PERSONAL ASSETS TRUST PLC

NOVEMBER 2007 QUARTERLY REPORT No. 47

NEW-LOOK INTERIM REPORT

As usual, the November Quarterly accompanies Personal Assets' Interim Report. You will notice that this is rather different in format and content from previous Interim Reports. The reason is that it now has to conform with International Accounting Standards ("IAS") 34, 'Interim Financial Reporting', as adopted by the EU, and the Disclosure and Transparency Rules.[1]

'NO' TO QUARTERLY DIVIDENDS

Before getting on to the main business of this Quarterly, there's another housekeeping matter to mention. In the last Quarterly I asked if Personal Assets should follow the example of some other trusts and pay quarterly dividends. The response from shareholders proved overwhelmingly negative and there were even suggestions that Personal Assets should revert to paying only one annual dividend, as was our practice until 1991. For the time being, therefore, our pattern of paying two dividends a year will continue.

PAT GOES 100% LIQUID

On 18 September, following Alan Greenspan's reported claim that US house price percentage declines would probably be in double digits — almost guaranteeing a US recession — and in the conviction that huge worldwide sales of assets would sooner or later have to occur in order to repay debt and de-leverage the global financial system, we announced that we had gone 100% liquid.

Such a liquidity decision is virtually unprecedented for a mainstream UK investment trust, and it indicates the gravity with which we view the current situation. So — how big do we see the problem as being? Let's go back to July, when Charles 'Chuck' Prince, then still the Chairman and CEO of Citigroup, uttered these astonishing words in an interview with the *Financial Times*:

'When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing.'

Not any more, they're not. The party was over even by July, when Chuck Prince was still enthusiastically shaking his booty.[2] The scale of the inevitable hangover, however, was still not apparent to all. Ben Bernanke, Chairman of the Fed, forecast in July that subprime-related losses would be between $50 billion and $100 billion. Even then, according to Jan Hatzius, Chief US Economist at Goldman Sachs, Bernanke's numbers seemed quite optimistic. Now, Hatzius believes, *'it is clear to most observers that they are far too low'* and his early November back-of-the-envelope calculation of US home foreclosure related losses was as high as $400 billion for financial companies. Such a shock, he argues, could force the US banking system to cut lending by $2 trillion (equal to 15% of US GDP), causing a major recession.

'YOU AIN'T HEARD NOTHIN' YET'

These numbers sound bad enough, but they may prove to be only a fraction of the eventual total. Here Donald Rumsfeld's words, regarded as *naïf* at the time, are in fact both perceptive and profound:

'There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. There are things we don't know we don't know.'

This is alarmingly true; and to quote Al Jolson:

'You ain't heard nothin' yet . . . '

We first pointed to the huge scale of US mortgage issuance in February 2006, in Quarterly N°. 40. It was not then clear to us how much of this lending was subprime, but now we know the worst. Statistics from the Joint Economic Council of Congress for the six years from 2001 to 2006 inclusive show that subprime issuance, which in 2001-03 averaged 8.4% of total mortgages, averaged 19.5% of the total over 2004-06. Gross subprime issuance during the six year period was $2.5 trillion, which might net down to perhaps $1.5 trillion after refinancings, to which we can add, say, another $0.5 trillion of Alt-A mortgage loans (i.e. those which are not fully documented, or are self-certified by borrowers).

MARKET — OR MAKE-BELIEVE?

How much is this $2 trillion of subprime mortgages worth? Until now, it has been valued by the lenders on the basis cruelly described by Bob Janjuah (Global Head of Credit Strategy, Royal Bank of Scotland) as *'mark-to-make-believe'*. With effect from November 2007, however, there has been a significant change in US accounting regulations. The new 'fair value' requirements, known as FAS 157 (introduced only after stiff resistance — remarkably, the Financial Accounting Standards Board was forced to meet the day before it was to be implemented and then only approved the new regulation by a 4 to 3 vote), affects the Level 3 tier of assets[3] currently valued by the

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[1] Whether the result is any more transparent than it was before, or whether Hutber's Law comes into operation instead (*'Improvement means deterioration'*), I leave to you to decide.

[2] Ian has asked me to explain that this is a modern expression for dancing, and does not refer to Mr Prince's payoff from Citigroup, estimated by some to have been almost $100 million.

[3] Level 1 assets are those quoted in active markets, such as mainstream equities, Level 2 contains less-traded securities, which are valued by using prices for similar assets elsewhere.

banks themselves according to in-house models. Banks such as Citigroup, Goldman Sachs and Morgan Stanley will no longer be able to value subprime mortgages and other exotic debt on the basis of 'assumptions'. Instead, companies with fiscal years beginning after November 15 2007 must value assets such as these by reference to market values, which will usually be far lower.

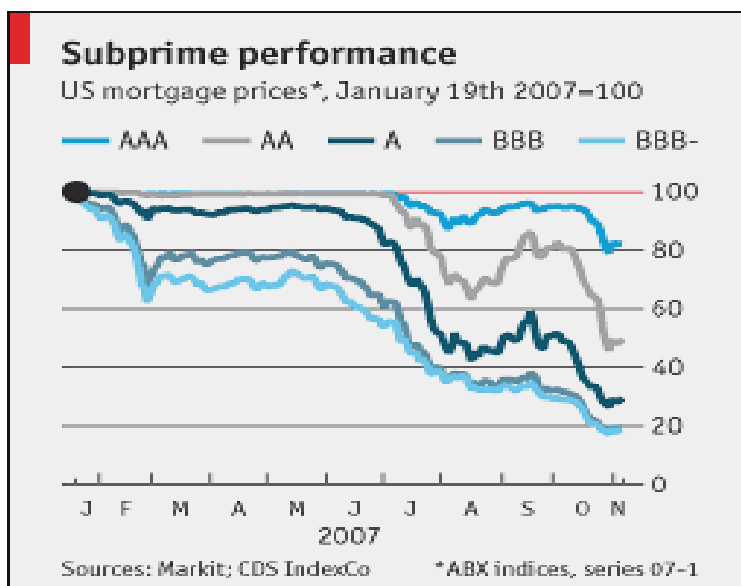
ABX-HE Subprime Indices

So what are the market prices and derivative reference values that might be used for valuing this notional $2 trillion worth of subprime mortgage instruments? The ABX-HE Subprime Mortgage Indices produced by Markit Group (a private company backed by 16 shareholding banks) enable reasonably accurate market valuations for US subprime mortgages and thus for the implied write-offs facing the world's financial system. The ABX indices, which are part of the synthetic asset-backed securities (ABS) market, are based on the subprime home equity sector. They are a family of five sub-indices, each consisting of a basket of 20 credit default swaps *(don't ask!)* which are equally weighted at the time of the index launch. The minimum deal size is $500 million, and each tranche included must have an average life of between four and six years except for the AAA tranche, which must have a weighted average life greater than five years. To quote Ben Logan, director in product development at Markit:

> *"The portfolio for ABX.HE is developed through an independent rules-based algorithm that seeks to identify a universe of deals that is both liquid and representative of the market as a whole."*

Performance Horror Story

The recent performance of the ABX-HE Subprime Mortgages Indices is dire *(see chart)*. The average fall in value of subprime mortgages, if marked to market per the ABX-HE Indices, amounts to over 50% — a loss in value of some $1 trillion. This dwarfs Bernanke's $50 billion to $100 billion, his revised 8 November estimate of $150 billion and Goldman Sachs's $400 billion.



The top six banks alone have $365 billion of assets in Level 3. Although Level 3 assets are thinly traded, the ABX indices referred to above give a rough guide to their market value, and from the chart we can see that BBB grades of subprime debt are down to 20 cents on the dollar, AA grades are around 50 cents and even AAA grades are only worth 80 cents.

Much of the entire $3 trillion global market for collateralised debt obligations ("CDOs") is under strain. Merrill Lynch has declared a 30% writedown on its holding of CDOs. Few of the banks have admitted to losses on anything like the scale suggested by market prices; UBS, for instance, is still valuing its US mortgage debt at 90 cents on the dollar. But nasty things could be lurking down in Level 3. According to the *Daily Telegraph* for 12 November, Citigroup has $128 billion of assets in this category, or 205% of its tangible equity before its recent transfusion of $7.5 billion of new capital from the Abu Dhabi Investment Authority. The figures for other banks are just as frightening: Morgan Stanley $88 billion (275% of tangible equity); Goldman Sachs $72 billion (212%); and Lehman Brothers $35 billion (194%).

In other words, a 50% writedown of Level 3 assets as indicated by the ABX-HE Indices would in each case wipe out the bank's entire equity.

It is no surprise that the banks are unhappy about the rule change and claim a temporary panic has pushed prices below fair value, no longer reflecting likely default rates. *(If so, why don't they buy more?!)* Goldman Sachs said the rules had compelled the bank to place quality assets in the Level 3 category that are not at risk in any way. Investors, however, are in the mood to believe the worst. What we don't yet know is just how bad the 'worst' may be.

It's Not Just The Banks . . .

Hedge funds hold more than 45% of all CDO assets, according to the IMF. Insurers are also exposed, American International Group, the world's largest insurer, and Swiss Re have both announced sharply lower earnings as a result of subprime losses. Then there is crisis at Fannie Mae and Freddie Mac (see Quarterly N$^{o.}$ 46), both of which buy mortgages from lenders and package them into securities. Fannie Mae lost $1.4 billion in the third quarter of 2007, writing off $800 million in loans and recognising a $2 billion drop in the value of derivative contracts used to hedge financial exposures. Freddie Mac stunned the market with a $2 billion quarterly loss and looks set either to cut its dividend, raise new capital or (very likely) both.[4] Since their

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[4] The risk to Fannie Mae and Freddie Mac is not only from subprime losses. Falling house prices increase the overall mortgage default rate and hence endanger prime mortgage portfolios too.

latest quarter 2007 results were announced, the share prices of both Fannie Mae and Freddie Mac have halved.

Moreover, the probable $1 trillion loss in value on subprime mortgages earlier referred to does not include other subprime lending. The Bank of England Financial Stability Report (October 2007) states that the US and Europe have $3.5 trillion of non-mortgage asset backed securities in issue, including auto loans, consumer loans, credit card debt, student loans, etc.

These *and* large amounts of mortgage backed securities are held by money market funds, of which some $6.4 trillion worth exist. There is now a threat that some of them might 'break the buck' (not repay 100 cents on the dollar) and we are currently witnessing the subprime-related problems of the Florida Local Government Investment Pool, run by the State itself, which has suspended redemptions following a massive run on the fund which reduced it in size by nearly half, from $27 billion to $15 billion.

In all, we estimate that banks, SIVs and hedge funds will eventually have to absorb a loss in value of some $1.5 trillion worth of assets, including non-mortgage backed securities.

THE BANKS' DILEMMA

It is now obvious that the capital base of the world's banking system has been seriously eroded and that capital adequacy ratios are a pressing problem for many banks.

When a bank writes off, say, $1 billion of assets its capital is reduced by $1 billion. That $1 billion will previously have supported at least $10 billion of commercial lending and/or asset investments. Thus to maintain its capital adequacy ratios the bank must *either* increase its capital by $1 billion *or* reduce its lending or investments by $10 billion and repay debt. *(Scale up for your own choice of bank!)* Such a bank has a variety of courses open to it. In order of attractiveness, it can:

- Sell profitable long-term investments previously held at cost (assuming they exist), recording the gains as an increase in capital;
- Sell portfolio investments to pay down borrowings;
- Call in outstanding loans and repay bank borrowings (a strategy fraught with obvious difficulties, both commercial and political);
- Raise new equity (or regulatory) capital (e.g. Citigroup/Abu Dhabi, which was at 11%, far above any rate they could possibly achieve on lending); *or*
- Cut its dividend in order to replenish capital over time (which is potentially suicidal).

THE FED'S DILEMMA

So the banking system is in serious trouble and may not be able to save itself by its own exertions. What can the Fed (in effect, the world's central bank) do about it?

The Fed has two options at its disposal to save the world's banking system. *In extremis*, it could:

- Cut the Fed rate to zero (which was the Bank of Japan's policy from 1992 onwards); *and/or*
- Raise dollar liquidity infinitely by printing money (the policy of the Reichsbank in 1923).

Unfortunately for the Fed's policy, the US economy and the world's banking system, these courses would, if attempted, prove highly counterproductive.

- The dollar would collapse well before either extreme was reached;
- Inflation would surge, inevitably causing a deep economic recession; *and*
- The banking system would still be forced to dispose of investment assets *and/or* reduce current credit facilities to meet capital adequacy requirements.

Given the scale of the problem, the Fed is incapable of resolving it. Nor can Fannie Mae and Freddie Mac do it, as some hoped earlier. Only the US government could do so. However, the bail-out costs to the US taxpayer would be so huge that such a resolution would be politically impossible. Instead, Hank Paulson, the US Treasury Secretary, is pushing a 'teaser freezer' scheme whereby rates on some $400 billion of subprime loans would be frozen for those who might default if the rates rose to a market level. This is akin to the Bank of Japan's 1990s policy in continuing support for loans that should have been written off long before.

ARMAGEDDON?

So, what next? If outstanding debt cannot be funded, then either the SIVs together with a considerable percentage of the hedge fund industry will have to be allowed to fail, *or* the debt will have to be eliminated through high levels of inflation. ***Either outcome could, in our view, cause a collapse of equity markets akin in magnitude to that of 1973/74 (or the Japanese equity disaster post 1989).***

That, then, is what we fear will happen. Who will be to blame? The Fed will be to blame, for having allowed asset bubbles to develop in the belief that when they collapsed, it (the Fed) could always protect the US economy through lowering the Fed rate.

Ian ended his report to the Board at its 22 November meeting:

'We are witnessing the collapse of the 'originate and distribute' debt model of investment banking. The world is awash with a vast amount of debt that should never have been extended and that now cannot be funded by the investment banks and their conduits — the structured investment vehicles and the hedge fund industry. A crisis takes a longer time coming than you think and then it happens much faster than you would have thought.'

Readers of *Private Eye* may recall the post-9/11 cover that showed an adviser whispering to President Bush, *'It's Armageddon, sir,'* and Bush replying, *'Armageddon outahere.'* Well, if going 100% liquid is *'geddon outahere'*, we have reacted like George. And this is even before we take into account the beginnings of a rise in the Yen, which could force yet further enormous debt repayments by the hedge funds if the 'Yen Carry Trade' collapses (see Ian's Managing Director's Report in the 2007 Report & Accounts). All in all, world markets may still have a Merry Christmas. But will they see a Happy New Year?

ROBIN ANGUS

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:

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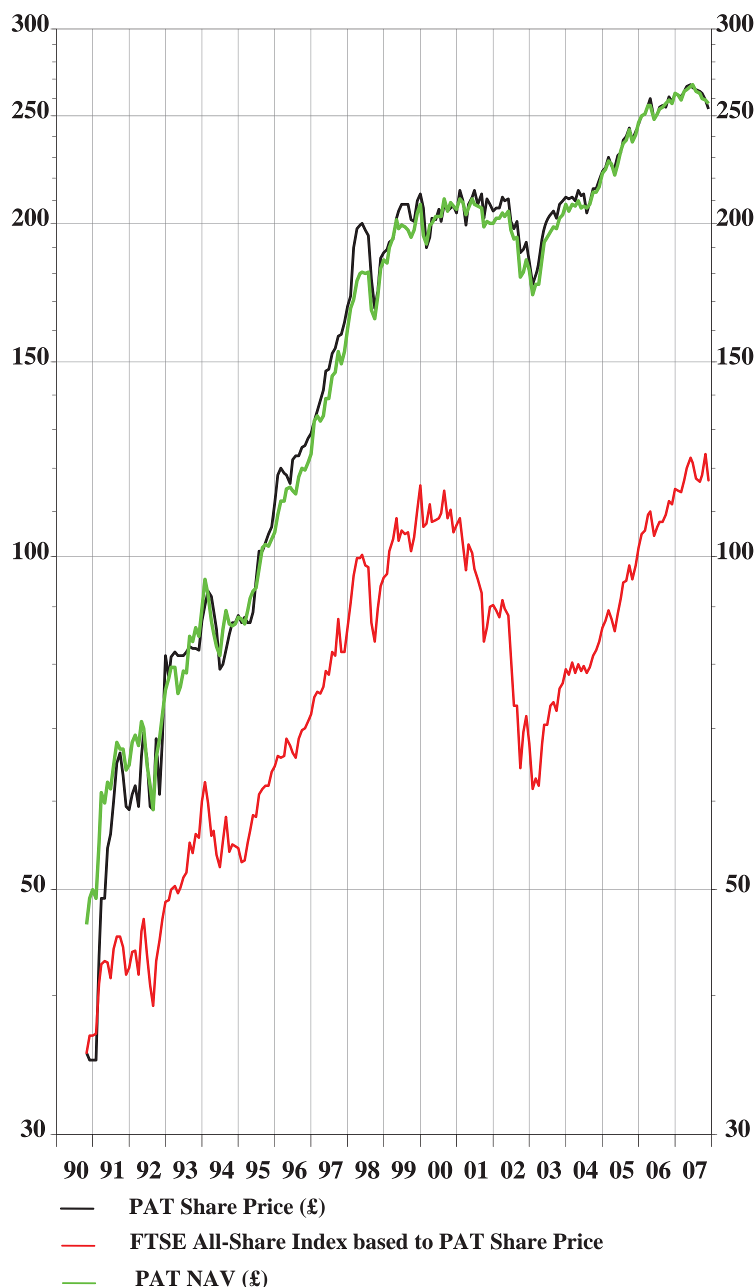
PORTFOLIO (000's)	**30-Nov-07**
Royal Dutch Shell 'B'	£15,226
BP	£14,160
HBOS	£8,778
GlaxoSmithKline	£8,372
BT Group	£7,449
Royal Bank of Scotland	£6,973
Scottish & Newcastle	£6,121
Alliance Trust	£4,680
Barclays	£4,472
F&C Asset Management	£1,513
Top Ten Equities	**£77,744**
Other Equities	**£12,416**
FTSE 100 Future Sold	**-£92,210**
Liquidity	**£186,851**
Shareholders' Funds	**£184,801**

Personal Assets Trust Performance



% Changes from	31-Oct-90	30-Nov-02	30-Nov-04	30-Nov-06	30-Nov-07
Period	17 Yrs 1m	5 Years	3 Years	1 Year	Values
Share price	615.5%	32.3%	16.0%	-1.5%	£254.00
NAV per share	452.6%	38.5%	18.7%	0.1%	£256.61
FTSE All-Share (FTSE)	230.5%	63.8%	39.9%	5.2%	3,280.87
NAV relative to FTSE	67.2%	-15.4%	-15.2%	-4.9%	