PERSONAL ASSETS TRUST PLC

MARCH 2007 QUARTERLY REPORT No. 44

OPM + (2 + 20) = MH

What on earth is this? It lacks the elegance of Einstein's $E = MC^2$, but for financial markets it could prove far more important. It is *Rushbrook's Law of Hedge Fund Manager Behaviour*. OPM is 'Other People's Money'. (2 + 20) is the characteristic structure of a hedge fund's management charges — 2% per annum of gross funds, and 20% of profits. MH is 'Moral Hazard', where the manager of a fund has an incentive to take great risks with investors' funds in an effort to achieve returns that should never have been promised.

Here is an extreme, but not unreasonable, example of it in practice.

- A fund is launched in March 2005, raising $100 million.
- It borrows $900 million in Yen at an interest rate of 0.25% and converts them to Dollars at 105.3.
- It puts the $1,000 million on deposit at 5%. Since the borrowing cost of the $900 million is only 0.25%, the fund grows over the two years to $1,097 million.
- Currently, the Yen is 118.0 against the Dollar. The liability of the $900 million of borrowed Yen falls to $803 million. The fund, originally $100 million, would be $294 million.
- The manager's fees total $73 million. The investors profit by $121 million. All are delighted.

BUT — if the Yen then rose to 92.5[1], the manager retains his fees but investors would be wiped out. 'Moral Hazard' in action!

THE 'YEN CARRY TRADE'

Later in the Quarterly I'll revisit Ian's analysis in his 2006 Managing Director's Report, to see how things have developed since then. There is, however, one major new factor to build in to the analysis. This is the importance to global markets of what I've been describing — the 'Yen carry trade'.

Japan, the world's second largest economy, has for a long time been trading with an undervalued currency. Its central bank rate is currently 0.5%, making the Yen unattractive to hold as a source of interest income but very cheap to borrow. So speculators (particularly hedge funds) have made apparently easy profits by borrowing huge sums in Yen and depositing the money elsewhere in higher-yielding currencies or, even more riskily, investing it in higher-yielding financial assets. Over the last two years this has been a gift to the hedge funds, desperate to generate rewards in a world where available returns on virtually every asset class have become ever lower and flatter.

If spreads between available returns are narrow, the obvious way to make big profits from arbitrage is to use ever higher gearing. The Yen, which can be borrowed very cheaply but has (so far) been repayable at lower exchange rates, has been the financial world's most significant pricing anomaly. Will it stay that way?

Some in Japan and outside it want to see interest rates at a more 'normal' level (they stood at zero for six years in an effort to cure the country's deflationary slump).

- The Bank of Japan is keen to raise interest rates; *but*
- A weak Japanese government is desperate to keep them down in order to fuel economic growth.

Moreover, the Japanese Finance Ministry is worried that higher interest rates could (as the *Daily Telegraph* described it recently) *'raise the interest burden on Japan's colossal public debt, fruit of desperate Keynesian pump priming in the 1990s.'* [2] So there are pressures both ways.

'IS IT STARTING TO UNRAVEL?'

I am counting no chickens, but it does start to feel that we're into the 'end game'. The more credit expands, the greater the risk rises for investors. It is a fundamental misconception that massive global liquidity (i.e. ever more available credit) makes it safer to invest in high risk assets. Instead, it just increases the penalty that will ultimately have to be paid by those seduced by the concept.

We can't tell you when this will happen, but the longer the journey lasts, the worse it will prove to be when it ends. In January we increased our liquidity from 39.6% to 47.8%. It currently (23rd March) is 49.5% of shareholders' funds, its highest level since the summer of 2002, when it briefly climbed over 60% before we began reducing it in predetermined stages in anticipation of what proved to be the March 2003 market rise.[3]

Before I explain the thinking behind this increase in liquidity, I can't help pointing out that global markets since we made the move have been even more jittery and erratic than usual. I have always maintained that (leaving aside our long-term worries about underlying valuations) the short-term reasons for a market fall would be unpredictable and would probably be things no-one had even considered. So it proved. Not only was there an attempt on the life of Vice President Cheney but the Chinese market suddenly slid in February and, as one commentator put it, *'China caught a cold and the USA caught pneumonia.'*

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[1] As in 1998, when the Yen rose against the Dollar by 30% following the Russian bond crisis.

[2] The Japanese public debt currently stands at around 170% of GDP.

[3] Personal Assets' relative performance against the FTSE All-Share from its April 2000 year end is still in excess of 20%.

It was Asian 'flu, if not avian 'flu, and the rest of the world soon started shivering. During the most panicky trading day (5th March) the FTSE 100 briefly dipped below 6,000, although it later recovered to close at above that level. Then, having somewhat groggily righted themselves after the China scare, markets were caught up in the woes of the US sub-prime mortgage lender New Century Financial — to say nothing of the peril to the 'carry trade' and, therefore, to the stability and profitability of the hedge fund industry caused by the rise in the Yen.

SIX YEARS OF CHEAP MONEY

I confidently predict that we shall be hearing a lot more of both the US mortgage market and the 'Yen carry trade' in the months to come. Now, however, I must step back from the kind of short term market chat Ian hates and reexamine the long term fundamentals. In Ian's speech at the last Personal Assets AGM, in July 2006, he pointed out that global interest rates had been unusually low for an unusually long time, so that the world's central banks would have to move faster to raise interest rates. Moreover, global inflationary pressures were already rising, so leaving economies vulnerable to any unforeseen (and unforeseeable) market crises.

At the root of the problem was Alan Greenspan, the Chairman of the US Federal Reserve. What is the chief task of any central banker? It is, surely, to fine-tune a country's economy by using monetary policy and the central bank rate to moderate excessive growth and mitigate economic slowdown. Yet after the attack on the Twin Towers in 2001, Greenspan did what US drag-racers used to do. He added nitroglycerine to the fuel, which (Ian says) makes it possible to get to 200mph in under six seconds, but doesn't do a lot for the engine!

Over the two years from September 2001 he cut the Fed rate from 6.5% to an amazing 1% and kept it there for a further year, so (as Ian put it) *'applying a blowtorch to a case of US economic frostbite and, while resolving the problem in the short-term, causing potentially enormous long term financial damage to the world.'* [4]

The Greenspan era of dangerously cheap money is responsible for the challenge currently facing the US Fed to control inflation and avoid a Dollar collapse without causing a recession. Yet inflation worries us increasingly. In the US, Bernanke has previously stated that he was comfortable with a range of 1% to 2%, but core inflation (now over 2.7%) has been well in excess of this for some considerable time. In the UK, the RPI has risen from 2% to 4.6% since January 2000 and the CPI from 0.8% to 2.8%.[5] And as regards recession, even Greenspan — who still has the power to unsettle markets — has recently suggested the possibility of one by the end of 2007. Here are his words of 26th February in all their opaque splendour.

'When you've been through a cycle of expansion as we have since, really 2001, the recovery is, as what people like to say, long at [sic] *the tooth, and that when you get this far away from a recession, invariably, forces build up for the next recession. And indeed we are beginning to see signs of, for example in the United States, profit margins, after extraordinary upward-side moves, have begun to stabilize. Which is an early sign that we are in the later stages of a cycle. But I think, having said that, the probabilities of forecasting a recession are probably more in the area of a third than they are more than a half. And while yes, it is possible that we could get a recession in the latter months of 2007, most forecasters are not making that judgment and indeed they are projecting forward into 2008 at a reasonably good level with some slowdown.'*

THE GREENSPAN RECESSION?

Isn't recession to be expected after such a long boom? It's worth looking at what sort of boom we've actually had. To return to Ian's July 2006 AGM speech:

'In our view, there has been no real GDP growth at all (that is, growth based on savings and investment) from 2000 onwards. All GDP increases have been generated from debt: government debt, corporate debt and particularly consumer debt. But, unfortunately, a consumer boom and GDP growth based on debt can only continue for so long . . . Since all debt must be repaid ultimately, whatever boom consumer debt has caused must be followed by a bust of exactly the same magnitude. Effectively, real household earnings in the UK and US have not increased over the last six years. This is why company earnings are currently so high; businesses haven't had to pay their employees more. When consumers spend not only their earnings but also their increased borrowings, businesses get to sell more without having to pay anyone more. The result is high but unsustainable corporate earnings.

'Meanwhile, consumers have borrowed against the increased value of their houses and banks have been delighted to extend the credit. Unfortunately, even if their houses are worth three times what they were six years ago, it won't help them pay off their debt — they still have to live somewhere and therefore they can't very well sell their houses to repay the debt — so they have to cut their consumption. As housing weakens so will the UK and US economies.'

Neither Ian nor I would alter that assessment today. Our only question is *when*, not *if*, our predicted market fall will happen.

WE QUESTION CONTINUALLY

Ian and I revisit our analysis constantly, debating with each other and with other members of the Board to make sure our deductions still hold good. And we would not have been human if, during the four years of rising markets since March 2003, we had not had periods of self-doubt.

Later on, at Ian's suggestion, I'm going to quote his favourite comparison with *Alice in Wonderland*. Here, however, I want to quote another great work of fantasy. At times, when people have been trying to persuade us that equities are cheap, I've wondered if they've inwardly been comparing us to those maddening and pig-headed creatures, the Dwarfs in C S

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[4] The Bank of England followed suit. The former Governor, Lord George, was reported in the *Daily Telegraph* for 22nd March 2007 as saying that the Bank deliberately encouraged a consumer boom that left families in debt and house prices soaring. He said the *Bank 'did not have much of a choice'* as it used interest rates in an attempt to prevent Britain being dragged into a worldwide economic slump.

[5] Many of the readers of this Quarterly will be suffering inflation a good deal higher than this. It makes little sense to speak of a single national inflation rate. We all have our own personal inflation rates, and those who, for instance, have school fees or council tax or private health care costs to meet, or are struggling to clamber up the housing ladder, will be enduring inflation considerably in excess even of the RPI's 4.6%.

Lewis's *The Last Battle*, the final book in his *Chronicles of Narnia*.

Towards the end of *The Last Battle*, the forces of evil having been defeated, the humans and the talking beasts of Narnia are rejoicing — all except for the Dwarfs. They sit on sweet-scented grass in glorious spring sunshine, but (having once been fooled) they are so determined not to be fooled again that they've convinced themselves they are still imprisoned in a dark, smelly stable. Lucy, the little girl who is High Queen of Narnia, is upset that they seem so miserable and so she picks violets for them.

'She leaned across and held the fresh, damp flowers to his nose. But she had to jump back quickly in order to avoid a blow from his hard little fist. "None of that!" he shouted. "How dare you! What do you mean by shoving a lot of filthy stable-litter in my face?"'

Even Aslan the Lion, the Christ-figure of the tale, tries to give the Dwarfs delicious food and drink, but they see only slops and rubbish. They refuse to trust anyone or anything, vowing repeatedly:

'Well, at any rate there's no humbug here. We haven't let anyone take us in. The Dwarfs are for the Dwarfs.'

'MODEL' BREAKS NEW GROUND

Have Ian and the Board been as obstinately blind as the Dwarfs? Let's look at our model, by which I mean not an in-house version of *Private Eye*'s Miss Rita Chevrolet (our wives might have something to say about that) but the equity valuation model I referred to in Quarterly No. 39.[6] Two problems hinder the working of such models. The first is the occurrence of unforeseeable events. The second is when the quality of statistics changes in such a way that they can no longer be trusted.[7]

During the second half of 2002 and in early 2003 the model was indicating a somewhat undervalued market, so we reduced our liquidity from over 60% to under 25%. We were misled, however, by the modesty of the undervaluation. We had expected the pendulum to swing much further into undervalued territory, as it had always done previously, rather than just hovering briefly at a little below fair value. In retrospect, we should have reinvested earlier and more aggressively than we did, rather than waiting for the final sell-off that never came.

Now, the model has moved decisively into new ground. Starting in the last quarter of 2006, it has risen to a level of overvaluation not seen since the beginning of 2001 — something of the order of 40%. Although this is not a forecast of future market levels, the model has proved a reliable indicator of fundamental equity values historically and hence not to be ignored, and it has led us to increase our liquidity again, to batten down the hatches and to wait.

THOSE SIX IMPOSSIBLE THINGS

Ian's 2006 Managing Director's Report asked how long Western governments could continue with economic policies that, while apparently producing ever greater levels of GDP, required both government and consumers to borrow ever-greater amounts of money to forestall economic collapse. He ended it by declaring that we were living in a financial world as surreal as Lewis Carroll's *'Alice's Adventures in Wonderland'* and *'Through the Looking Glass.'*

'"I can't believe THAT!" Alice told the White Queen . . . "Can't you?" the Queen said in a pitying tone. "Try again: draw a long breath, and shut your eyes." Alice laughed. "There's no use trying," she said. "One CAN'T believe impossible things." "I dare say you haven't had much practice," said the Queen. "When I was your age, I always did it for half-an-hour a day. Why, sometimes I've believed as many as six impossible things before breakfast."

Ian then listed what the White Queen's (highly inter-related) 'six impossible things' would have to include in the next year or so. Here they are, just as he formulated them in May 2006, with, in each case, a progress report.

FIRST IMPOSSIBLE THING. *Foreign investors will continue to fund the US current account deficit of over $800 billion per annum, and won't withdraw their funds.*

PROGRESS REPORT. Despite a deficit now of over $850 billion, foreign investors continue to fund the shortfall.

SECOND IMPOSSIBLE THING. *The Dollar won't collapse and inflation won't escalate.*

PROGRESS REPORT. The Dollar fell against the pound from 1.818 to 1.960 (7%) but didn't collapse; however, US core inflation rose from 2.2% to 2.7%.

THIRD IMPOSSIBLE THING. *The oil price doesn't really affect the economy (and anyway, by focusing on 'core' inflation, the Federal Reserve ignores it!), Iran will accept US 'nuclear logic' and the oil price will fall.*

PROGRESS REPORT. The average price of Brent crude fell from $71 to $64. As for Iran and 'nuclear logic', we now anxiously await news of our British sailors and marines held prisoner there. May they be freed safely and soon!

FOURTH IMPOSSIBLE THING. *The US government won't be forced to cut back the Federal deficit.*

PROGRESS REPORT. The US government still ignores it, although it has declined somewhat thanks to a rise in tax receipts from what, we believe, is an unsustainable level of US corporate profits.

FIFTH IMPOSSIBLE THING. *The US housing market won't collapse and US consumers will go on borrowing to spend.*

PROGRESS REPORT. Perhaps the housing market is already in the process of collapse, given the fall of 9.3% in the median house price since April last year and the traumas still to be played out from sub-prime mortgage lending.

SIXTH IMPOSSIBLE THING. *The extraordinarily low real rates of return ("RRRs") on financial assets won't revert to mean.*

PROGRESS REPORT. They haven't, yet!

ROBIN ANGUS

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[6] Ian has used this equity valuation model for over 15 years, refining it on various occasions in the light of experience, to help make 'macro' investment decisions. Having first described his thinking in the 1992 Annual Report, he wrote in the 1996 Annual Report, *'For many years I have wanted to create an explicit valuation framework for UK equities, fixed interest and index-liked gilts, so that I could make investment judgements among them at any given time.'*

[7] A prime example of this was the calculation of yields on the FT indices following the removal of the ACT tax credit, a problem which took the *Financial Times* and the Institute of Actuaries quite some time to resolve. During the waiting period, equity valuation models relying (like ours) on yield statistics were gravely hampered.

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Steven Budge
Personal Assets Trust PLC
10 St Colme Street
Edinburgh EH3 6AA

Tel: 0131–225 9995
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PORTFOLIO (000's)	28-Feb-07
RBS Group	£14,458
Royal Dutch Shell 'B'	£12,847
BP	£12,516
HBOS	£11,891
GlaxoSmithKline	£9,295
Barclays Bank	£8,874
BT Group	£7,683
Scottish & Newcastle	£4,309
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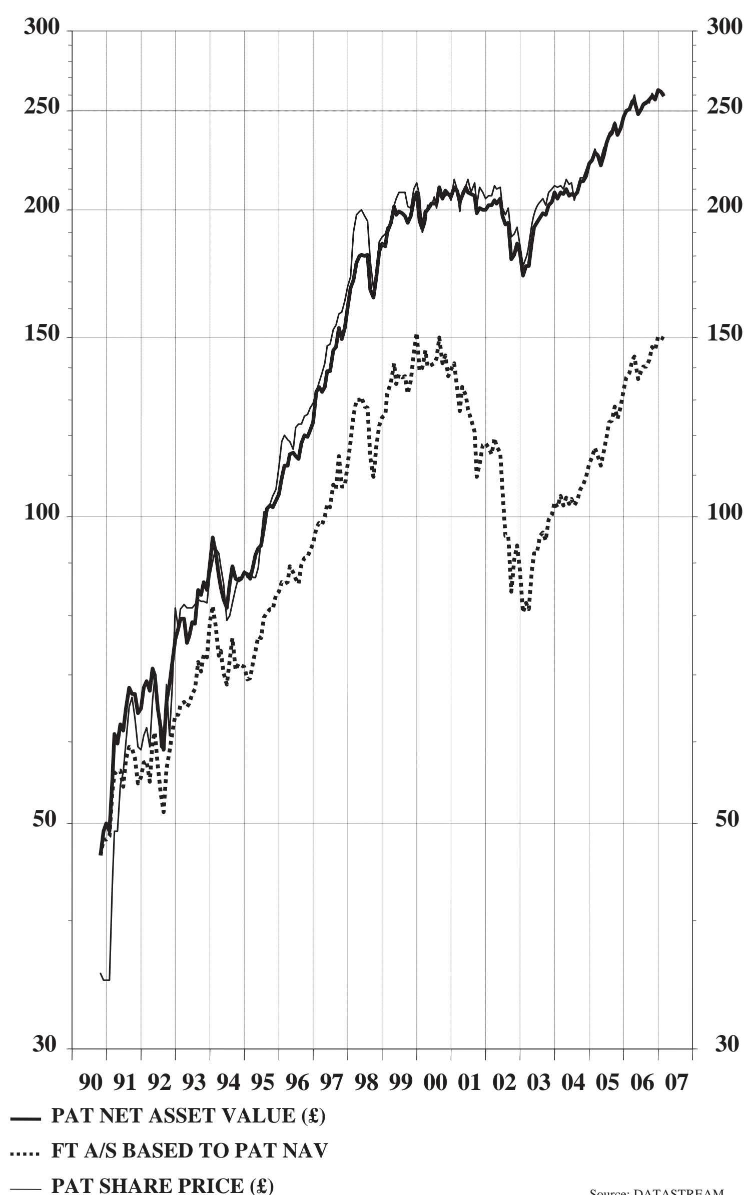
Top Ten Equities	**£86,625**
Other Equities	**£12,813**
Effective Liquidity	**£90,742**
Shareholders' Funds	**£190,180**

Personal Assets Trust Performance



% Changes from	31-Oct-90	28-Feb-02	28-Feb-04	28-Feb-06	28-Feb-07
Period	16 Yrs 4m	5 Years	3 Years	1 Year	Values
Share price	633.8%	26.2%	23.3%	3.6%	£260.50
NAV per share	458.1%	28.1%	24.4%	3.0%	£259.14
FTSE All-Share	222.2%	29.6%	42.6%	8.2%	3,198.28
NAV relative to FTSE A/S	73.2%	-1.2%	-12.7%	-4.8%	