PERSONAL ASSETS TRUST PLC

DECEMBER 2002 **QUARTERLY REPORT NO. 27**

PITY PRIVATE INVESTORS!

In my last Quarterly I promised to look at the problems faced by private investors when seeking advice on investing their capital. This is the first of two Quarterlies I intend to devote to the subject, and I'll begin with some words I quoted in the last Quarterly. They came from the *'Blue Bible'* — the book of collected Personal Assets Trust Quarterlies sent out in September of this year to those shareholders who requested it.[1]

'I meet many [private investors] *who have a six-figure (or seven- or eight-figure) sum managed by a financial adviser — perhaps a firm of stockbrokers, an investment management house or a wealth management company. I am often horrified by the inappropriate investment management "services" these investors get. Far too many holdings? Far too much buying and selling? Slavish obedience to a "black box"? Belated pursuit of fashionable sectors when no profits are left to be made and a fall is just round the corner? I've seen them all.*

'Such "services", seldom cheap, would be dear at any price. So even the private investor with many millions to invest is in my view best served by a portfolio of half a dozen good general investment trusts. Professional management, a spread of investments, no transactions (so no broking costs) and freedom from Capital Gains Tax within the portfolio, all at a reasonable price. It's what I do for myself — and it's what I'd still do if I had ten or even a hundred times as much money.'

[1] Copies are still available from the Company Secretary at the address on the back page of this Quarterly.

So it is. However many millions I had, half a dozen good general investment trusts would be all I would need for full diversification of risk. Yet I keep meeting private investors whose equity portfolios, managed individually for them by investment professionals at considerable expense, seem merely to replicate an investment trust, and an inferior and expensive one at that — lots of holdings and the constant drain caused by transaction costs, all in the name of 'diversification'. *(Or, to be cynical, all in the name of commission?)*

THREE HORROR STORIES

You will have noticed the use of the word 'horrified' in the passage I quoted from the *'Blue Bible'*. 'Horrified' is a strong word. Can it be justified? By way of answer, let me tell you three stories from my own recent experience.

- I know a couple who are high earners and are relatively young. Their aim is to build capital and, since they are higher-rate taxpayers, investment income is not tax-efficient for them. So I was surprised to learn that their IFA had recommended a range of high yielding investment products. But I was less surprised when I discovered that these all had hefty front-end charges; and I wasn't at all surprised that no investment trusts had been recommended to them, except for one in a commission-heavy ISA. After all, investment trusts as a rule pay no commission to IFAs who recommend them, and financial intermediaries must live. *(Why? Ed.)*

- In the opposite situation was a lady who three years ago (at the top of the market, as you will remember) had given highly specific instructions to her new IFA (who had greatly impressed her when she met him at a cocktail party) that she wanted a very low risk portfolio. So what did the IFA do? He sold her entire existing portfolio of low risk investments and reinvested her money into a range of considerably riskier ones. Lo and behold, her new high-risk portfolio has since then fallen in value by around 40% whereas her old low-risk portfolio (consisting mostly of fixed interest investments) would have held its value or even risen slightly.

- Perhaps most extraordinary of all was an older investor who entrusted all his family money to a 'wealth management' company which promised to manage it *'as if he were an institution'*. This, I discovered, involved buying and selling in line with an inflexible system which seemed to leave him with one share *(yes, just one share!)* in many companies and a string of holdings almost as tiny in numerous others. I suppose the system might have made sense *(if systems ever do make sense)* for a large institution with hundreds of millions to invest. It made no sense at all for a private investor with just under a million pounds. Holdings were being bought and sold almost daily, at considerable cost but (as far as I could see) to no good purpose. The end result? A very substantial loss of capital for the poor investor and a lot of worry and bewilderment too.

THE INVESTMENT JUNGLE

I get frustrated and angry when such things happen to my friends.

The financial world is confusing enough for the private investor as it is. So many products, so many enticing advertisements, so much gobbledegook — and all at a time when so many of the old certainties seem to be slipping away at a

frightening rate. Just look at the events of the two or three years.

- ***Equities always go up, don't they?*** Not for the last three years, they haven't. Since 2000, markets have nearly halved in value.

- ***Surely your pension is safe?*** 'As safe as the Rock of Gibraltar' might be the answer today (not saying much, despite the clearly-expressed wishes of the inhabitants in their recent referendum).

- ***Isn't life assurance always a low-risk bet?*** Many thought they couldn't do better than invest with the oldest-established mutual of all — and that was Equitable Life.

Such anxieties only increase private investors' need for sensible advice. Where can they find it? There are good IFAs, but not enough of them. And except for fee-based IFAs *(the sort I instinctively prefer, as being more likely to be objective and impartial),* even the best of them live by the commissions on what they sell.

Perhaps we are asking IFAs to do the wrong job. The ideal would be for an IFA to be a comprehensive source of advice on pure insurance, tax planning, trusts, provision for children, etc — all requiring highly specialised knowledge. As I said to Ian, an IFA of this sort would be almost a financial Feng Shui consultant.

But no-one will pay them for this, so IFAs live by selling commission-bearing investment products they don't really understand. I separate my own specific insurance needs from my investment needs — I don't choose to entrust these to insurance companies. The FSA would do something genuinely useful for private investors if it investigated ways of separating investment advice from insurance and tax planning advice.

IFA — OR DIY?

In the real world, however, you will find them inextricably linked in the minds of most financial advisers. So what can you do? More than you would think, I'm glad to say, as long as you're prepared to do some homework and use your common sense. When it comes to making investment decisions, I'm a great believer in the merits of common sense, which no investment advice should be allowed to transcend. So I find it a mystery that private investors seem to scan the Personal Finance pages of the weekend Press with all the trustful innocence of Homer Simpson, to whom Bart once scornfully remarked, *'You'll buy* ***anything****!'*

Why do people who usually take such care with their money bungle their biggest financial decision of all by putting their savings in investment vehicles that are obviously unsuitable? I suspect it's for a reason I find both worrying and depressing — that they think of investment as a mysterious and unfriendly world they can't hope to understand, so they just swallow what they read, or are told, in a way they would never dream of doing when making vastly less important decisions about buying a car or a washing machine or a cheap package holiday. So let's try to demystify things by asking ourselves some questions.

LIFESTYLE CHOICES

Maybe the first question ought to be, *'Do I want to build up capital at all?'* As someone once said, *'Why travel at the back of the 'plane so that your children can travel at the front?'* However, I assume readers of this Quarterly have made the opposite decision. They will possess (or be accumulating) capital they want to preserve and to see grow. So let's think about making money grow. What might be a reasonable rate of growth to hope for?

Notice that I use the word ***'reasonable'***. If inflation is 2%, gilts are yielding 4½% and equities are looking expensive (as they do just now — the UK market yields less than 3.4% and its price/earnings ratio is 20 times) our expectations can only be modest.

In my view, a 'reasonable' <u>long-term</u> annual rate of total return to anyone investing in equities today would be in single figures.

A good friend, an amateur investor of well above average intelligence and market knowledge, assured me some time ago that he, too, thought in terms of single figures. He believed that he could make 4% *a month* from trading his portfolio, which would represent an annual return of around 60%. At first he had some successes, but before too long he had given up the struggle and is now an investor in Personal Assets!

Investment returns come in various forms, however, so one must ask, *'What do I want from my money? Income? Capital growth? Total return?'* You can't have everything. Leaving aside short-term market inefficiencies, the general principle is that the higher the income return you get from an investment, the lower will be the rate of capital growth it produces, and *vice versa. (Ian assures me that each 1% per annum over the current yield on equities will cost you at least 3% per annum of capital return!)* Common sense will tell you that most high yield investments offer you a real prospect of capital loss.

One useful way of calculating the total return you can expect from equities in general starts from the observation that the capital value of a share tends to grow in line with the dividends on it. Therefore, because dividend growth on equities as a whole will reflect both the inflation rate and the growth of the economy, so will the capital value of equities. You can therefore work out your likely long-term total return from equities by taking the yield on the equity market (at present, just under 3.4%) and adding to it the inflation rate (2%) and the rate of growth in GDP (2.5%). In total, this gives us just under 8%.

Of course, it seldom happens so neatly. But drawing a higher income from an investment than the total return you can reasonably expect from the investment's underlying assets will in due course lead to a capital loss. Trust me.

RISK IS FOR REAL!

The next question is, *'How much risk can you tolerate?'* Or, putting it bluntly, *'How much of your money can you afford to lose?'*

We hear a lot about comparing interest rates and expected growth rates, but much less about com-

paring degrees of ***risk***. So don't forget the Bank of Credit and Commerce International (BCCI) collapse of 1991. Local councils (among others) deposited money with BCCI, which paid a higher rate of interest than any other bank, but didn't stop to ask *why* the rate of interest was higher. Well, it wasn't a free gift from a cuddlier bank than the High Street meanies. The depositors should have realised, since their common sense should have told them, that ***in return for a higher return they were accepting a higher risk.*** And in due course they suffered the consequences. The risk was not theoretical. ***The risk was real.*** And that is what the lady I mentioned on the first page found out when in exchange for her IFA's promise of a higher total return she lost 40% of her money. It wasn't a good bargain.

WHAT IS DIVERSIFICATION?

'Don't put all your eggs in one basket' is good advice, but gives rise to misunderstandings galore. For instance, if mining stocks *as an investment class* are risky it isn't 'diversification' to hold six of them, any more than you are spreading your risk by betting six times on the same horse in the Grand National. Similarly, diversification doesn't simply mean holding lots of different shares. It depends on what the shares are. A breakfast of crisps, nuts, chocolate and gin would be 'diversified' in that it would have four different constituents, but it could hardly be called a balanced meal.

To quote Ockham's Razor, the principle laid down by the famous English theologian and philosopher William of Ockham (c.1285-1349), '*Entia non sunt multiplicanda prœter necessitatem.'* This is usually translated as something like, *'Other things beings equal, the simpler of two explanations is to be preferred'*. However, the literal meaning is, *'Entities are not to be multiplied unnecessarily.'* In other words, diversify for what you need to — hold six trusts rather than one, to diversify away the risk it would be to have all your money managed by just one Board and one set of managers — but not for what you don't. Yes, you can diversify your stock market exposure by buying individual equities, but this is costly and inefficient. Since the *raison d'être* of investment trusts is to provide diversification of investment to individuals at a reasonable cost, why reinvent the wheel?

THE BENEFITS OF TRUSTS

At this point I can't do better than revisit the section of Personal Assets' Annual Report that spells out to higher-rate taxpayers or people with substantial capital the advantages of investing in investment trusts rather than managing their own portfolios directly or through a financial adviser.

- Such private investors usually lack the time and expertise to run their own investment portfolios. Investment trusts, however, offer them the benefit of full-time, professional portfolio management, while the direct relationship between the shareholders and the elected Board ensures accountability for investment decisions.
- Investors who manage their portfolios directly or through an adviser cannot offset their investment management and administration costs against their taxable income. Nor can they offset the interest they pay on any money they borrow to invest in equities. Investment trusts, however, can offset all such costs against their taxable income.
- Higher-rate taxpayers are taxed at their top rate of Income Tax (currently 40%) on all realised capital gains over £7,700 per annum. So they are often faced with ***either*** paying Capital Gains Tax ***or*** making unsuitable, tax-driven investment decisions. Investment trusts, however, are free of Capital Gains Tax on gains realised within their portfolios, so they can buy and sell investments ***on investment grounds alone.***

TRUSTS . . . AND TRUSTS

All investment trusts, however, are not the same. The other day I opened a half-forgotten tome entitled *The Pilgrim's Progress: An Historical Guide to Investment Trusts,* which I produced in 1995, towards the end of my broking days. After praising trust savings schemes (first launched in 1984) and PEPs (launched in tax year 1986-87) I went on to ask, *'What IS an "investment trust"? There is a huge difference between a diversified trust like Alliance or Scottish Mortgage* [or, I might have added, Personal Assets] *and a Latin American specialist. Yet all are "investment trusts" to the Press and in the popular mind. We may be approaching the time when to speak of investing in an "investment trust" will be like speaking of investing in a "share" – which might be anything from ICI to Polly Peck . . .*

'[The] *question of making clear the very different risk/reward ratios of different types of trust and trust security must be firmly tackled.* ***I dread the idea that retail investors who think that they are investing in a low-risk type of equity investment might get their fingers burned through investing in the wrong trusts for them.'***

Sad to say, my fears were realised — witness the problems in the split capital trust market thanks to over-enthusiastic launches, overstretched balance sheets and over-ambitious targeted returns. So the trusts to buy must be chosen with care, using the common sense principles I outlined earlier.

END OF PART ONE

I am conscious of many gaps in the Quarterly so far, and of things half-explained or not explained at all — and on past form I expect lots of questions from shareholders too! ***So I plan to deal with these in the next Quarterly and also to pick up some loose ends from what I have written here.*** I make no apologies for returning to this important subject. But I will end with a plea. ***Please don't write to me and ask me for the names of some trusts to invest in!*** It isn't that I don't want to help. But the law doesn't allow me to give direct advice of that kind. All I can do is write in common-sense terms about the subject in general — which I promise I'll keep trying my best to do.

ROBIN ANGUS

Personal Assets Investment Plans

While the shares of Personal Assets Trust are listed on the London Stock Exchange and so can be bought and sold in the normal way, investors can also buy shares ***free of all commissions and charges*** through the Company's ***Investment Plan***.

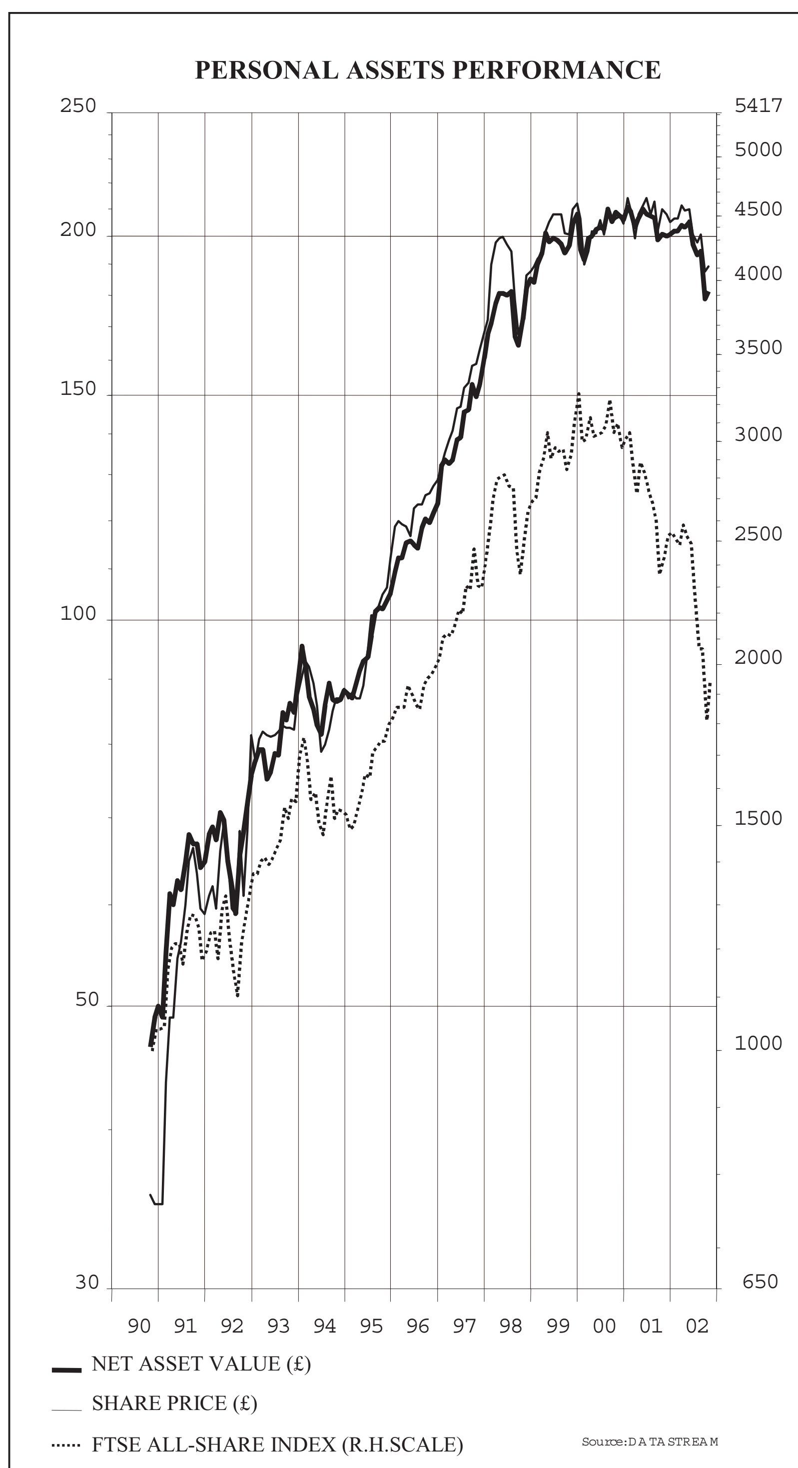
Investments in the Company's shares can also be made free of all commissions and charges through the Company's ***ISA*** or through ***PEP and ISA transfers***.

Details of all these methods of investing in the shares of Personal Assets can be obtained from the Company Secretary at the following address:

Personal Assets Trust PLC
One Charlotte Square
Edinburgh EH2 4DZ

Tel: 0131 465 1000

PORTFOLIO	**30-Nov-02 £'000**
Royal Bank of Scotland	£3,730
Scottish & Newcastle	£3,698
BP	£3,641
HBOS	£3,169
Shell Transport & Trdg	£2,335
Rentokil Initial	£2,105
Barclays	£1,953
GlaxoSmithKline	£1,805
British Assets Trust	£1,526
BT Group	£1,460
Top Ten Equities	**£25,422**
Other Equity Exposure	**£30,059**
Effective Liquidity	**£40,116**
Shareholders' Funds	**£95,597**



% Changes From	31-Oct-90	30-Apr-00	30-Apr-01	30-Apr-02	30-Nov-02
Period	**12y-1m**	**2y-7m**	**1y-7m**	**7m**	**Values**
SHARE PRICE	**440.8%**	**-5.0%**	**-7.9%**	**-8.4%**	**£192.00**
NET ASSET VALUE	**299.0%**	**-7.3%**	**-10.5%**	**-8.9%**	**£185.26**
FTSE ALL-SHARE	**101.8%**	**-33.3%**	**-30.2%**	**-20.3%**	**2,002.97**