0)	(4.2)
Troy Trojan	(0.1)	1.2	1.5	(0.7)	11.0

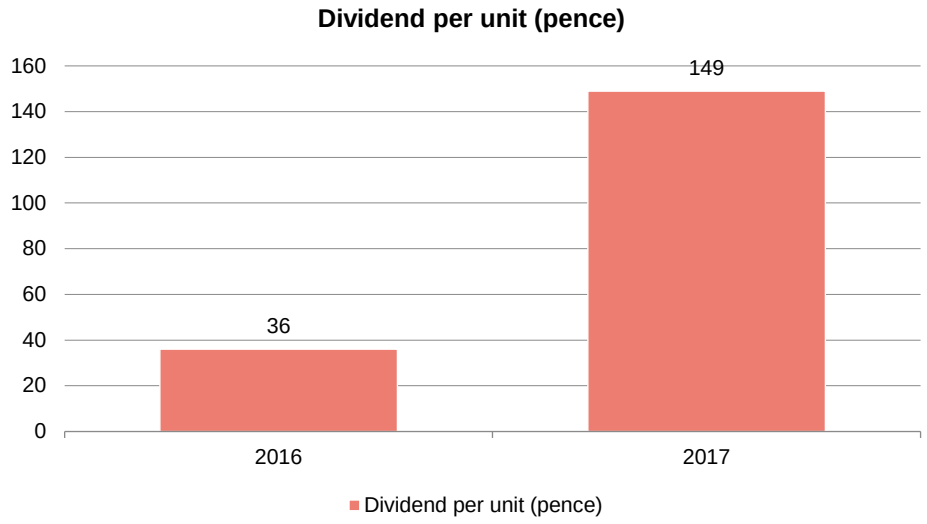
Source: Morningstar, Marten & Co

Since CG Absolute Return Fund launched in May 2016, its returns have been well ahead of these competing funds.

Dividend

CG Absolute Return Fund's focus is on capital growth and it has no income return target. Two dividends have been declared since launch in November 2016 and 2017.

Figure 35: CG Absolute Return Fund dividend history since launch



Source: CG Absolute Return Fund, Marten & Co

Fees and costs

Low flat management fee of 0.35% with no performance fee

CGAM receives an annual management fee of 0.35% on the NAV of CG Absolute Return Fund which is accrued daily and paid monthly in arrears. There is no performance fee.

The administrator is entitled to 0.07% per annum of the first £100m of the total NAV of all the sub-funds within the CG Portfolio Fund, 0.05% on the next £150m and 0.03% on the remainder. This fee is accrued daily and payable monthly in arrears. The administrator is also entitled to an annual fee of £7,500 for the provision of performance attribution services.

The depositary is entitled to 0.0325% per annum of the first £100m of the total NAV of all the sub-funds within the CG Portfolio Fund, 0.0275% on the next £150m and 0.0225% on the remainder. This fee is accrued daily and payable monthly in arrears.

The ongoing charges ratio for CG Absolute Return Fund (from its KIID) was 0.7% for the period from launch to 31 December 2017.

Capital structure

CG Absolute Return Fund is a sub-fund of CG Portfolio Fund Plc. This fund is authorised in Ireland and regulated by the Central Bank of Ireland. Units in CG Absolute Return are class M shares of CG Portfolio Fund Plc.

At 31 October 2017, directors and related party interests in CG Absolute Return Fund (including the entire investment management team) amounted to 30,400 class M shares (up from 20,000 shares as at 31 October 2016).

Appendix

The team

Peter Spiller co-manages CGAM's fund and acts as CGAM's CIO. He has managed Capital Gearing Trust since 1982. He was a partner and strategy director at Cazenove & Co Capital Management and a US equity investor at Capel Cure & Myers. He was a co-founder of CGAM in 2000.

Alastair Laing is CGAM's CEO. He joined CGAM in 2010 and has co-managed its funds since that date. He was appointed as a non-executive director of Capital Gearing Trust in 2013. Alastair joined CGAM from Hg Capital LLP (a pan-European private equity fund) and previously worked with the mergers and acquisitions team at Deloitte LLP. Alastair was educated at Edinburgh University and was an MBA Scholar at London Business School. He is a member of the Chartered Institute of Accountants of Scotland.

Chris Clothier is a co-manager of CGAM's funds. Before he joined CGAM in 2015, he was a director at IPGL Limited, a private investment vehicle with a range of public and private interests predominantly in the financial services industry, where he worked for six years. Before that he worked at MMC Ventures, an early-stage venture capital firm. Chris studied Chemistry at New College, Oxford.

Chris Taylor is CGAM's chief operations officer. Prior to joining CGAM in 2015 Chris was an operations officer at State Street Bank. He has held operational roles servicing investment trust and institutional pension fund clients.

Jason Barlow is operations manager for CGAM. Before joining CGAM, Jason was an operations officer at State Street Bank. He has over 28 years of fund accounting experience.

Richard Goody is CGAM's risk and compliance director. Before joining CGAM in 2011 as its operations manager Richard held operational and senior fund accounting roles at Cazenove, BNP Paribas and Smith & Williamson. Richard was appointed a director of CGAM in 2015.

Assets under management

CGAM manages £1.85bn across six funds; four have an absolute return objective and two invest solely in index-linked securities issued by governments.

Figure 11: Funds managed by CGAM, AUM as at 31 May 2018

		AUM (GBPm)	Inception	Focus	Status
Capital Gearing Trust	Investment trust	237	April 1982*	Absolute return	Listed
Capital Gearing Portfolio Fund	UCITS - Ireland	212	November 2001	Absolute return	Hard closed
The Capital Value Fund	UCITS - Ireland	276	June 2010	Absolute return	Hard closed
The CG Absolute Return Fund	UCITS - Ireland	89	May 2016	Absolute return	Open
The Dollar Fund	UCITS - Ireland	284	May 2009	Index-linked	Open
The Real Return Fund	UCITS - Ireland	459	March 2004	Index-linked	Hard closed

Source: CG Asset Management, Marten & Co. Note * in its current form.

CGAM has at times made sizeable allocations to index-linked securities within its absolute return funds. A group of investors asked it to create funds dedicated to this strategy. This led to the creation of The Real Return Fund in 2004 and The Dollar Fund in 2009. An international hedged version of the Dollar Fund was launched in August 2016.

Today, The Dollar Fund (which offers investors access to US Treasury inflation-protected securities – TIPS), the CG Absolute Return Fund (described in more detail on pages 23 to 29) and Capital Gearing Trust (described in more detail on pages 11 to 22) are the only funds open to new investors. The latter by virtue of its zero discount mechanism (see page 19).

QuotedData

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