PERSONAL ASSETS TRUST PLC

FEBRUARY 2003 QUARTERLY REPORT No. 28

INVESTMENT TRUSTS FOR THE PRIVATE INVESTOR (PART II)

These are the things that people do not know;
They do not know because they are not told.

Hilaire Belloc

This is the second of three Quarterlies dealing with investment trusts and the private investor. In the first of them, Quarterly 27, I argued that private investors, even those with millions to invest, were usually best served by a portfolio of half a dozen good general investment trusts. As I expected, responses from shareholders were many and various, picking me up forcefully on what I had written and asking for elaboration on some of the points I had made.

This Quarterly contains a selection of these responses, extracted from much longer letters, together with the gist (suitably edited) of my replies. Here I have naturally focused on the questions most commonly asked, those quoted often standing for several others.

DIRECT TELEPHONE LINE

We now have a direct access telephone line for inquiries concerning Personal Assets' Investment Plans. Shareholders who require ISA application forms, Single or Monthly Investment Plan application forms and/or PEP or ISA transfer forms, or who have any other queries about our Investment Plans, or who require copies of Reports & Accounts, Interim Statements, back copies of Quarterlies, copies of the *Blue Bible*, etc, should contact **Steven Budge** on the following number:

0131-225 9995

I have felt it worth devoting an entire Quarterly to shareholders' comments because these Quarterlies are intended to be a forum for communication between shareholders and the Board. I shall use Quarterly 29, due for publication in May, to pick up loose ends and draw the subject to a conclusion.

So — over to our shareholders! Their chief concerns included the bad recent performance of general investment trusts, their widening discounts, the failure of most such trusts to go substantially liquid, the degree of culpability of managers for underperformance and the perceived riskiness of putting all one's eggs into an investment trust basket. By and large, those shareholders who wrote to me seemed happy with the performance and investment approach of Personal Assets itself. However, some of them appeared to need more convincing that diversified investment trusts in general were both adequate and appropriate as a long-term home for their capital.

OUR SHAREHOLDERS WRITE

"There are hundreds of investment trusts out there. How on earth am I going to be able to choose suitable ones?"

Yes, there are hundreds of investment trusts — over 370 at the last count. Some of them, notably in the split capital trust sub-sector, have weird and wonderful capital structures and/or investment policies. I'm not suggesting you invest in trusts like these. I look chiefly at the biggest dozen or so trusts that can combine a flexible investment policy with a reasonable (and growing) dividend and low total management costs. Such trusts help me spread the 'management risk' of my portfolio — after all, Ian isn't *always* right!

"In the past I tended to agree with you about the suitability of investment trusts for most investors. But now I am having second thoughts. For example, in the period 30 April to 30 November 2002 Foreign & Colonial fell 30% and Witan fell 29% while the FTSE fell 20%."

You are by no means the first person to draw my attention to the thoroughly rotten performance of the big generalists over the last few months — not that I *needed* my attention drawing to it, since (other than Personal Assets) they are my own biggest investments!

The first thing I would say is that, while I do recognise the poor performance of the big generalists recently, the seven-month period you quote is a very short time. When Ian started running of PAT in 1990 the Board decided to take three years as our term for measuring performance and we have stuck to this principle ever since.

Now to the burning question — what went wrong? The big generalists have been underperforming for three main reasons. The first is that, unlike Personal Assets, they have typically been fully invested in (declining) equities. Secondly, some of them have even been positively geared, which exaggerated the effect of the market fall on their net asset values (NAVs).

Thirdly, discounts have widened significantly (which also usually happens when markets fall) and this has further depressed such trusts' share price performance.

"So how has PAT managed to escape this 'discount trap' into which other trusts have fallen?"

It is simple. PAT sells at around NAV *because the directors have decided that it should.* So if our

shares go to a discount we buy them back — in any size, at any time (although we have not had to since April 2000). If they go to a premium, we create new shares to satisfy demand. Furthermore, the Board believes that shareholders dislike not only 'discount risk' but also 'premium risk' (which has in the past brought severe disappointment to investors buying into other good trusts, but at a premium which then vanished). As shareholders we ourselves prefer to avoid both these risks. Judging by the continued demand for PAT shares, our fellow shareholders seem to agree with us. In April 1995 we had 152,000 shares in issue. Today we have over 537,000, an increase of more than three and a half times.

"But if 'discount risk' is such a bad thing, why do other trusts not do as Personal Assets does and eliminate it also?"

Ask their Boards! In theory, there is no reason why they shouldn't. In practice, there are three main reasons. First, buying back shares would shrink the trusts' size and so reduce the fees paid to their managers! Secondly, geared trusts would become even more highly geared as their equity base shrank while their gearing stayed fixed (although this could be neutralised by an increase in liquidity).

Thirdly, large percentages of the big diversified trusts are still held by institutions who are sometimes reluctant to sell their shares in the market at a discount to be bought in for cancellation, preferring to wait to see if they can get NAV at some future date through a hostile bid or through some sort of restructuring scheme. PAT has been lucky in that from the very beginning we have had only 'natural' shareholders — private shareholders who genuinely wanted to be invested in the trust. Most other trusts are less lucky and still have to contend with an historical 'overhang' of discontented institutional shareholders.

"PAT's liquidity has benefited shareholders greatly. Why have other general investment trusts stayed so heavily invested in equities over the last three years?"

I think there are three main reasons for this. First, most general investment trusts are still held heavily by institutional investors. These often don't like investment trusts to go liquid. They prefer to make their own decisions about liquidity and regard their trust shareholdings simply as an alternative to holding equities directly. If they find they are holding cash or bonds at one remove through an investment trust, this annoys them because it distorts their own asset allocation calculations.

Secondly, trust managers are human. Because they are paid to be equity investors, they are terrified not to be fully invested in equities. To go liquid is to break step with their rivals. Needless to say, the Board of Personal Assets believes that sometimes one has to be bold and break step. But never under-rate just how hard this is for equity managers. Like a GP prescribing alternative therapies, if it goes wrong there will be serious trouble! It can feel much safer just to risk making the same mistake as everyone else, even if one is pretty sure it *will* be a mistake.

This brings me on to the third reason, which might be called *'The Curse of Relativity'*. Investment managers are trained to think in terms of relative, not absolute, returns. This is how they are measured by their peers, the Press and performance consultants. So for a portfolio to fall in value by 15% when the market falls 20% is a triumph, but for it to rise by 15% when the market rises 20% is a disaster — even though the 'triumph' involves the shareholder losing £15 in every £100 and the 'disaster' means he has gained £15! The problem is that shareholders, in my experience, are interested in absolute as well as relative performance. This is why Personal Assets places such emphasis on protecting, as well as increasing, shareholders' capital.

"Do you agree that the big general trusts look risky just now?"

Well, to echo the late Professor Joad, it all depends on what you mean by 'risky'! If there were to be another 1,000-point fall in the FTSE 100 Share *(which stood at just over 4,000 when I wrote this particular reply to a shareholder)* they would almost certainly do much worse in the short term than the market in general. So I should not buy them in the hope of short-term outperformance. But I never *would* buy anything in the hope of short-term outperformance. I am hopeless at that sort of investment. If today I were giving some money to a new godchild as a christening present, the capital to be kept intact until the godchild came of age, I should not hesitate to put the money in a big general trust. The ups and downs of NAV performance and the vagaries of the discount will have washed out by then, and that is what I mean by long-term investing.

"A reason for the big generalists' recent poor performance is the silly trend of the trust industry to become quasi-trackers and do so in some instances with aggressive gearing. I would be interested in your comments on this."

It is hard to imagine a worse recipe for portfolio performance than to be a quasi-tracker with aggressive gearing over a three-year period during which the UK market, as measured by the FTSE 100, fell from just under 7,000 to just under 3,700! Like you, I find it infuriating when Managers' reports blame 'gearing' for under-performance, as if their gearing were some sort of unlucky accident beyond their control. Who made them gear in the first place? To borrow a phrase used by Scots children as a lame excuse for their misdemeanours, there is today sometimes a sense of *'a big boy geared up my trust and ran away'*[1] about Managers' reports. And why didn't they hedge the gearing later? Even if trusts do have a geared balance sheet, this does not mean they must at all times have a geared portfolio. One can neutralise gearing by holding gilts or other fixed interest securities, or by selling FTSE 100 Futures.

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[1] Ian, who has a sharper ear for the urban Scots vernacular than I do, alleges that the excuse should read, *"It wisnae me, Sur, it wuz a big laddie whae's ran aff."*

However, don't fall into the trap of supposing that gearing is always a bad thing. Ten years ago, people fell into the opposite trap of thinking it was always a good thing. Neither is true. Gearing is an investment tool which it is appropriate to use at some times but not at others, and which can be a good servant but a bad master.

"Surely managers should be involved in the decision on the trust's debt position and, therefore, must also share the responsibility for underperformance during their management? Is it right that management fees are tied to gross assets?"

Managers are heavily involved in deciding on a trust's debt position and so must bear much of the responsibility for gearing-induced underperformance during the period of their management. As for management fees tied to gross assets, they are a disgrace. Indeed, I strongly attacked them in print some time ago in the two articles on split capital trusts I wrote with Dr Andrew Adams of the University of Edinburgh (published in *Professional Investor*). They can all too easily induce greedy or unscrupulous managers to put their own interests ahead of those of the shareholders. In my opinion they were a prime cause of the recent split capital trust scandal and I should like them outlawed. No self-respecting manager should accept them; no self-respecting Board should permit them.

"You can never be certain that the tax treatment for trusts will remain as kind as is currently the case. In the mid 1970s investment trusts were taxed twice on all gains, once within the confines of the portfolio and again in the hands of each investor."

I do indeed remember how in the mid 1970s trusts were subject to internal Capital Gains Tax *(albeit at 15%, half the personal rate)* on gains realised within their portfolios. As a trainee fund manager at Baillie, Gifford & Co I was then much involved in the annual flurry of bed-and-breakfasting, and transferring overseas holdings between dollar loan and dollar premium accounts.

There is no guarantee that those bad old times will not return. From the point of view of private investors, Mr Brown has proved to be a thoroughly unsympathetic and unhelpful Chancellor (witness his plundering of the pension funds). He could turn nasty on investment trust taxation too. Furthermore, I have for some time been afraid that the split capital trust scandals could lead to a lot of unwelcome new regulation of investment trusts — regulation that would benefit nobody, would have done nothing to prevent the split capital débâcle itself, would make life difficult for responsible trust Boards and managers, and would serve only to appease the FSA and other highly-paid busybodies in what has sadly become the City's latest growth industry. I hate regulation. Common sense and *'caveat emptor'* served investors well in the past. I fail to see why they shouldn't be enough for the future. We must look to the AITC, our trade body, to defend the trust industry vigorously against the empire-building of unaccountable government agencies and the publicity-motivated posturing of supercilious Treasury Select Committees.

"It is too extreme a view to suggest investors simply hold investment trusts and no other types of investment. The key rule of investment is never to have all your eggs in one basket . . . one should never have just commitment to investment trusts."

What I wrote was, *"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."* I stand by that. Firstly, it is (I hope) clear that it's very much a personal opinion rather than some kind of *ex cathedra* pronouncement which I would have no authority to make even if I wanted to. I am a partisan of investment trusts and anyone who knows anything about me or my writings knows that. Second, there are always exceptions and qualifications to everything. So I might happily differentiate, for instance, between someone's core portfolio (which could be in half a dozen investment trusts) and a range of other investments held as 'insurance', as deliberate diversifications or just for 'fun'.

"You say, 'half a dozen good investment trusts would satisfy all my investment needs'. But I have spread myself a little wider and have found this stimulating."

I'm delighted to hear it. There's no contradiction between our positions. Half a dozen good investment trusts would indeed satisfy all my investment needs, just as water would satisfy all my drinking needs and bread and vitamin pills all my eating needs — but I might get a bit bored!

So I often suggest that people keep aside 10% of their money for *fun*, so that they can gamble a little bit, speculate on the odd hot tip and thus find it exciting to turn to the City pages every morning. There is more to life than just one's *'needs'*, and so I'm glad you've found interest, excitement and (I hope) profit in pursuing a wider-ranging investment policy.

"I would argue that a private individual's portfolio could perfectly well be made up of carefully-chosen individual equities."

Yes it could; and at its best such a portfolio would be very suitable. I have no doubt that any of a number of excellent private client stockbrokers known to me could construct a first-class one. But I have all too often seen such portfolios *not* at their best. Some of them have been costly dogs' breakfasts that made me ashamed of the industry I serve. This is why I have come to the conclusion that half a dozen general investment trusts would be a reliable choice for most people. It is not the only choice, but it would be a sound and dependable one and would be less likely to cause worry and uncertainty than most of the other options available. To stress the advantages of investment trusts, however, is not to damn all other ways of investing. I rejoice that Personal Assets' relationship with good private client stockbrokers has been of the happiest. Long may it continue so.

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***.

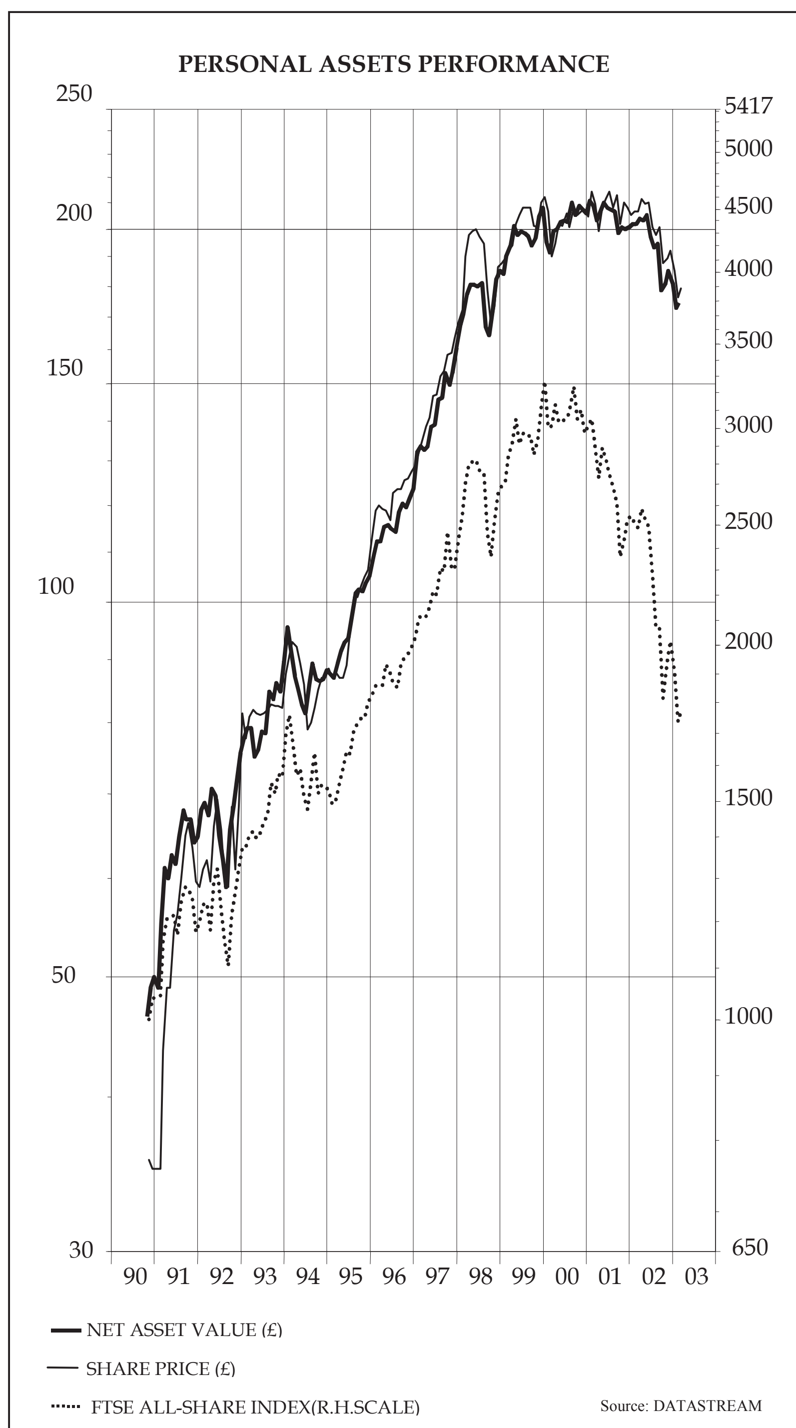
Details of all these methods of investing in the shares of Personal Assets can be obtained from the following address:

Personal Assets Trust PLC
One Charlotte Square
Edinburgh EH2 4DZ

Or by telephoning Steven Budge:

Tel: 0131-225 9995

PORTFOLIO	31-Jan-03 £'000
GlaxoSmithKline	£4,233
Scottish & Newcastle	£3,370
BP	£3,323
Royal Bank of Scotland	£3,031
HBOS	£2,507
Shell Transport & Trdg	£2,066
Rentokil Initial	£1,968
Barclays	£1,471
British Assets Trust	£1,264
BT Group	£1,206
Top Ten Equities	**£24,439**
Other Equity Exposure	**£38,606**
Effective Liquidity	**£28,896**
Shareholders' Funds	**£91,941**



% Changes From	31-Oct-90	30-Apr-00	30-Apr-01	30-Apr-02	31-Jan-03
Period	12y-3m	2y-9m	1y-9m	9m	Values
SHARE PRICE	**396.5%**	**-12.7%**	**-15.5%**	**-15.9%**	**£176.25**
NET ASSET VALUE	**271.9%**	**-13.6%**	**-16.6%**	**-15.1%**	**£172.67**
FTSE ALL-SHARE	**73.5%**	**-42.6%**	**-40.0%**	**-31.4%**	**1,722.28**