PERSONAL ASSETS TRUST PLC

SEPTEMBER 2007 QUARTERLY REPORT No. 46

OUR LIQUIDITY REACHES 80%

The trouble with these markets is that anything I write today may by tomorrow read like the *Chicago Tribune* headline when Harry S Truman beat Thomas E Dewey in the 1948 US Presidential election: *'Dewey defeats Truman'*.

That was how I felt on 17 August, when the Fed cut its primary discount rate by ½%. Following the Fed's announcement, the plunging UK and US stockmarkets smartly turned and rose. But we did not share their optimism. So, having already raised our liquidity to 60% on 3 July following the Board *'AwayDay'* (of which, more later) and having also sold some of our holdings in banks at prices well above those now ruling, we upped our liquidity to 70% that afternoon. As Ian phrased it:

'Following today's endorsement by the Fed of a systemic threat to the financial system, we increased our liquidity from 62.5% to 70% with a further sale of FTSE 100 futures.'

Then on 4 September, after the separate statements from President Bush and Ben Bernanke about the sub-prime mortgage crisis *(see later)*, we raised our liquidity even further, to its current 80%.

INTERESTING TIMES

August was exciting. At first the market weakness was reminiscent of last summer's tumble, when the FTSE 100 reached 6,106 on 9 May but then fell as low as 5,507 on 14 June (a 10% correction of the type so often forecast by market analysts). This time, however, the movements have been bigger. The FTSE 100's highest 2007 level was 6,732 on 15 June, less than 200 points below its all-time high of 6,930 on 30 December 1999; but on 16 August it fell to 5,859, or 13.0% below its year's high. So we started to wonder — ***COULD THIS BE IT AT LAST?***

The rollercoaster continued. On 20 August, in an amazing scramble into government paper at almost any price, the yield on the one month US Treasury Bill fell 1.6 percentage points to 1.34%, while the yield on three month T-Bills fell 1.2 percentage points to 2.51%, a sharper fall even than during the October 1987 crash.

Yet within a day or so all was calm. Then we saw Sentinel, the money market managers, accused of fraud by the SEC; KKR Financial trying to raise $500 million in an emergency rights issue while its executives agreed to find $100 million themselves if it failed; the government of Saxony selling the state bank, Sachsen LB, which may have accumulated $80 billion of risky assets through a set of Irish funds kept off balance sheet *(you couldn't make it up)*; HBOS intervening to fund Grampian, its $37 billion conduit; and Barclays drawing on the Bank of England's emergency lending fund for two weeks running. Bad news has kept on breaking, yet equity markets have remained almost perky.

OUR 2007 AGM

Talk of when a crunch might come dominated the AGM on 19 July, which saw the usual good attendance and lively discussion following Ian's presentation.[1] As in 2006, the Quarterly is accompanied by a copy of Ian's AGM speech, which is the starting point for the analysis and comment that come later. First, however, I have some other matters to report on and *(unusually, but not without precedent)* a question to ask you.

[1] In contrast to last year, no-one suggested we should buy hedge funds or private equity funds. Again unlike last year, no-one tried to persuade us to buy MAN Group. It's unlikely we would have been tempted if someone had, given its recent price fall of 30% from its year's high and the pulling of its planned float of a hedge fund on the NYSE in September.

SET IN STONE?

Nobody has ever called Personal Assets a high turnover fund, but sometimes we get told that our portfolio seems to have been set in stone over the last few years. Not so. We constantly re-assess the position, and as part of the process we had a Board *'AwayDay'* (to use the trendy expression) at the start of July. It was a productive meeting — and not just because it was interrupted by a 'phone call to announce the arrival of a new grandson for the Chairman.

One discussion topic was our overseas investments. Why do we hold them at all, given that our exposure is so small in percentage terms (only 4.3% of our equity portfolio and 2.3% of shareholders' funds at our 30 April 2007 year end)? Well, during much of the 1990s we had between 25% and 30% of our funds overseas and there is no reason why we should not do so again. Apart from their own merits, our overseas stocks serve as a kind of *'aide-memoire'* for this.

We addressed, too, our use of other investment trusts. Why do we sometimes hold general trusts which offer us no apparent extra portfolio diversification? The answer is that they were bought as another way of getting exposure to equity markets — like holding direct equities or using futures, but at a discount we believed would narrow. Examples are Scottish Investment, British Assets and Foreign & Colonial (all sold at a good profit) and our current holding in Alliance Trust. We also hold trusts to exploit opportunities in geographical or industrial areas we don't have the expertise to invest in directly. Examples here have been TR Property and City Natural Resources. We'll continue to use trusts in this way as opportunities arise.

QUARTERLY DIVIDENDS?

In recent years we've been paying particular attention to Personal Assets' dividend policy. Over the last three years our dividend has risen by 32%, a compound annual rate of nearly 10% compared to the RPI's 3.4%. Should we be like some other trusts and pay dividends quarterly rather than half yearly? In favour of this might be your cash flow, and people more usually budget quarterly than half yearly. Against it would be greater expense and more paperwork.

In Quarterly N$^{o.}$ 4 in May 1995 I asked shareholders for their views as to whether Personal Assets should have a warrants issue. The answer was **NO**. This time I ask:

'Should Personal Assets pay quarterly dividends?'

Answers, please, on a sheet of paper to the usual address![2]

TURMOIL IN THE MARKETS

Now back to the markets. I got worried when I spotted three early straws in the wind. First, BNP Paribas suspended three of its hedge funds for a period because it couldn't accurately price *(or perhaps it could, but rejected the answer!)* the funds' assets, let alone sell them, because of:

'The complete evaporation of liquidity in certain market segments of the US securitisation market.'

When used along with 'liquidity', 'evaporation' is a scary word. No-one knows what many of these securitised financial instruments are worth. They are traded privately between banks, not on any public market. They can't be valued accurately and they can't be sold.[3]

Second, in the *Financial Times* for 10 August Lex wrote:

'More esoteric assets, however — say a pool of 3,000 subprime mortgages in Iowa — are often priced by the fund manager itself.'

Third, in the *Financial Times* for 12 August James Simons of Renaissance Technologies suggested that problems at other, similar funds could be in part responsible for Renaissance's troubles.

'Given the undoubted partial overlap of our positions, their liquidations have had a negative impact on the institutional equities fund.'

The pricing of illiquid assets by the fund manager recalls the split capital trust trauma. So do cross-holdings and funds investing in the same assets. **BUT** the problem is much, much bigger than that.

THE NATURE OF THE CRISIS

Ben Bernanke, the new Chairman of the Fed, faces his baptism of fire as he tries to avoid a recession led by falling house prices while avoiding bailing out institutions heavily exposed to high risk investments.[4] Central bankers have so far avoided panic by pumping in short-term liquidity, the Fed and the ECB between them providing some $400 billion to credit markets in the last month. The Fed has gone further, lowering its discount rate by ½%. Bernanke has hinted that the Fed rate itself may be cut, saying that the Fed would *'act as needed'* to limit the *'adverse effects that may arise from the disruption in markets'*. But cutting the Fed rate would only sow the seeds of a new crisis.

Let's be clear. What sort of crisis faces world central bankers today?

- A ***temporary credit crunch*** (i.e. a lack of short-term funding thanks to lenders' doubts about borrowers' creditworthiness)?
- A ***liquidity problem*** (with investors being unable to sell assets to meet margin calls)? ***or***
- A ***solvency crisis*** (if assets have to be sold to meet debts, investors would be bankrupt)?

We believe that, as far as many financial vehicles are concerned, it is a ***solvency crisis***. According to Axel Weber, the President of the Bundesbank, the only difference between a classic banking crisis and the current turmoil is that the institutions most affected are not regulated banks but conduits and structured investment vehicles ("SIVs" or "SIV-lites"). But while a classic run on banks can be resolved when banks are basically sound, many SIVs are in fact insolvent (*'leaky SIVs'?*) and sponsoring banks are now being forced to assume direct funding requirements on to their balance sheets.

They brought this on themselves. As in the split trust *débâcle*, investment banks enticed investors to invest in high yield products and created the products for them to invest in. Investment banks drove the hedge fund industry, acting as prime brokers and even carrying out the marketing. They created the entire conduit, SIV and SIV-lite sector so as to generate fees through off-balance sheet lending; and, joy of joys, the system developed the derivatives market and such exotica as CDOs.

The investment banks which securitised these loans, sliced them up into CDOs with inappropriately high credit ratings and sold them to investors in search of high yield probably had no idea of the risks they were taking; but given the toxic nature of the securities sold to the innocents (if institutions can be so described!) the investment banks will find that their liabilities and duties didn't end with the sale of their services and products.[5]

REMEMBER THE S&LS?

The Savings & Loans ("S&Ls") crisis arose in the early 1980s, lasted for a decade and was described by J K Galbraith as *'the largest and costliest venture in public misfeasance, malfeasance and larceny of all time'*. It cost the US government as much as $125 billion to bail them out, and that's in the dollars of 20 years ago.

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[2] If your wish for income is more pressing than our present dividend policy allows, there is the ***Cash Income Option*** within the Personal Assets Investment Plan. This was described in Quarterly No. 34 (copies are still available) and details of how to invest in it, or transfer shares into it, can be requested from Steven Budge at the address and telephone number shown on the back page.

[3] I can't resist pointing out that because of its buyback powers and its 'no discount' policy Personal Assets offers the nearest thing to perfect liquidity in the investment trust market.

[4] So far, he hasn't shown much insight. He claimed that the damage caused by sub prime mortgages was *'contained'* before the credit collapse in money markets, and in 2005 that housing prices *'largely reflect strong economic fundamentals'* and that America had *'never had a decline in housing prices on a nationwide basis'*, implying that it never would.

[5] Central banks exercise considerable authority over banks under their jurisdiction and it is not sufficient for any bank to plead contractual terms with other parties when things go wrong. E.g. it is obvious that Barclays didn't willingly act as lender of last resort to Cairn High Grade Funding I, a SIV-lite vehicle it created for Cairn Capital. Barclays will have been told in no uncertain terms by the Bank of England that it would be required to provide support. So it duly provided $1.4bn through a long term credit facility, replacing the vehicle's commercial paper funding.

The S&Ls made 30-year fixed rate loans and had a ceiling on the rates they could offer savers. So when in 1981 Paul Volcker, the Fed Chairman, doubled the Fed rate to 18% to kill inflation, S&L depositors fled to high-interest money market funds and S&Ls had to borrow short-term money commercially at a higher cost than the return on their loan portfolio, destroying profitability. But rising interest rates also meant the loans in their portfolios were worth well below their face value, so their net worth was eroding too. Congress passed a Bill letting them sell on their mortgage loans and amortise their losses over the loans' life — in effect, fraudulent accounting bailed out only by the future fall in interest rates — and use the proceeds to seek better returns; but because they had to make margins big enough to cover the cost of borrowing funds in the commercial market, they made riskier loans and suffered many customer defaults. 1,043 insolvent and over-extended S&Ls holding assets of $519 billion were closed by government agencies.

THE CONSEQUENCES FOR TODAY

The aftermath of the S&L crisis left the US mortgage market grossly under-regulated. Lenders who thrust billions at Americans with poor credit ratings should have been stopped much earlier. But the problem isn't just lax regulation. Monetary policy is too loose; and the solution to too much credit is **NOT** more credit. When central banks increased liquidity to solve short-term problems they previously withdrew it when the problem was solved. But over the last decade this has not happened. Ever more liquidity has been pumped into the system. The ***'Greenspan put'*** encouraged investment banks to pursue high-risk strategies because they knew the Fed would bail them out. This increased potential instability and is doubtless also why the futures markets have priced in a ¾% cut in the Fed rate by the year end.

BERNANKE'S CATCH-22

One has to feel for Bernanke — he has to deal with the mess left by Greenspan. While the Fed did tighten money between 2004 and 2006 by a series of ¼% rate rises from 1% to 5¼%, the effects were foiled by creative Wall Street financing. Aggressive lenders offset this tightening by 'teaser rates' for house buyers who couldn't afford the inevitable higher reset rates. *But the sudden collapse of credit availability means that the whole of the Fed's 2004-6 tightening is taking effect now*, coupled to an increase in credit spreads.

Bernanke's decision day is 18 September, when the committee to set the Fed rate next meets. He is in a Catch-22 situation — a paradox, described in Joseph Heller's famous novel, whereby one is a victim regardless of the choice one makes. Yossarian, a US bombardier in World War II, recognising the increasingly suicidal nature of the missions he has to fly, seeks to be grounded. However, the only basis for a pilot's being grounded is if he is insane; and a pilot seeking to be grounded is obviously sane and so must fly.[6]

Consider Bernanke's dilemma. He would be crazy to cut the Fed rate and sane if he didn't — ***but if he's sane he has to cut the Fed rate!*** Being sane, he wants to avoid replacing the ***'Greenspan put'*** with a ***'Bernanke put'***, as would happen if he cut the rate. But to avoid major upheaval (which is a ***sane*** aim) he must cut the rate to fulfil the unanimous expectations of financial markets (which would be ***insane***, because it would both increase moral hazard and be a step towards renewed inflation, which all sane people should dread).[7]

Will President Bush's 31 August statement enable Bernanke to *'flee forward'* from cutting the rate? Bush wants government to work with lenders, insurers and others to develop more favourable loan products for borrowers, and will let the Federal Housing Administration ("FHA"), which insures mortgages for low and middle income borrowers, guarantee loans for delinquent borrowers, allowing them to avoid foreclosure and refinance at more favourable rates. Perhaps Bush's involvement reveals the truth: ***the problem is too big for the Fed to handle and the US government has to underwrite it, as it did the S&L crisis.***

SOMETHING'S GOT TO GIVE

Vast sums will have to be withdrawn from vehicles created by-intermediaries that have borrowed short and lent long. Among these are the hedge funds, often using huge amounts of leverage; and in this respect conduits, SIVs and SIV-lites are particularly scary (SIV-lites can be leveraged up to a horrifying 70 times). Leverage is provided to hedge funds by their prime brokers, who in turn borrow money in the open market. Hedge funds' assets, however, have suffered considerable falls and leverage has geared up the decline. Previously, prime broker margin requirements have been remarkably low (typically 10%). Unsurprisingly, these have now been raised considerably. In addition, required margin calls will have increased significantly owing to the falls in hedge fund assets.

At the same time, hedge fund investors will have been increasing their level of redemptions. All of this means that hedge funds will have to sell large amounts of investments (often far from liquid) into falling markets. And as if this were not enough, appreciation of the Yen makes the Yen carry trade increasingly costly to borrowers. If the hedge funds face heavy redemptions in September the Yen will strengthen, causing further downward pressure on assets.

Our going 80% liquid shows just how seriously we view a situation in which $2 trillion of sub-prime US loans may, through the labyrinthine and untraceable workings of creative investment banking, still be poisoning the world's credit markets. We cannot lose what we hold in cash; and we will not hesitate to go even more liquid if things look like getting worse.

ROBIN ANGUS

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[6] Yossarian's answer is, in the Prussian expression, *'die Flucht nach vorne antreten'*, or *'to take flight, or flee, forward'*, decisively freeing oneself from a situation from which one can't otherwise withdraw. He does this by deserting and fleeing to Sweden.

[7] Here, 'moral hazard' means that if the central bank or the government bails out lending institutions when they get into trouble, the lenders may come to believe that they can take on high and profitable risks without having to bear the losses if things turn sour. As for inflation, most people love inflation and would welcome it. All their problems get inflated away.

PERSONAL ASSETS TRUST 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***.

Full details of how to invest in the shares of Personal Assets can be obtained from:

Steven Budge
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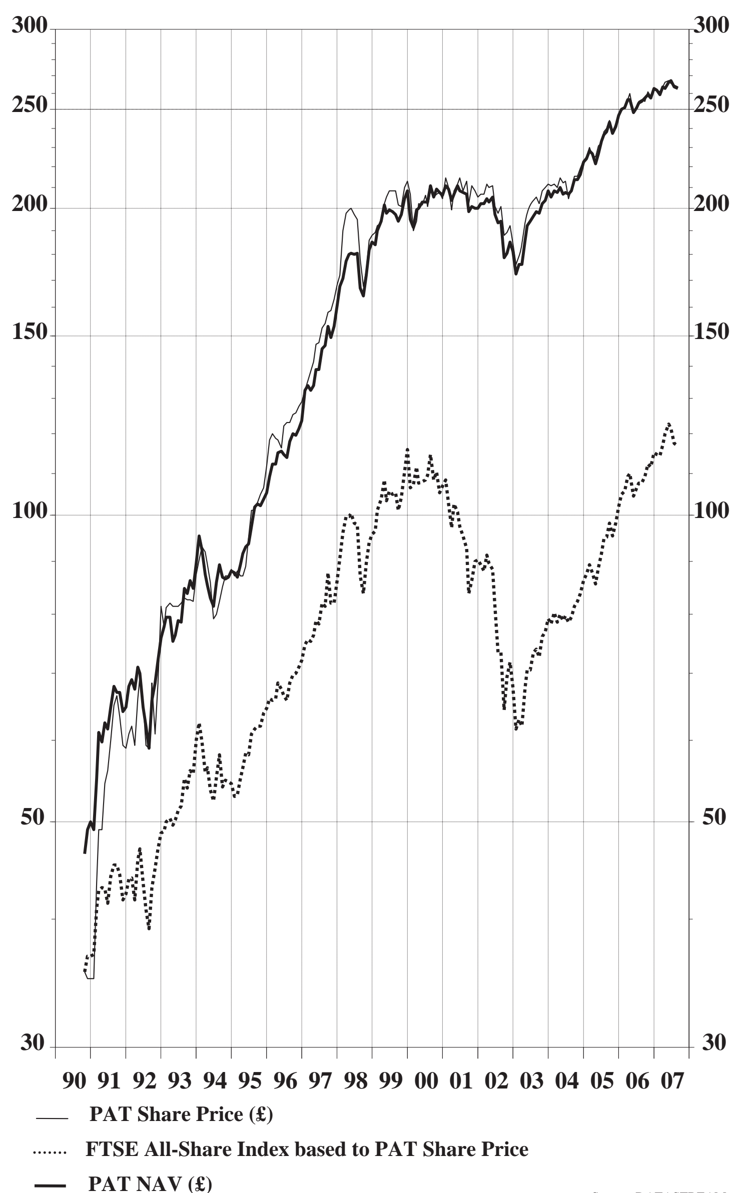
Tel: 0131–225 9995
E-mail: steven@personalassetstrust.com

PORTFOLIO (000's)	**31-Aug-07**
Royal Dutch Shell 'B'	£15,085
BP	£13,380
HBOS	£9,669
RBS Group	£8,725
GlaxoSmithKline	£8,411
BT Group	£8,203
Scottish & Newcastle	£5,072
Barclays Bank	£4,873
Alliance Trust	£4,592
Rentokil Initial	£1,732
Top Ten Equities	**£79,742**
Other Equities	**£12,317**
Effective Liquidity	**£97,556**
Shareholders' Funds	**£189,615**

PERSONAL ASSETS TRUST PERFORMANCE



% Changes from	31-Oct-90	31-Aug-02	31-Aug-04	31-Aug-06	31-Aug-07
Period	16 Yrs 10m	5 Years	3 Years	1 Year	Values
Share price	640.8%	30.8%	26.0%	2.8%	£263.00
NAV per share	464.9%	34.9%	25.8%	2.9%	£262.32
FTSE All-Share (FTSE)	228.5%	59.3%	47.3%	8.4%	3,260.48
NAV relative to FTSE	72.0%	-15.4%	-14.6%	-5.1%	