Transcript of Peter Spiller podcast with Jonathan Davis

Recorded March 7th. Released 13th March. Lightly editing for sense and clarity.

JD
I don't think I'm exaggerating by saying this has been quite a momentous few weeks, both for investors and for the world at large. I'm delighted, therefore, to be speaking with someone who's been in the markets longer than anybody else who still manages an investment trust, and whose professional experience goes back to the early 1970s. That gentleman is Peter Spiller, the manager of Capital Gearing Trust since the early 1980s.

So, Peter, let me just start with that big picture. We can come back to talking about what you're doing with the trust, but let's start with the big picture. A lot of people are saying that we're seeing the overturning of the international order that we become accustomed to as investors and as citizens over the last 40 to 50 years. Would you concur with that?

PS
I think it's a turning point, absolutely, because for a long time, Europe has prospered under the defence umbrella of the United States, and it no longer has that defence umbrella (and in particular in Ukraine, where one's reaction has to be just simply horror at the betrayal by the United States of its support for Ukraine). If you're talking about the national consequences of this, I think the first thing to say is that there was clearly a huge increase in the requirement for defence expenditures in Europe and that probably should include the UK. It's very unclear whether we actually are going to increase defence expenditure in a meaningful way, because one minute Starmer says we are going to step up, and the next he talks about two and a half percent of GDP in two years' time……..

JD
Which isn't going to cut the mustard in any event.

PS
Yes. So, we have an army of under 80,000 people looking to fulfil with others the roles of peacekeepers for Europe in Ukraine, which will be extraordinarily difficult given our current capacity. That is an important feature, because increasing defence expenditure, both here and Europe, makes everybody else poorer, every country poorer.

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It's a bit like buying a new car. If you buy a new car, you need to spend less on something else for the moment. The zeitgeist seems to be that you can borrow the money for defence, just as you can borrow the money for climate transition, but unsurprisingly we have seen a very strong reaction from the bond market, because borrowing by Europe as a whole is already at wildly excessive levels and the same thing is true for the UK.

We are at a level of borrowing where further borrowing can easily become problematic. The levels in which these things become problematic is as much as a function of confidence as anything else. So, I would say that we have very difficult decisions to take.

On top of defence, the best hope for peace in Ukraine, I'm afraid to say, has to be peace by surrender, so to speak, peace on Putin's terms, but that still leaves a huge reconstruction bill in Ukraine. Up until very recently, we would have been assumed the United States would provide a great deal of that money.

I think that's not a fair assumption now, even with the mining concessions that Trump has talked about, and that's an additional burden on European budgets. The assumption again seems to be that that would be borrowed, and if that is true, then I think the real-life implications for bond markets are quite important.

JD
Talking of momentous moves, we've seen this week some potentially very significant increase in the yields on German government bonds, which are basically the bottom of the structure for the whole European bond market. That is obviously underlining what you have just said, that if we do borrow money, it's going to cost more and at some point, that will come to a crunch moment, where we can't do that anymore without collateral damage.

PS
Yes, part of that, I should also have mentioned, is that these policies are very inflationary. If you're spending much more on your economy than your tax take, then that's inflationary. For Europe as a whole, that's not such a big issue because the outlook there before all this happened was one where inflation was as likely to be below as above target. That isn't true for the UK. So the extent that we are caught up in helping to finance Ukraine - this is all speculation, of course, at this stage - then, for inflation, the implications for the UK are much worse than they are for Continental Europe.

JD
That's not the first time I've heard that said, of course. We've long had a greater tendency to inflation than other parts of Europe. More fundamental perhaps is that this is creating, as you suggest, massive uncertainty, because nobody actually knows what's going to happen next.

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With Trump every day, every week, seems to bring a new development, and that, you would think, is likely to lead to a loss of confidence, more risk aversion and so on.

Of course, we do know that Mr. Trump can change his mind very quickly. So maybe this could all unwind. But I think the point you're making is those at the damage has already been done by the way the US has behaved so far in changing its policies fundamentally.

PS
Even if they were reversed, you'd still have the uncertainty. You can't come from being someone who was prepared to lend you an umbrella last week, but this week isn't but says he might do in the future. That's a very different proposition.

Which leads me on to the tariffs. So the tariffs appear to be almost whimsical as far as how long they will be applied to Mexico, Canada and China. We also have a promise of action with respect to Europe, but once again, we have no idea what levels on what and indeed any details at all. The point you make about uncertainty is, I think, very, very important, because uncertainty is the enemy of investment.

If you're building a factory somewhere, it is very important that you know you can move the goods from that factory to another country on terms that you can anticipate now, and which won't suddenly change. So, I fear it will be quite depressing for investment, which, again, is a particular problem in the UK, because in the UK we have a very low level of investment already as the Chancellor likes to point out. (She doesn't do anything to help reverse it, but that's a different point!).

And it isn't just tariffs that are going to have an impact. In America we're looking at large numbers of people potentially being deported, even if we don't know whether that's going to happen or the manner in which is going to happen, but it is quite inflationary if it does. So altogether, one cannot make a significant actual forecast here, because so much of the environment which we will be operating under, with respect to tariffs and the level of the dollar and so forth, is just unknown.

As for the dollar, just to mention, it is obviously under pressure from tariffs, and from the risk of greater inflation in United States, but also in the short term, there will be lower imports. On the other hand, Trump has talked in the past about how the dollar is unfairly high, so there's always a possibility of some kind of "Mar-a-Lago accord" [*a concerted attempt to get the dollar down, similar to the Plaza Accord in 1985*]. Again, none of this is knowable, because it's all in Trump's mind and his mind is not constant.

JD

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We're all struggling to try and work out how that mind works, for sure. Just on the tariff point, we've all been brought up on simplistic economic notions that tariff wars on the whole are not a good idea for anybody, and tariff wars if they happen tend to depress global trade, which was a factor in the 1930s depression. These are all standard assumptions we have. But either Trump doesn't understand that, or he doesn't care, although he is seemingly motivated by reducing the trade deficit that the US has with a number of countries.

PS

There's one additional motivation, which is to raise revenues. He needs revenue for the central government, that's unquestioned. Tariffs operate a little like that. Consumers pay a bit more and they then effectively pay more to the government. To some extent, tariffs are not paid for by the exporters, but by the consumer. But actually, in a big market like the United States, there is an extent to which we can expect exporters to the United States to be able to tolerate lower margins in order to keep their presence in the market.

The real damage that tariffs do is very much tied in with the retaliation and reciprocation that they tend to encourage, as we've seen already from Canada and China. As a general statement, therefore, even without knowing the numbers, the overall impact is likely to be that inflation will be higher and growth lower than before.

JD

Yes, and that certainly seems to be what the bond market thinks as well. This all leaves investors with a significant need to think about what they're doing with their money. Let's just talk about some of the asset classes out there. Perhaps bizarrely, we've seen UK and European stock markets doing quite well, for example, in the last few weeks. How does that work?

PS

Well, the background to to that is what has been happening in the US, and the extraordinary levels of valuation, very high valuations, which seems to be bound up in part with the most extraordinary euphoria associated with the election of Trump. I remember listening to podcasts talking about how Elon Musk was going to reduce costs in the civil service without any corresponding loss of output. One commentator said that, even if they do absolutely nothing, even if they wash up at McDonald's as an alternative career, then they will be adding to productivity. It seems a little harsh, and I'm sure isn't true!

We did however start off also with a very reassuring appointment to the Treasury. Almost all the other appointments are alarming, but Scott Bessant at Treasury undoubtedly gave quite a lot of comfort to bond markets. We had this conceptual miracle of "three, three and three",

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meaning increasing oïl production by three million barrels per day, growth of 3%, and reducing the deficit to 3%.

Unfortunately, none of that's visible in the Budget that's been sent to Congress at the moment. It certainly doesn't do anything to narrow the budget deficit, which remains extraordinary. That is somewhere between 6%-7% of GDP, and at a time of full employment! This is unprecedented in history.

So I think a 3% target for the 10 year government bond is achievable only in the context of a recession where the Fed has to come to the rescue and essentially introduce zero interest rates. I don't think that's really what Bessant has in mind, but that, I think it's the only sense in which it could happen.

Nevertheless, this idea that bond markets would be behaving themselves, together with animal spirits, did push the S&P 500 to levels, about 6100, which even at the time looked excessive. The markets have reacted since and we've come back a fair amount, and I think that's helped in the UK and Europe, because for the first time in a very long time, the smart guys weren't just the people who had the most exposure to the US. We have also had emergence of some Chinese competition to AI and that that is, I think, also moderating some of the ambitions.

Meanwhile, in the UK and Europe, there was much better value. I suspect what we see is also a a little bit rebalancing, but I do have reasonable doubt whether there will be much follow through when it comes to today's markets. Clearly, there have been a few sectors, including the defence sector, which have been extraordinarily strong in Germany and the UK. But all the problems in Europe are still there. There are still financial issues to come, including the budget in France, the levels of borrowing and so on, so I'm afraid we have not been attracted by putting money into Europe, notwithstanding the much better valuations.

JD
Well, let me ask you then what are you doing? Obviously, you've anticipated some of it because you weren't involved in the bubbly US market, and you've got a lot of very defensive assets and quite a lot of dry powder waiting for cheaper things to come along. Your hopes on that score must presumably have risen a bit after all this.

PS Yes, absolutely, we've always said that the substantial correction which we believe valuations demand in the United States will happen, but we can't time it, and there are definitely more reasons to think it's going to happen sooner rather than later than there were. What is very clear is that the outperformance of index-linked against nominal Treasuries since the turn of the century has been quite significant, partly perhaps because of the inflationary

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premium, but also partly because investors consistently underestimate what inflation is going to be in the forthcoming period.

So we currently have about 37% index-linked of one kind or another, only about 30% in risk assets and the balance in other things, such as hedged Japanese treasuries, and some high quality short term corporate bonds, which still offer good returns. Within our equities, about a third are investment trusts where we think there are interesting features of one kind or another that will allow us to outperform.

One of the features, actually, of the world now I find really interesting is that risk was very high in equities, and potential returns particularly low, but you can still get in both the US and here better than 2% real risk free on an index-linked government bond, which I find, quite special.

JD
So if you can get 1%-2% real on an index linked bond, that's a very good building block, particularly when other assets are not looking so attractive. Do you still have some gold?

PS
Shame on me, because other people in my office were keen to have a little bit more gold, but I said no. We have a 1% holding, which actually right now is ahead 15-20%. I refer to gold as a defence against inflation but we cannot make sensible analysis of what the returns might be. It has done extraordinary well, yes. I think it has to do with less confidence in the United States, particularly after Russia's assets were seized. China in particular, but a number of other countries also, worry that for whatever reason, they might be sanctioned and their assets seized.

JD
If, as seems possible, Mr. Trump gets his so called peace deal in Ukraine, in other words, the fighting stops for a period, on some basis yet to be determined, for Russia one of the advantages will be that it is readmitted to the global order, and sanctions will be lifted, and they will presumably ask for some of their money back as well.

PS **I**t's going to be very interesting. It does seem to be possible that the $200 billion in Europe will be part of the negotiations for the peace. As these seems to be extraordinary one sided negotiations, when it comes to that you're entirely right, it must be possible. On the other hand, Europe does have this huge issue of the reconstruction of Ukraine, yes, so they might have something to say when it comes to that negotiation.

JD

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Last question on the big picture. The way Trump is going, can we assume that the independence of the Fed is is assured?

PS
I always recall the story of Lyndon Johnson pressing his Fed chairman against the wall urging him to collaborate. The independence of the of the Federal Reserve, I think, has always depended on it being reasonably close to some sort of consensus about appropriate monetary policy. Regarding the dynamics of replacing the people, most Federal Reserve members have quite a long time to run. The reaction of Congress will be critical.

JD
Lets talk about investment trusts. We're actually speaking, as it happens, at a conference for directors this week. Obviously there's a lot of talk about what's been happening in the investment trust sector, and whether or not, at the most extreme, it's facing an existential crisis, as some have said.

But let's just start first of all with something that you've done, which is you have supported this IPO trust called Achilles investment trust, which is going to go out there and make some money out of the situation that prevails in the alternative sector of the investment trust world, where discounts remain stubbornly wide. Tell us why you've done that and what you're hoping to achieve by backing that particular trust.

PS
Well, we had a happy experience with Christopher Mills and Robert Naylor on PRS REIT, which is a company with excellent assets, but a board that was much too close to the management company, and as a result of that there was a substantial discount to what were very clearly very attractive assets, assets that could be sold.

So we joined together with a number of other shareholders to put Rob and Christopher on the board, and they had a very big effect. There are a lot of boards which just need some more spine and a greater sense of reality. We thought with Achilles we would back those two to repeat that performance, where they have opportunities, where there's a big difference between the stock market and the private market value of the assets these companies hold, something that's most clearly true in the property sector, but it also might be true of renewables or other kinds of infrastructure.

We will see what they pursue, but we certainly think that they are a force for good in these markets, unlike Saba, which had an approach which was quite ruthless, but it was clear that, whatever statements they made, anything that benefited Saba was their only interest. As you know, the trust community came together extremely well to encourage people to reject these

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approaches, notwithstanding the particular approach, which was very unsophisticated - it was really quite odd, the trusts that they chose to attack.

Nevertheless what I think it has done is to accelerate a process that was already happening, which is that boards have recognised that they could not sustainably run trusts where the discount is wide and remains there. I feel very sympathetic to the view that the board could have done more before that to prevent it happening and I think there's a very clear message there for a lot of trusts. So whether it's Saba or whether it's an imitator who is more sophisticated, in the UK market, I think it's very unlikely that trusts with liquid underlying assets that could be hedged and trade at significant discounts will be around in three years' time.

JD
So it's a case of reform yourself or die, right?

PS
Yes, exactly that. I think there are some very positive ways of reacting. So if you have liquid underlying assets, the zero discount model that we operate, I think, is a proven success, and actually is the only way for good managers to grow their assets under management. I think that is a clear way forward.

Boards should be much more vigorous in announcing targets where investors can be confident that the discount will not get bigger than that and importantly, boards keeping to those targets. We've had a number of trusts which have announced targets and have not kept them. They just haven't bought back enough. If you operate open ended funds, and you know we operate both, it is extraordinary, the swings that naturally occur in demand for particular niches in the market.

It can grow by 50% and then fall by 30%. Boards seem to underestimate how much they have to do to control discounts. So what happens? They buy a lot of stock and the discount doesn't move, and therefore they say discounts aren't affected by buying back stock. That's demonstrably untrue. It's because they have underestimated how big the imbalance in supply and demand is. Buybacks have to be big enough to take out the shortfall.

JD
Self interest, one assumes, might be important here. The obvious source of that might be that fund management companies have seen a lot of outflows from their open ended funds. They're not in a hurry to see their fee income decline.

PS

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Although the analysis that buybacks did not make a difference does have at least one supporter among investment banks, right?

JD

Just thinking about alternative assets, why is it that we've we haven't, if you like, seen more institutional buyers coming for some of the alternative assets, if the value is there, for example, in renewables? Is it a question of whether the assets are actually properly valued, or is it other factors that may be deterring potential predators coming in?

PS

Well, we'll see whether there are potential predators coming, but I think the boards of all these alternative funds do understand what's happening. They all have significant programmes to sell assets and if they can sell assets that are close to the current asset value, then they're very cheap, and they will do very well. The test of that will come in the next six months. What we understand is that there are buyers out there.

JD

Yes, and I guess also another positive factor might be if we move into a period when inflation expectations are rising, and bond yields do rise. There's a very strong correlation between the behaviour of bond yields and the share prices of infrastructure trusts,

PS

There is absolutely no doubt that's true. There's always an interesting argument to be had, whether it's nominal or real yields that make a difference. Looking back five years I thought that if real yields were good, it wouldn't matter what nominal nominal yields did. That was completely wrong. And the more I think about it, actually, there was a good reason why it's nominal that has a big effect on the price. Most of these assets have significant elements of indexation in their assets.

Theoretically they shouldn't do too badly, Nevertheless, I do think that the bond markets are a very relevant indicator as to what the share prices will do, and what the economy in the UK will do. As we speak today, the ten-year is at 4.7%, which is very bad luck on Rachel Reeves, because it means she has no room for manoeuvre.

I'm afraid we think that, because inflation will probably be more persistent over time, the nominal yield curve will steepen. The real yield curve is already quite steep and is offering very good levels of return, which are, as you say, competitive with trusts, with tax advantages too.

The other response of boards in the equity trusts to the Saba threat, or the threat of people like Saba, has been rather less attractive to observe - Bankers Trust, for example, or at Montenaro

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UK Smaller Companies, where one shareholder may have got a deal that is not available to the others. This wasn't done at NAV, it was about a seven and a half cent discount, but that was much lower than this trust historically trades at *[see my note on this in the newsletter for some clarification this point - Editor]*. That I hope will not become a feature going forward, as then I am pretty confident that if people try to do that in scale, there will be a reaction among investors.

JD

Yes. In other words, neither poison pills nor preferential treatment, nor greenmail, are good corporate governance practice. I guess you could argue in the latter case if the impact of that was to bring the discount in sharply, then the board might say, "Well, look, if you have hung on, you've done okay". I'm just trying to think of possible rationalisations,. I think what you're saying is basically, shareholders have have to be vigilant. They've got to be thinking about what the board is doing. And you know, some boards may take mis-steps.

PS

Yes but one shouldn't miss the positive, which is the boards generally do understand the issue. They are taking action, and I think it's reasonable to expect the urgency of the action will increase, and all that's a positive development for shareholders. Where this thing ends up, with respect to liquid portfolios in the end, is with a few trusts that are much bigger than they are today. And I'm afraid the tail of small trusts is likely to disappear by way of consolidation, conversion to open-ended or simply wind up; there have been nine consolidations in the last 12 months.

For less liquid underlying assets, structures that allow periodic opportunities to go into a realisation class and allow new subscriptions at the same time can work well. This was a path pioneered by Blackrock Frontiers Trust. It doesn't force the liquidation of them in a fire sale. As they are sold, those existing shareholders will get the money, which I think is as good as a solution I can think of for dealing with that situation. But I think what doesn't work is just continuing with double digit discounts, struggling on with inadequate buybacks and hoping something turns up.

JD

One thing that does seem to be happening is a trend towards, as you said, towards trust ssaying, let's have a performance related trigger for some kind of redemption where it is, but it should be however much people want, rather than just a portion of what they're asking for.

PS

I don't think performance-related redemptions actually work in practice. And here's why, because if you have a trust which generally trades at a modest discount, and it gets towards

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the end of that performance measurement period, it can be worth more if they underperform than if they outperform, and that's perverse. In practice, the discount effect is modest until close to the redemption opportunity. It is just not the right way of doing it.

JD

Final question. Just going back to the big picture some people have mentioned the question of the investment trust sector facing an existential threat. Some people say there is an existential threat to the investment trust because they're not getting the regulation they deserve. We haven't mentioned cost disclosure. They is also competition from passive, from newer semi liquid, longer term asset vehicles and so on. Would you think the investment trust sector will come through?

PS

Yes, if it reforms itself. To be fair, a lot of the problems are not restricted to investment trusts; the regulatory environment in the UK with its emphasis on precautionary features rather than the high return opportunities has been unhelpful to all small and medium-sized companies. If boards are prepared to take the risks necessary to grow, we should end up with fewer but much bigger investment trusts in liquid assets and some specialist/smaller funds with attractive structures.

In that event, those trusts with good management and appealing strategies absolutely could become part of every retail portfolio. Overall, trusts can be much larger in total than they are today. There is a lot of reform and restructuring that needs to be done to reach that goal. But there is definitely the opportunity for the investment trust movement to thrive.

There's quite a few ifs in that! So that was Peter Spiller, the long term manager of Capital Gearing Trust, talking to me this week about what has been a very momentous start to the year for all of us.

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