

# PERSONAL ASSETS TRUST PLC

NOVEMBER 2009

QUARTERLY REPORT No. 55

## PAT'S LONDON MEETING

Support for the idea of a London meeting for shareholders has been overwhelming and we have arranged it for 12.30 pm on Wednesday January 20 at the Clothworkers' Hall, Mincing Lane (nearest tubes Bank and Tower Hill). It will take the form of a presentation by Sebastian Lyon, our Investment Adviser, followed by a light buffet lunch. If you have not already done so, you can indicate on our website if you would like to attend.

<http://www.patplc.co.uk/>

My thanks are due also to those shareholders not on the internet who wrote or telephoned to say they hoped to be present.

The *book* of Quarterlies N<sup>os</sup>. 1-50 which we are intending to publish as a memorial to Ian Rushbrook will appear in the spring of next year and will be available free of charge to shareholders on request.

## A DEBATE ABOUT REGULATION

*'Was the recent banking crisis caused by insufficient regulation of financial markets?'*

That was the topic for the 2009 Annual Debate of the Centre for Financial Markets Research at the University of Edinburgh Business School last month and, as a long-standing sceptic about regulation in all its forms, I was delighted to be asked to make the case that the problem had not been insufficient regulation but the very opposite — that there had been *far too much* government interference, not least from central bankers who were in constant terror of alienating the politicians who kept them in their jobs. It will become clear from what I have to say later in this Quarterly about the EU's pro-

posed Alternative Fund Managers Directive ("AIFM") that interference by the authorities, including well-meant but counter-productive regulation, is an ever-present menace not just to our lives in general but to the investment trust sector in particular; so in my speech I was at pains to explode the myth that the banking crisis was caused by governments' benign neglect rather than by their malign meddling. To do so, I first looked back at what happened before and during the crisis and then tried to ascertain whether more regulation could have cured it.

## THE CREDIT CYCLE RULES, OK

Readers of these Quarterlies will not be surprised by my speech's starting point — that the root cause of the banking crisis had been a clash between an irresistible force (*Alan Greenspan*) and an immovable object (*the credit cycle*). According to the Austrian School of economics<sup>1</sup> (for which, as shareholders may know, Sebastian and I have a *tendresse*), credit cycles are the inevitable consequence of the adoption by central banks of policies which cause interest rates to remain too low for too long, resulting in excessive credit creation, speculative bub-

bles and lowered savings. Low interest rates stimulate more and more borrowing from the banking system, which causes an expansion of the money supply leading to a credit-fuelled boom during which the funds created by all this artificially stimulated borrowing seek out ever-diminishing investment opportunities, causing capital resources to be misallocated into areas that would not attract investment at all if the money supply had remained stable.

## THIRTEEN YEARS OF MADNESS

So far, so familiar. That was the banking crisis in a nutshell. **BUT** the process should have been brought to an end long before it actually was, when it became clear even to central bankers that exponential credit creation could not be sustained. Then the money supply should have contracted sharply as the market 'cleared', causing resources to be reallocated to more efficient uses. In May 2002 Ian Rushbrook wrote about how Alan Greenspan had been intent on propping up the equity market and postponing the inevitable reckoning. He concluded:

*'[One] of the strengths of the capitalist system is its ability to rid itself of excess. Dr Greenspan should have trusted capitalism.'*

But he never did. In December 1996 he famously criticised the *'irrational exuberance'* of markets. He was quite right to do so. But what happened then? A series of annual crises turned the former arch libertarian, gold bug and disciple of Ayn Rand into the Great Interventionist. 1997 saw a major Asian currency crash, followed in 1998 by the Russian bond default and the collapse of Long Term Capital Management. By 1999 the world's central banks were getting paranoid about Y2K (*remember it?*), succeeded in 2000 by the dot.com bubble and in 2001 by

<sup>1</sup> A school of economic thought that emphasises the spontaneous organising power of the price mechanism or price system. The Austrian School holds that the complexity of human behaviour makes mathematical modelling of the evolving market extremely difficult and advocates a *laissez faire* approach to the economy, the strict enforcement of voluntary contractual agreements between economic agents and the subjection of commercial transactions to the smallest possible imposition of coercive forces (in particular, the smallest possible amount of government intervention). The Austrian School derives its name from its predominantly Austrian founders, including Ludwig von Mises (quoted in Quarterly N<sup>o</sup>. 40). Its best known representative is probably Friedrich von Hayek. In 1975 Mrs Thatcher, on a visit to the Conservative Research Department, famously interrupted a speech advocating a 'middle way' by holding up a copy of Hayek's *The Constitution of Liberty* (others say it was his *The Road to Serfdom*) and announcing sternly, *'This is what we believe!'*

the attack on the Twin Towers. Dr Greenspan intervened every time. Then, over the 2½ years that followed the Twin Towers, he reduced the Fed rate from 6½% to a crazily irresponsible 1%.

To deny the inconvenient truth that the central bankers were responsible for the banking crisis is like saying that, while producing *pâté de foie gras* may be immoral, the moral fault rests with the geese for allowing themselves to be force fed. The market never got the chance to clear itself. We never suffered the necessary pain. As Ian wrote in July 2006:

*'In a Faustian bargain to avoid the recession he dreaded but knew was inevitable, Dr Greenspan created worldwide a deadly debt mountain the enormity of which will only be revealed over the next three years.'*

Those three years are now up and we can see how right Ian was.

#### SPIKING THE PUNCHBOWL

William McChesney Martin, the Chairman of the Federal Reserve from 1951 to 1970, famously said that the job of a good central banker was to take away the punchbowl just as the party got going. So what did Dr Greenspan do? He spiked the punchbowl with industrial alcohol and poured it down the throats of the drunken partygoers. The Federal Reserve? You'd have thought it was the Bullingdon Club.

And Dr Greenspan knew exactly what he was doing. Everyone now knows about the disaster of sub-prime mortgages, but *as early as September 2005* Dr Greenspan, as Fed Chairman, published a major research paper<sup>2</sup> quantifying what was happening in the US mortgage market. Mortgage refinancing at crazily low rates of interest went hand in hand with the ever lower real rates of return that were available on financial securities, and yet governments consciously

continued to pursue 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.

#### RECESSIONS ARE GOOD FOR YOU

Well, we've seen the bursting of the mother of all bubbles, but the bubble-blowing goes on. '*Quantitative easing*' has been joined by fiscal tinkering such as '*cash for clunkers*', a bizarre circular process which saw the government print money for people to spend on new cars so that General Motors could get cash to start repaying its debt to the government. Any benefits from such tinkering last only while the tinkering continues, but the distortions to the economy remain. The cumulative result of these distortions may be not the bringing back to health of an ailing giant but the creation of a Frankenstein's monster.

Rather than turning the Fed into a gigantic speakeasy over the last decade, Dr Greenspan, Dr Bernanke and the politicians should have followed the excellent advice of Andrew W Mellon, Secretary to the Treasury from 1921 to 1932, and *welcomed* recession:

*'It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people.'*

The plain fact of the matter, however politically incorrect it may be to say so, is that we *need* recessions. It has been cowardly, irresponsible and stupid of central bankers and their political masters to keep on artificially avoiding them. Recessions are good for you — just as hangovers are good for you (*they remind you not to keep on drinking until you damage your health*) and pain is good for you (*it tells you when things are going wrong in your body, so you can do something about it*).

#### REGULATION IS BAD FOR YOU

Now to regulation. I've already said that recessions are good for you. By contrast, although sometimes it can be a necessary evil, regulation is bad for you. It is de-

structive of true morality because it creates an atmosphere in which anything is deemed permissible unless there is a law against it. Instead of cultivating a moral sense, people find themselves adopting a '*within the rules*' or '*find a loophole*' mentality. But as the world's greatest authority on business ethics, St Paul the Apostle, so wisely wrote in his Second Epistle to the Corinthians, Chapter 3, verse 6:

*'The letter killeth, but the spirit giveth life.'*

As St Paul might have predicted, the letter of regulation has all but killed the spirit of financial morality. Of plenty of things recently, both bankers and MPs have been saying, '*It was within the rules.*' It may well have been within the rules. But that didn't stop it being wrong. Once, people would have known this by instinct. Now it seems that they no longer do. It is a tragedy that we now demand thousands of pages of rules and millions of miles of taped conversations, all to replace three little words: *DICTUM MEUM PACTUM — 'My Word Is My Bond'*.

#### PERSONAL RESPONSIBILITY

Two other words have also been forgotten today: *CAVEAT EMPTOR: 'Let the Buyer Beware'*. Remember those people who lost what the media always call '*their life savings*' with Barlow Clowes? Tell them that water could go uphill, or that you had a perpetual motion machine, and they'd have laughed at you. Tell them you could invest in gilts, pay a hefty management fee and still get a yield higher than the gilts themselves, and they chorused, '*Where do we sign?*'

Their equivalent this time were the '*ninja*' borrowers (no income, no jobs or assets) who took out borrowings they knew they could never repay. The whole thing was the single greatest act of corporate irresponsibility since the commissioning of the proposed new Edinburgh tram system. It was irresponsible of the banks to lend them the money; it was irresponsible of the borrowers themselves to borrow it; it was irresponsible of the bankers again to slice up the mortgages and confuse investors with fancy packaging; it was irresponsible of those investors to buy

<sup>2</sup> *Estimates of Home Mortgage Originations, Repayment, and Debt on One-to-Four-Family-Residences*, Alan Greenspan and James Kennedy, Washington DC, Board of Governors of the Federal Reserve System, 2005. As Ian wrote in his Managing Director's Report in 2006, between 2000 and 2006 outstanding US mortgages increased by \$3.5 trillion, from \$5 trillion to \$8.5 trillion. This represented merely the difference between the origination of \$14.8 trillion of new mortgages and the refinancing of outstanding mortgages of \$11.3 trillion.

what they didn't understand; but most of all it was irresponsible of central banks to keep interest rates so low for so long.

#### THE LIMITS OF REGULATION

The power and scope of regulation is also exaggerated. Two recent scandals not in the financial world have evoked the usual knee-jerk response of *'something must be done'*. Firstly, remember that poor woman in Leicestershire with the disabled daughter, who was driven to her death by local bullies? The trouble there wasn't a lack of regulation. It was a lack of enforcement of existing and perfectly adequate regulation designed to prevent a type of crime which at the time just didn't happen to interest the police very much. In this it was very like the Bernie Madoff scam, when the SEC met repeated tip-offs, warnings and even formal complaints with an uncomprehending yawn.

Then there was the horrible tale of the abusing childminder in Plymouth. Would better regulation, or even just more regulation, have been the answer? No, it wouldn't. Just as the existing checks didn't show up the abusing childminder, neither would the new *'Vetting and Barring'* procedures in England and Wales, even though these will apparently require checks to be made on some 11½ million people. While such checks will complicate the lives of many innocent citizens, the childminder in question would still have sailed through them triumphantly.

#### A CHILL WIND FROM EUROPE

And now, from the people who gave you such idiocies as straight bananas and the metric system, comes the EU's proposed AIFM Directive. Too blinkered or obtuse to recognise that the original problem was largely of their own making, the politicians are now determined to cover their own *derrières* in future by introducing *'one size fits all'* legislation to regulate all investment companies regardless of their assets, domicile, size or venue for trading their shares. The Directive threatens to harm the trust sector in various ways identified by the Association of Investment Companies (the "AIC"), notably:

- **Prevention of new share issues.** This is an unintended consequence of the Directive but is a critical problem for the sector.

- **Caps on leverage (gearing).** The proposals limit commercial flexibility and are poorly thought out, difficult to comply with and create systemic risks.

- **Risk management.** The Directive would give the external manager authority over risk management — an issue which should be determined by the Board.

- **Threat to rôle of the Board.** Maintaining the position of the Board is likely to be resolved by enabling the Directive to be applied directly to the company.

- **Independent valuations.** These are costly and would create scope for conflict with the Board.

- **Regulatory overlap.** Overlap creates costs without benefit.

- **Transparency requirements.** These (relating to the Annual Report, investor disclosure etc) overlap with existing obligations and create unnecessary costs.

The AIC is arguing that where investment companies are listed on regulated markets and subject to the Listing Rules, Prospectus Directive, Transparency Directive, etc, they should not be regulated under the AIFM Directive. Instead they should continue to be regulated through these existing Directives, even if this meant adjusting them where appropriate. However, changes should be tailored to take account of the unique characteristics of investment companies and any new obligations imposed should be commercially flexible and avoid unnecessary compliance burdens. The goal should be effective, proportionate regulation, not simply 'more' regulation.

#### LOBBYING FOR LIBERTY

The AIC's current lobbying seeks to resolve problems created by the Directive through two routes:

- **Reducing potential compliance burdens.** This involves addressing each of the proposed requirements of the Directive to secure their removal or adjustment so as to make them more workable where they affect investment companies, which includes pointing

out where there is overlap in the Directive with obligations created by other European rules and explaining where requirements are not relevant for closed-ended investment companies.

- **Amending the Directive to fit the investment company structure.** This involves calling for changes which would make investment companies directly responsible for complying with the Directive. If this outcome is not possible, other measures must be included to allow the Directive to operate without compromising the rôle of the Board.

The current timetable is for the rules to be finalised in July 2010 and introduced in the UK perhaps 18 months later, which suggests they could be in force by mid 2012. However, it is possible the timetable will change — as, we hope, may the content and requirements of the Directive itself.

#### *'TACK SO MYCKET!'*

This, of course, is Swedish for, *'Thank you very much.'* Thanks are due to the Swedes because it was announced on 13 November that the Swedish Presidency of the EU had published possible amendments to the Directive. The new proposals are wide-ranging and include possible changes to the specific obligations implied by the Directive on leverage, liquidity management, requirement for independent valuation, etc, as well as the overall framework for its application and the possibility of the company itself taking responsibility for compliance with the Directive. However, nothing is yet guaranteed. The AIC will continue its lobbying and Personal Assets, like many other UK investment trusts, will play its part in this.

*'Du gamla, Du fria . . . Jag vet att Du är och Du blir vad Du var.'*

These are words from the Swedish National Anthem and they mean:

*'You ancient, you free . . . I know that you are and you will be as you were.'*

By careful scrutiny and negotiation on the part of the industry as a whole we hope, along with the AIC, to ensure that this remains true of the trust sector as well.

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, ISA or ISA Transfer*.

The Company also operate a *Cash Income Plan*, which allows shareholders' to take a capital return of either 4%, 7% or 10% per annum of the value of their plan.

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**

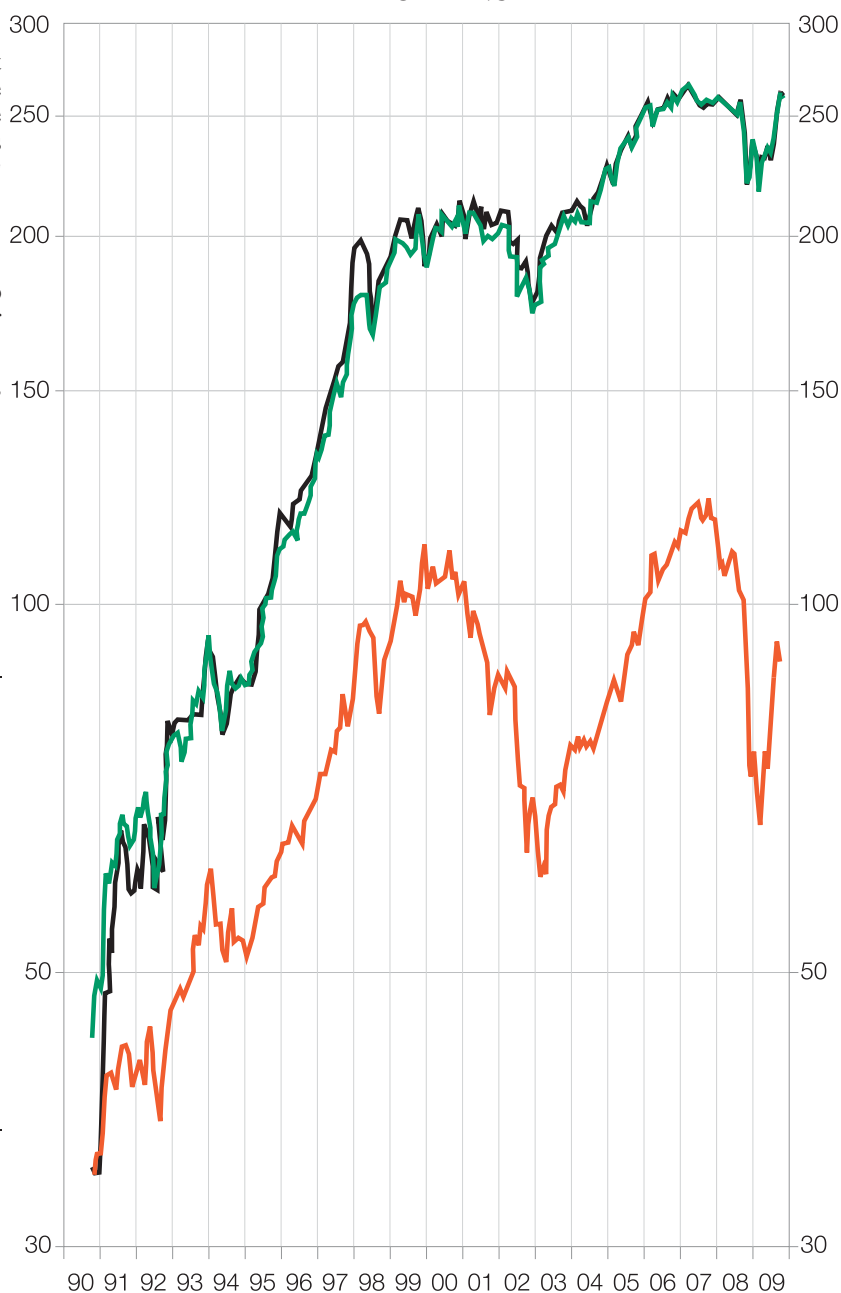
**Tel: 0131-225 9995**

**E-mail: [steven.budge@patplc.co.uk](mailto:steven.budge@patplc.co.uk)**

PORTFOLIO (000's)	31-Oct-09
Alliance Trust	£14,222
Royal Dutch Shell	£13,728
Nestlé (Switzerland)	£10,707
British American Tobacco	£8,743
Coca Cola (US)	£8,172
GlaxoSmithKline	£8,122
Diageo	£7,810
Tesco	£7,055
Berkshire Hathaway (US)	£5,766
Philip Morris Intl (US)	£5,140
<b>Top Ten Equities</b>	<b>£89,465</b>
<b>Other Equities held</b>	<b>£23,858</b>
<b>FTSE 100 Futures held</b>	<b>£36,507</b>
<b>Gold Bullion (8.6%)</b>	<b>£17,530</b>
<b>Liquidity (17.6%)</b>	<b>£35,866</b>
<b>Shareholders' Funds</b>	<b>£203,226</b>

[A more detailed portfolio list can be found in the Interim Report.](#)

**PERSONAL ASSETS TRUST  
PERFORMANCE**



— PAT Share Price (£)  
— FTSE All-Share re-based to PAT Share Price  
— PAT Net Asset Value per Share (£)

Source: DATASTREAM

% Changes from	31-Oct-90	31-Oct-04	31-Oct-06	31-Oct-08	31-Oct-09
Period	19 Years	5 Years	3 Years	1 Year	Values
Share price	640.8%	22.0%	1.0%	18.5%	£263.00
NAV per share	461.4%	22.2%	0.8%	17.0%	£260.67
FTSE All-Share (FTSE)	160.4%	12.5%	-17.7%	18.4%	2,584.59
NAV relative to FTSE	115.6%	8.6%	22.5%	-1.1%	