PERSONAL ASSETS TRUST PLC

FEBRUARY 2008 QUARTERLY REPORT No. 48

AN EVENTFUL QUARTER

Ian suggested that I begin by telling you about January — in his words, *'a perfect month'* during which our benchmark, the FTSE All-Share, fell by 8.7%, our net asset value gained 0.1% (outperforming our benchmark by 9.6%) and our share price rose by 1.1%.

Well, it's nice when these things happen, and January was also interesting insofar as we actually bought and sold some equities. On 11 January we sold our holding of City Natural Resources, which we had held to get exposure to mining stocks, at twice what we had originally paid for it. Then, having sold a large slice of our holding in Royal Bank of Scotland in July 2007 at 643p, on 21 January we decided it had fallen too far and so we bought 1.5 million shares at 362p. By 1 February the price had, in our view, corrected itself, so we sold them again at 393p.

However, Ian is as dismissive of this kind of commentary as I tend to be of his *'perfect month'*, maintaining that *'in the short term, individual share prices are no more than corks bobbing in the water'*. So it's time to look at the broader picture. Since the last Quarterly, as bad news about sub-prime lending and the state of the UK and US economies has kept coming and markets have got ever edgier, we have stayed bearish of UK and US equities. We had been 100% liquid since 18 September, when Alan Greenspan had set out his gloomy prognosis of US house price declines in double digits (which, if it came true, would almost guarantee a recession). As the UK market slid during January from its end 2007 level of 6,457, however, we decided it was time *(I'd say 'prudent', if it didn't remind me of Calamity Brown!)* to lock in some of our resulting outperformance by reducing our liquidity in stages. On 15 January, when the FTSE 100 had fallen to 6,026, we reduced our liquidity to 90%. On 16 January we cut it to 80% and on 21 January, when the market was at 5,578, to 70%.

Volatile markets, however, mean being prepared to respond to sudden movements. So on 1 February, when the market had recovered to 6,029, we increased our liquidity again to 82%; and on 12 February, after a intra-day 200-point rise in the FTSE 100, we took it back to 100%. At this level it remains.

NIGHTMARE ON WALL STREET

So what is going on? Think of Groucho Marx as Otis B Driftwood in *A Night at the Opera*.

'Signor Lasparri comes from a very famous family. His mother was a well-known bass singer. His father was the first man to stuff spaghetti with bicarbonate of soda, thus causing and curing indigestion at the same time.'

Since 9/11, the Fed has kept on pumping vast amounts of cheap money (or spaghetti) into the economy as a 'cure' for the much-dreaded forthcoming recession. But these continued helpings of spaghetti, far from being a cure, are what created the problem in the first place. The US financial system is now like a bloated hedge fund, the Fed being prepared to lend to the system however much money it demands at ever lower interest rates, irrespective of the damage this will ultimately cause. Signor Lasparri's father would have agreed with Walter Bagehot, famous mid-19th century editor of *The Economist*, on the duty of central banks. This was not to bail out unwise lenders, but to lend unlimited amounts to *bona fide* financial institutions ***at a penal rate***. The Fed is now at serious risk of being in dereliction of its twin charges: to maintain stable prices and sustainable long term employment. It is no surprise that the US Budget of $3.1 trillion projects a near-record deficit of $400 billion (*circa* 3% of GDP).[1]

WALL ST'S GLUTTED VULTURE

At the beginning of 2007, after a rise of 92% from the bottom of the market in March 2003, the FTSE 100 stood at 6,311. By July 2007, however, the sub-prime crisis was becoming apparent and Ian in his speech at the AGM said:

'The catalyst [for a market fall] *won't be a butterfly fluttering its wings over Peking. It'll be a vulture, glutted on sub-prime mortgages, falling from its perch on a skyscraper over Wall St.'*

The financial sector is now crucial to the US market as a whole, and financial errors and malfeasances therefore have the power to harm not just the holders of financial shares, or the banking system as a whole, but the entire US economy. As Martin Wolf pointed out in the *Financial Times* for 6 February, the aggregate profits of US financial companies increased from below 5% of total post-tax corporate profits in 1982 to 41% in 2007. So, when on 5 February the US Institute of Supply Management announced that its index for services sector activity had fallen from 54.4 in December 2007 to 41.9 in January (a reading of 50 or below indicates a contraction), the US market as a whole fell by 3%.

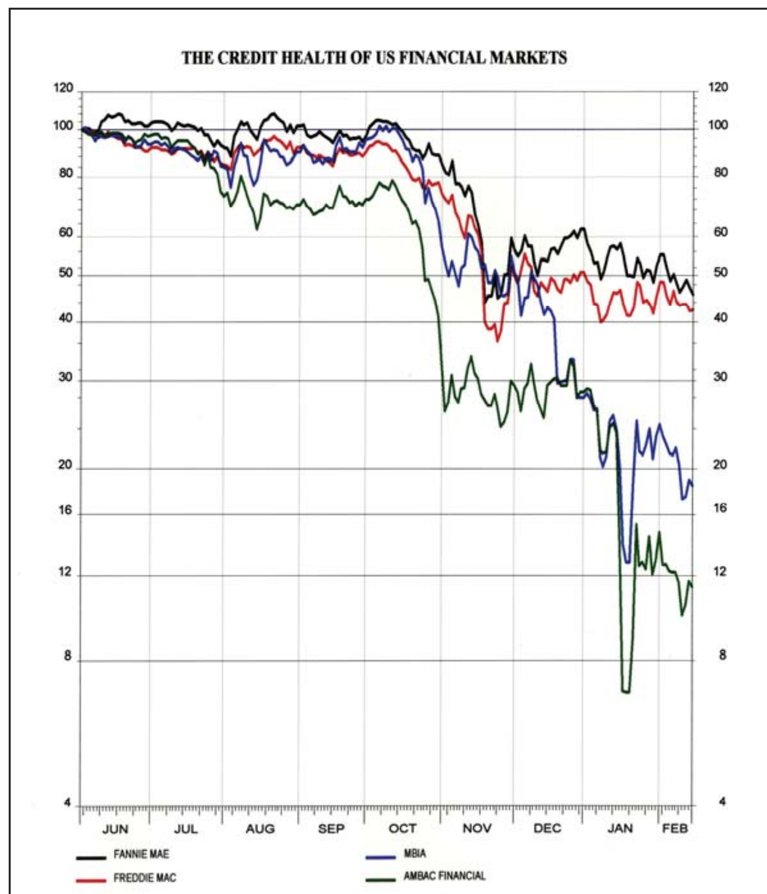
The chart entitled *The Credit Health of US Financial Markets* shows Freddie Mac and Fannie Mae (discussed in Quarterly 47) together with MBIA and AMBAC Financial, two of the major monoline insurers (see below). It seems that every Quarterly I write calls for the description of financial entities, dubious practices and acronyms for financial instruments which, if fully understood, would

---

[1] The UK has a current account deficit of no less than 5.7% of GDP and a percentage budget deficit similar to that of the US.

never have existed. So let me now introduce you to Credit Default Swaps ("CDS") and the Monoline Insurers. CDS are simply derivative contracts which provide insurance against defaults on debt instruments; but if such insurance is extended at very low premia on Collateralised Debt Obligations ("CDO", described in previous Quarterlies) based on subprime mortgages, the losses can be enormous. The CDS market is huge, with a total notional value of $43 trillion *(sic!)* and replete with multiple counterparties of unknown creditworthiness.

The monolines historically operated in a highly profitable financial backwater, guaranteeing a triple-A status for municipal bonds which rarely, if ever, defaulted. Unfortunately, like financial companies worldwide they became greedy and expanded into writing CDS on corporate loans and CDO.



THE SUB-PRIME CRISIS GROWS

In the last Quarterly I described the ABX Home Equity Indices, which enable reasonably accurate market valuations to be made of US subprime mortgages and thus of the implied write-offs facing the world's financial system. The aggregate fall in these indices between January and the end of September 2007 was 30%. By 27 February 2008 there had been a collapse of 66% in the aggregate January 2007 value of all CDO based on subprime mortgages.

We hear continued calls for full disclosure of sub-prime and related credit problems in order to allow markets to recover. However, the more the credit problems are revealed and understood, the worse they seem to become. We all know the story of the girl who looked into Bluebeard's chamber, but this did not stop Peer Steinbrück, the German finance minister, appealing to the financial institutions at the February G7 meeting to provide 'prompt and full disclosure' of losses to restore confidence (!). The G7 (he said) feared that write-offs of losses on securities linked to US subprime mortgages could reach $400 billion, compared to the $130 billion that Wall Street banks and other institutions have revealed in recent weeks and the Fed's estimate of up to $150 billion. However, the G7 finance ministers were unsure where much of these losses would eventually emerge!

WHERE HAS IT ALL GONE?

What about the secretive hedge fund industry? Could it be there? Much of it undoubtedly will be. The hedge funds (in the main sponsored by the major investment houses) were major buyers of sub-prime based CDO, but apart from the two Bear Stern funds which collapsed there has been little disclosure of such losses from hedge funds. This is obviously nonsense and major losses must be being concealed.

Moreover, the poison may have spread elsewhere. The knowledgeable *Telegraph* commentator Ambrose Evans-Pritchard recently suggested that Japan may be the next sub-prime flashpoint and that Japanese banks could be concealing $300 billion of bad debts. Americans and Europeans have so far disclosed only $130 billion of the $400 billion to $500 billion of wealth that G7 has estimated to have vanished. Where is the rest? Somebody, somewhere must be sitting on a vast tangle of undisclosed losses. Japan, however, is introducing strict new audit codes by March, the end of its tax year. Add the generally closer scrutiny by auditors (see later) and we may soon find out how much of the missing sub-prime is in Japan.

There is enough happening in Japan to make us uneasy as it is. The Japanese economy is the world's second biggest and Japan is the world's biggest creditor nation. Its net foreign assets of $3,000 billion roughly match the US government's net debts. And where have the Japanese recycled their annual $¼ trillion trade surplus? Not into US Treasury Bonds, as official data show. Since last October, too, the Japanese economy has nosedived. Machine orders dropped 2.8% in November and a further 3.2% in December. January housing starts fell to the lowest in 40 years, down 18% on the year. Tokyo property was off 22%.

The yen 'carry trade' (borrowing cheap in Tokyo to chase yields

elsewhere) has pumped the global asset boom this decade by $1,000 billion — perhaps the biggest liquidity pump of all. Yet in August it stopped pumping and is now sucking funds back, the yen having risen 16% against the dollar.

WHERE DOES THIS LEAVE US?

Despite 2007's seeing the greatest systemic risk to the financial system for generations, the UK equity market is down only 8%. And UK banks are down 34%; so if we exclude them, the FTSE All-Share is down by under 3.5%. Naïvely, investors seem to believe that the credit crisis will affect only the financial system (i.e. the banks), ignoring how the 'real economy' depends on the financial system for the provision of short, medium and long term financing. The erosion of banking capital and the banks' increased risk aversion will have considerable impact on both the consumer and corporate sectors (affecting consumer spending, employment levels and corporate profits), and hence on all equities.

As Ian told the AGM in 2006:

'We hear interminably from Gordon Brown about his Goldilocks Scenario: outstanding economic growth, stable inflation and the lowest interest rates for a generation — and about how he has abolished 'Boom and Bust'.

Alas! It was always a myth. No government has ever been more fortunate than New Labour was in the legacy it inherited from the Conservatives, or so ungrateful in squandering the nation's resources. Yet the longer the golden legacy lasted, the stronger grew the 'Goldilocks Scenario' myth.

'The story of Goldilocks [Ian continued in 2006] *was that of Goldilocks **and the Three Bears**. Let me introduce you to them, in order of importance: (i) **Rising Interest Rates**, (ii) **Rising Inflation**, and (iii) **Declining Economic Growth**. Over the years many fairy tales, which traditionally carried strong themes on conduct and morality, have been sanitised and lightened for children. The original Goldilocks wasn't simply chased from the house, fleeing to the forest — the Three Bears killed her and ate her.'*

AUDITORS IN THE ASCENDANT

Now to a lost Sherlock Holmes story: *'The Case of the Frightened Auditor'*, or, *'The Case of the Dog that Didn't Bark'*.

'Great Scott, Holmes!' cried Dr Watson. *'How did you know that the Big Issue seller on the corner of Baker Street was a chartered accountant?'*

'Elementary, my dear Watson. You know my methods. His suit was expensive but frayed, his faithful hound was chewing on a faded list of Arthur Andersen partners, and the pseudonym on his seller's badge was "N Ron".'

*'Upon my soul, Holmes! You excel yourself. But what can be the meaning of the sinister coded message that he chalked up on the wall behind him — **"PWC/KPMG/DTT/EY, beware!"** The letters make no sense. Can they refer to our old adversary, Professor Moriarty?' 'I think not, Watson. The letters encrypt the names of the "Big Four" accountants, the partners of which are terrified of becoming as destitute as our Big Issue seller. As for Professor Moriarty, he long ago changed his name to "Greenspan" and became Chairman of the Fed....'*

In 2001, the accounting profession got a wake-up call. Arthur Andersen and many of its partners were ruined by the firm's attempts to help ease Enron through escape hatches in accounting principles when preparing its accounts, leading to an eventual $66 billion collapse in the market value of Enron shares. So the remaining 'Big Four', terrified of the same fate, will now resist any attempts by its clients, regulators, other government agencies or the Fed to 'go easy' this time round in marking to market their clients' exotic investments under FAS 157.[2]

The highly artificial distinction in UK bank accounting (unlike US practice) between loans held in their banking and treasury books enables UK banks to conceal 'mark to market' losses. While investments held in the treasury book (effectively, the bank's trading account) must be marked to market, direct loans made from the banking book can be valued on the bank's own assessment of the borrowers' creditworthiness.

So, how much 'window dressing' are we seeing in UK banks' results? The latest bank results so far (19 February), from Barclays, raise three questions in our minds:

- Barclays reported write-downs of £1.635 billion. However, that included a £658 million gain on the carrying value of the bank's own issued debt — an accounting sleight-of-hand used widely in the financial sector in recent months but quite inappropriate accounting. The issued debt is a real liability that will have to be repaid by the bank unless they actually buy it back in the marketplace.
- We also query Barclays' approach to valuing its £7.37 billion of loans to private equity groups. Although Barclays wrote off fees of £130 million, it took only a £58 million loss on its private equity loan portfolio, well under 1% and much less than most of its rivals, even though many leveraged loans are now changing hands at less than 90% of their face value.[3]
- Given a yield of 7.5% on the shares at the time, surely it was inappropriate to raise the dividend by 10%? It awakes the unhappy memory of how banks used to put up their dividends five years running, only to hit shareholders with a huge discounted rights issue to claw back everything paid (and more) in the previous five years.

Meanwhile, shares in the world's largest insurer, American International Group ("AIG"), fell by more than 11% on 11 February after the company's auditors, PricewaterhouseCoopers, voiced concerns about 'material weakness' in how AIG valued defaults on credit (i.e. losses on CDS it had written).

What was important about AIG's announcement was that it was obviously forced on the company by its auditor.

Many similar announcements can be expected to appear in the near future, thanks to pressure from concerned and diligent accountants; and they will not necessarily wait for year ends to make their wishes known. At long last, we are starting to see the gradual but remorseless re-pricing of dubious, high risk, untraded financial assets to appropriate risk premia.

ROBIN ANGUS

---

[2] A common bank accounting manipulation of yesteryear of switching assets with potentially realisable gains from the banking book to the treasury book and switching impaired assets from the treasury book to the banking book, is now firmly on the radar of bank auditors. Such manipulation will no longer be tolerated.

[3] *Financial Times*, 20 February 2008

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***.

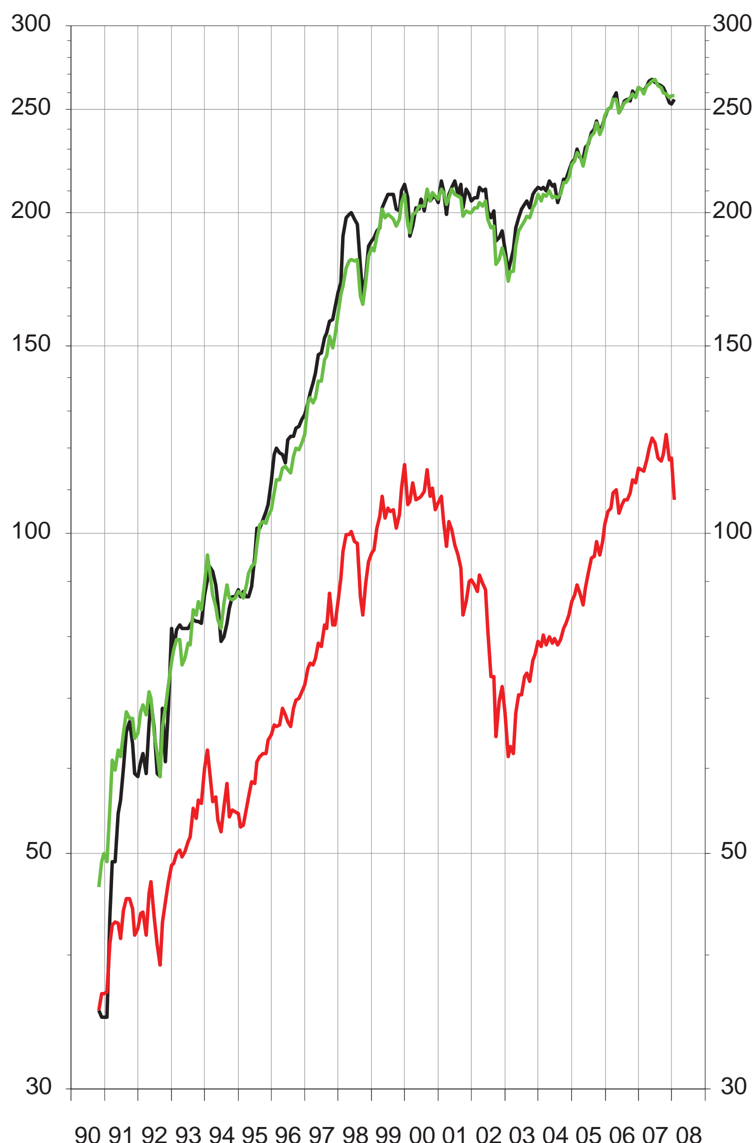
Full details of how to invest in the shares of Personal Assets can be obtained from:

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

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

PORTFOLIO (000's)	**31-Jan-08**
Royal Dutch Shell 'B'	£13,588
BP	£12,768
GlaxoSmithKline	£7,676
HBOS	£7,639
BT Group	£6,734
Scottish & Newcastle	£6,437
Royal Bank of Scotland	£5,730
Alliance Trust	£4,394
Barclays	£3,735
Altria Group (US)	£1,524
Top Ten Equities	**£70,225**
Other Equities held	**£10,114**
FTSE 100 Future sold	**-£30,485**
Liquidity	**£135,246**
Shareholders' Funds	**£185,100**

PERSONAL ASSETS TRUST PERFORMANCE



% Changes from	31-Oct-90	31-Jan-03	31-Jan-05	31-Jan-07	31-Jan-08
Period	17 Yrs 3m	5 Years	3 Years	1 Year	Values
Share price	619.7%	45.0%	13.8%	-2.2%	£255.50
NAV per share	454.8%	49.2%	15.1%	-1.4%	£257.61
FTSE All-Share (FTSE)	202.2%	74.2%	22.9%	-6.6%	3,000.10
NAV relative to FTSE	83.6%	-14.3%	-6.3%	5.6%	