PERSONAL ASSETS TRUST PLC

JUNE 2012 QUARTERLY REPORT No. 65

INTERESTING TIMES

Many startling events have taken place in the financial markets since I began following them as a schoolboy in the 1960s, but it still came as a shock earlier this month to see 3½% War Loan at par.

War Loan has been a joke. At one point during the 1970s its yield, 18.7%, equalled its price, which was £18.70 per £100 nominal of stock. In 1932, its coupon was reduced from 5% to 3½% and *'or after'* was added to its maturity date of 1952 to make it redeemable at the government's option. Since 1952, or indeed since 1932, it has been a rotten investment in terms of the erosion of the value of both capital and interest by inflation. But at least it *has* reached its nominal value again.

This is only one remarkable phenomenon among many. During the last decade, the unusual became usual and the unthinkable became an everyday occurrence.

- We are in a zero interest rate world. In the UK, Bank Rate has been at 0.5% since March 2009, and in the US the Fed Funds rate has been held within the range 0% to 0.25% since December 2008. There has been nothing like it since interest was invented.
- The 20-year bull market in gilts continued. The 2012 *Equity Gilt Study* from Barclays Capital shows that gilts produced real returns of 5.9% compound over the 20 years to end 2011, 3.9% over ten years and 15.8% over one year, compared to 4.8%, 1.2% and *minus* 7.8% respectively for equities. To my generation, these figures are counter-intuitive and disquieting. 20 years has been a long time for equities to underperform their supposedly duller alternative.
- Equities have got stuck. After a dozen years, the FTSE 100 Index has still failed to scramble back up to its 1999 all-time closing high of 6,930, while our comparator, the FTSE All-Share, stood at 2,984.67 at 30 April 2012 compared to 3,001.92 at 30 April 2000. Personal Assets has added value over the period, our share price rising from £202 to £340.70 while our comparator stagnated, but it has been hard work.
- The price of gold rose from US$307.70 on 30 April 2002 to US$1,660.28 on 30 April 2012. Rather than a *'barbarous relic'*, perhaps today we should re-name the yellow metal *'Buffett's Folly'*.

'A LARGE BLACK CLOUD'

Yes, we have been living through interesting times — and we continue to do so. The world believed it had come through the 2008 banking crisis and lived to tell the tale. Now, four years later, it starts to look as if it was only a dry run for something worse. Today we are worrying about the solvency not just of Greece, Ireland or Portugal, but of Spain, Italy, France *(the French, in their usual contrarian way, are defying reality by lowering their state pension age)* and even the US.

Meanwhile, back at home in the UK, Sir Mervyn King, the Governor of the Bank of England, spoke at this year's Mansion House Dinner of *'a large black cloud of uncertainty hanging over not only the euro area but our economy too'* and the Chancellor of the Exchequer, Mr Osborne, announced, in words that were meant to be reassuring but were unsettling to this disillusioned old cynic:

'[T]he Governor and I will take coordinated action on liquidity and on funding for new bank lending in order to inject new confidence into our financial system and support the flow of credit to where it is needed in the real economy. We are not powerless in the face of the eurozone debt storm. Together we can deploy new firepower to defend our economy from the crisis on our doorstep.'

They have got it wrong again. As Bill Jamieson, that very perceptive commentator and old sparring-partner of mine, wrote in *Scotland on Sunday* on 17 June:

'Our biggest financial problem at present (after the chronic overhang of public and household debt) is not in fact a cash shortage. It's an all-pervasive hoarding of cash. The banks say they have had little option to add to their cash hoarding to meet regulatory requirements on prudential reserves . . . The other cash hoarders are companies themselves. Cash on company balance sheets is now at historically high levels. The total across Europe (including the UK) is now reckoned at more than $1 trillion. At the same time, UK business investment has slumped to just eight per cent of GDP, the lowest since data began in 1965.'

The problem is not a shortage of funds to invest, but a shortage of sufficiently attractive returns to be earned on funds invested. If only they were allowed to do so, market forces would sort things out. The ubiquitous TV advertisements for payday loans remind us that there is no shortage of credit at a price; and it is not that Spain *cannot* borrow money, but that Spain has to pay 7% to do so. As Ian Rushbrook was fond of pointing out in another context, there was no risk of *'the oil running out'*, as environmentalists wanted us to believe. The risk was that oil *at its present price* would run out. If the price is right, there will always be oil — and credit — to be found.

AN UNAPPETISING OUTLOOK

The outlook at the moment is as perplexing and discouraging as ever, and the *malaise* is not confined to the UK and Europe. A survey by the Federal Reserve has shown that the median net worth of US families fell by 39% over the period from 2007 to 2010,

back to its 1992 level of $77,000, chiefly as a result of the collapse of the housing market. And lest we forget the sleeping threat that the world's largest economy presents, the US approaches a fiscal 'cliff' at the end of 2012 as George W Bush's tax cuts expire and predetermined spending cuts take effect. This could equal a fiscal tightening of as much as 5% of GDP, and at the same time the US debt ceiling, raised with such difficulty at the end of July 2011, is due to be tested again.

As Sebastian put it in his Investment Adviser's Report:

'Our greatest concern is that the European challenges that have dogged markets since early 2010 are merely the dress rehearsal for the main event – a US fiscal crisis.'

Of course, the policymakers keep trying out their quick fixes. But markets enjoy only temporary relief. The rally following the Spanish bailout lasted only a matter of hours, and the same was true after the Bank of England's announcement of credit easing and the news of the pro-bailout victory in the Greek elections. Things are not in good shape. The markets know it and, like God, are not mocked.

CHANGES AND CHALLENGES

To add to these financial and economic challenges, there have been significant changes in recent years to the legal and fiscal environment in which Personal Assets operates.

- Income tax has risen and there is now a top rate of 50p in the £ (albeit scheduled to be cut to 45p from April 2013), while some tax allowances have been frozen or removed for higher earners.
- Well-meaning legislation designed to protect shareholders is continuing to proliferate, and — as usual — will have an effect opposite to that which was intended. It will also add to costs, red tape and paperwork.
- The final salary defined benefit pension schemes which were such a pillar of financial planning in recent decades are dying out.
- There is growing pessimism about savings prospects. For the first time, young people expect to be less well off than their parents; and as regards capital, older investors are asking not so much *'how can I make this grow?'* but *'how can I make this last?'*
- Investment trusts have to decide what to make of their new ability, should they wish it, to pay dividends out of realised capital profits — an innovation even more radical than that in 1999 which allowed trusts to buy back shares using capital reserves.

Personal Assets is having to respond to these changes and challenges, but this is nothing new. While our key *objective* — to protect and increase (in that order) the value of shareholders' funds per share over the long term — has remained constant throughout the years, our *means of achieving it* have varied and will inevitably continue to do so.

Look at Personal Assets' portfolio ten years ago, at 30 April 2002:

- We were then, as now, 50% invested in equities. But 89% of our equity exposure was to the UK, rather than 2012's 38%.
- The balance of our equities in 2002 was all in the US, mirroring our statement that '*depending on circumstances . . . the Company may want to hold investments overseas, typically in the United States'*. But today we have 22% of shareholders' funds in US equities compared to only 5% in 2002, and we also hold equities in three other countries — Australia, Canada and Switzerland.
- Neither in 2002 nor thereafter has Personal Assets held Euro denominated securities, and we have a long record of scepticism about the Euro. But one never knows what opportunities may arise even in such an ill-starred area.

As the comparison shows, the way we invest has changed — sometimes in hope of higher reward, but more often to defend ourselves against risk. This is why today, for instance, we hold UK Treasury Bills rather than making large cash deposits in banks. Who would have thought such a precaution necessary in the days before the banking crisis? *Tempora mutantur nos et mutamur in illis*, as the Latin adage runs: *'times change and we change with them'*. Indeed, what once seemed prudent can come to seem the very opposite as circumstances change. The business of investment is hindered by the creation of arbitrary rules and stipulations, no matter how reasonable these seem at the time.

TWO TYPES OF TRUST

There are two types of investment trust — investment subcontractors which offer a service (investing in a particular sector or geographical area or type of company) and trusts which pursue a fixed objective by flexible means. Personal Assets is one of the latter.

The guiding principle is that Personal Assets is not run for some external focus group. It is run by the directors for themselves, their families and people like them. And we have always been prepared to think radically in pursuit of our objectives. Examples are:

- The significant switch out of small cap and into large cap stocks which we made in the early 1990s.
- Our decision in the 1990s not to gear up using borrowed funds but to get the effect of gearing through investing in investment trust warrants and in fund management company shares.
- Our preparedness to go 100% liquid in 2008 and our move into gold from 2009 onwards.
- The elimination of the discount through our discount and premium control policy.
- The introduction of our zero charge investment plans and then the Cash Income Option.

Policy restrictions cannot be set in stone for ever. Did we imagine a decade ago that we would be investing in gold and Singapore Treasury Bills? No. But have our objectives changed over the decade? Again the answer is No.

NEW MEANS, SAME OBJECTIVE

The Board believes that, within the objectives we have set ourselves, and within the spirit of our investment policy as we have pursued it over the last 22 years, we should not have our hands tied. We need to be as free as possible to do *what* needs to be done *when* it needs to be done.

Therefore the Board has decided that it is time to look again at:

- The wording of our investment policy and the various investment limits set out therein. Is it *'fit for purpose'* (to use the fashionable expression), or does it restrict us in unforeseen and unintended ways as a result of its having been formulated in different times?
- Our dividend policy, which was alluded to in the Chairman's Statement. Is it the right one in the circumstances of today?

THE DIVIDEND DILEMMA

High on our list of concerns remains the *'dividend dilemma'*. It gets harder and harder, as the Chairman remarked in his Statement, to achieve our objective of a dividend growing in real terms.

Of course, in one sense it needn't be hard at all. We could easily do it if we invested 100% of shareholders' funds in defensive equities with decent yields, of the type we currently hold. But we don't think it right at present to hold 100% of our shareholders' funds in defensive equities with decent yields, any more than we would think it right to hold 100% of shareholders' funds in gold or US TIPS or Singapore Treasury Bills. To allow our dividend policy to dictate our investment policy as a whole would, to use one of the Chairman's favourite phrases, be allowing the income 'tail' to wag the capital 'dog'.

DELIVERING THE GOODS

There are two reasons why *'paying a dividend'* raises questions for a trust like Personal Assets.

- A return in the form of a dividend is not as tax-efficient to many of our shareholders as a return in the form of capital.
- The need to earn revenue means we may sometimes have to invest in a different way from that which we would consider best for capital preservation or total return.

Here the corporate structure of an investment trust may come to our aid. There are two ways to deliver what shareholders want:

- Through how we run the investment portfolio.
- Through using some aspect of our corporate structure.

For example, shareholders know that despite our low yield they can draw an income through regular sales of a small number of their shares *via* the Cash Income Option in our Investment Plan. We are in the process of simplifying this so that investors can specify a required quarterly sum rather than a percentage of the initial holding, and we will be extending the principle to the Personal Assets Individual Savings Account ("ISA"), so that it will be possible for holders to draw a quarterly tax-free sum from their ISA pool.

Already there are more than 200 holders of Personal Assets ISAs who have ISA pools worth over £100,000. Given the growing disillusionment with pension plans and the fact that a married couple can now invest an annual £22,560 in ISAs, I expect ISAs to grow in importance as a source of tax free cash income for retired people.

What of the change in the law that will make it possible for trusts to distribute realised capital profits as dividends? My initial reaction was that while it may suit those trusts which cater primarily for basic rate taxpayers who rely on a high regular dividend income, for typical Personal Assets shareholders it would be like turning the trust into a tax-inefficient annuity. It is not, however, something the Board is ready to dismiss out of hand. The freedom to pay dividends out of capital profits could allow trusts to break for the first time the previously inescapable link between *'paying a dividend'* and '*investing for income*'. It is important to explore the implications of this, to see if any of them could work to our advantage.

There are three approaches a trust might take. The first would be to simplify its policy to '*paying out what's there*'. The second and third, however, would enable such a trust to pay a predictable and growing dividend stream without placing constraints on how its assets were invested.

- ***'Paying Out What's There'.*** Since retained earnings and revenue reserves will cease to be relevant after the change to the rules, a trust could end the complication of charging some of its expenses to capital and charge all expenses to revenue, investing shareholders' funds as seemed best for capital preservation and total return. (It could be argued that charging expenses to capital and then paying out some or all of the enhanced earnings per share as dividend was essentially the same as distributing capital.)
- ***'Paying Out A Predetermined Stream of Dividends'.*** Again, a trust could charge all its expenses to revenue and invest its shareholders' funds as seemed best for capital preservation and total return while paying out a predetermined (as far as the 85% distribution rule permitted) stream of dividends. This need have no implications for the structure of the Company's portfolio.
- ***'Paying No Dividends, But Making An Annual Scrip Issue'.*** Might it be possible to break the link between providing shareholders with an income stream and investing the portfolio in a particular way, while still giving shareholders the choice of drawing such an income stream or leaving their capital to accumulate in the trust? Could a trust make an annual scrip issue equivalent in value to around its current yield, allowing shareholders to choose either to keep the new shares or to have them sold by the trust on their behalf?

The Board is continuing its review of Personal Assets' dividend policy. Should it decide to recommend any change, this will be put to shareholders at an EGM later in 2012 along with any modifications we may propose to our investment policy as a whole.

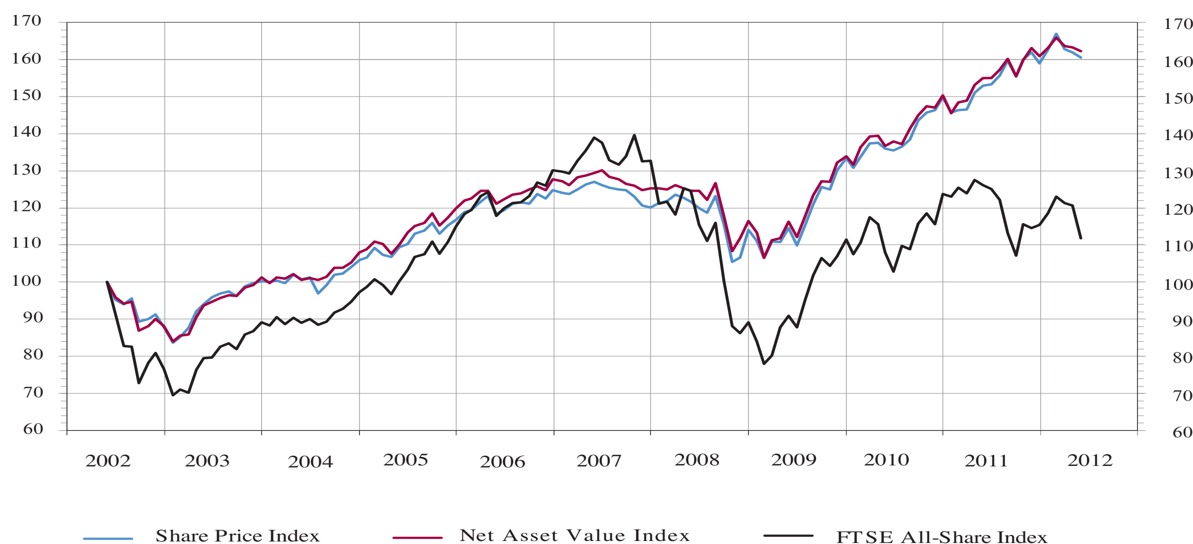
AND ANOTHER *'60 NOT OUT'* . . .

Last year we published ***'60 Not Out'***, a compilation of Quarterlies, and this year we celebrate another *'60 Not Out'* — the Queen's Diamond Jubilee. Here I should like to end by recalling what we wrote at the time of her Golden Jubilee.

'It is up to shareholders to judge our performance, but if we have carried out our duties half as well as the Queen has carried out hers over the years, we can be more than satisfied. Long may she reign, and may none of us ever forget or take for granted her astonishing example of faithful and selfless service over by far the greater part of the lifetimes of most of us.'

ROBIN ANGUS

PERSONAL ASSETS TRUST PERFORMANCE



	Value 31 May 2012	Percentage Changes 1 Year	3 Years	5 Years	10 Years
Share Price	£337.90	4.9	40.2	26.4	60.5
NAV per Share	£333.57	4.7	39.5	25.4	62.3
FTSE All-Share Index	2,767.09	(11.3)	22.8	(19.5)	11.8
NAV relative to FTSE All-Share Index		18.0	13.6	55.8	45.2

TOP 10 EQUITY HOLDINGS

Company	Country	Sector	Valuation 31 May 2012 £'000	Shareholders' funds %
British American Tobacco	UK	Tobacco	19,039	4.1
Nestlé	Switz	Food Producer	17,387	3.7
Microsoft	USA	Software	17,340	3.7
Centrica	UK	Utility	15,996	3.4
Coca-Cola	USA	Beverages	15,629	3.3
Becton Dickinson	USA	Pharmaceuticals	14,481	3.1
Imperial Oil	Canada	Oil & Gas	13,548	2.9
Newmont Mining	USA	Mining	13,466	2.9
Philip Morris International	USA	Tobacco	13,357	2.9
Diageo	UK	Beverages	12,159	2.6
			152,402	**32.6**

GEOGRAPHIC ANALYSIS

	Valuation 31 May 2012 £'000	Shareholders' funds %
US equities	107,254	23.0
UK equities	89,889	19.2
Canadian equities	18,147	3.9
Swiss equities	17,387	3.7
Australian equities	5,490	1.2
Gold	71,049	15.2
Government bonds (USA, Singapore and UK)	167,194	35.8
Net current liabilities	(9,107)	(2.0)
Shareholders' funds	**467,303**	**100.0**

Further information on the Trust can be obtained from the Company's website – www.patplc.co.uk or by contacting Steven Budge on 0131 538 6605.