PERSONAL ASSETS TRUST PLC

MARCH 2013 QUARTERLY REPORT No. 67

OVERVALUED MARKETS

Barring a springtime miracle, the year to 30 April 2013 will not be a vintage one for Personal Assets. Although our objective is capital protection rather than trying to outperform an index, over the ten months to 28 February our share price rose by only 5.5% compared to a rise of 12.2% in the FTSE All-Share Index, an underperformance of 5.8%. Most shareholders already know that we mistrust markets such as these. As Sebastian Lyon, our Investment Adviser, wrote in an article in the *Financial Times* for the weekend of 2nd/3rd March, we are almost four years into a bear market rally (or a cyclical bull phase, if you prefer it) which is running ahead of itself.[1]

At this stage in the market, more risk is being taken than investors admit to, or perhaps even realise, and there is panic in the air — not panic about the level of the markets, which would make sense, but panic to invest cash at any price, which makes no sense at all. The US VIX Index (commonly called the *'Fear Index'*) is at its lowest level since 2007. Sceptics of the rally are throwing in the towel and joining in. The lists of bond prices in the financial papers these days look to me like an extended financial suicide note — huge risk in exchange for very little return. Junk bonds, which are supposed to offer high yields because they are, well, junk, not only yield less than they did in 2007 but are also offering the lowest returns ever. What sort of world are we living in, when Bolivia can borrow for ten years at a mere 4.75% and Indonesia at 3.3%?

[1] I should point out that you may notice similarities between that article and parts of this Quarterly, which illustrates the way Sebastian and I work together, although the more sensible and cautious phrases are likelier to be his and the more extreme and lurid ones likelier to be mine.

An over-eager appetite for risk, a lack of discrimination in investing, and compression of yields into an unhelpfully narrow range are not new. Indeed, like most things in the financial markets, they tend to come in cycles. In the late nineteenth century an unfriendly critic wrote of the Scottish investment trust industry:

'The Scots, of all people in the world, are supposed to be best able to take care of themselves and their money. Whenever an honest penny can be earned, they will not be far to seek. And yet it has come to this with them, that they will face almost any risk for the sake of the difference between 4% at home and 4½% across the Atlantic.'

Between that time and this, the principles — lack of discrimination by investors and the compression of yields — are the same, although there are differences in the detail. 4% at home? Those were the days. And *'across the Atlantic'* is one thing, but *Bolivia*?

Sebastian wrote in his *Financial Times* article that *'the credit supply conveyor belts of the City and Wall Street will run 24/7 to ensure the income-starved are fed'*. To this I am tempted to add that we have seen recently how food can be adulterated. Who is to say that Bolivian bonds will not prove to be the credit markets' equivalent of horsemeat? But perhaps that is unfair. Investors in them will at least know what they are buying, whereas in the structured investment vehicles of the sub-prime loans crisis nameless and unidentifiable horrors lurked within their reassuring wrappers.

BONDS AND EQUITIES

Now that bond yields have collapsed, equities are the final game in town for those scrabbling around for income. But bond investors moving into equities are like bridge players trying their luck at roulette. They are nervous about what they are doing, because they are not used to big losses. Since 1970, the most that global equity investors have lost in a year is 48%, while the most that bond investors have lost is 16% — only a sixth of their money as opposed to nearly half of it. In today's topsy-turvy markets it is the most cautious, with the most to lose, who are taking on the most risk.

THE INCOME BUBBLE

Bubbles can be beautiful things, and the yield bubble in the bond market is no exception. It is so pretty to look at — all those lovely high prices, and its history of positive real returns — that we forget its dangers; and the bond bubble is now, we believe, extending itself to cover equities as well. In a zero interest rate world, income of any kind is at a premium. As Sebastian pointed out in his *Financial Times* article, the demand for UK and global income funds has been notably strong in recent years. Figures from the Investment Management Association confirm that, of the £3.4 billion of net UK fund sales in 2012, £2.3 billion — two thirds of the total — went into these two income sectors.

The yield on the FTSE All-Share Index at the time of writing is 3.3%. It has, of course, been lower than this in the past (it was 2.1% at the UK market's 1999 peak), but what worries us just now is that it is near the bottom of its long term 'normal' range of between 3% and 5%. Another 10% rise in the stock market (which would be quite conceivable in today's environment) would cut the yield to 3% and alarm bells would really start ringing. A 10% rise in the market would bring us back to the old high on the FTSE 100 Index of 6,930. Of course, 6,930 at a yield of 3% would not be as overvalued as 6,930 at a yield of 2.1%. But overvalued it still would be, and

the danger is that at 3% there are those yield-starved investors who might still find it attractive compared to bonds, and push the market up to levels at which it was more overvalued still.[2]

CAPITAL AND INCOME

Sebastian's view, as expressed in his *Financial Times* article, is that we have entered a bizarre phase of reluctant speculation in which tomorrow's income is being converted into today's (probably temporary) capital gain. He is quite right in this. The prices of both bonds and equities in effect capitalise a lot of future income. Yet, looked at in another way and from a longer-term perspective, it might be said that in a world without interest rates and with ever dwindling yields on traditional income-paying securities, both the bond and equity markets have become gigantic machines converting capital into income.

I say this because if I want income, I have to buy a bond or an equity share that produces it; and in today's markets I will almost certainly have to pay more for a stream of income than it is objectively worth. Therefore, I am exchanging pounds of capital I already possess for fewer pounds of income than I would have got in the past or might get in the future. In other words, because I need a particular kind of return categorised as 'income', I have to deploy my capital inefficiently. This problem, and the whole question of the too rigid division between capital and income in the minds of most investors, lies at the heart of the recent reassessment of Personal Assets' dividend policy.

Many of the ways of converting capital into income are obvious. I can buy investments which are wasting assets, such as annuities, bonds selling at above par, or mines coming towards the end of their productive lives (which were quite common investments when I first followed gold shares in the late 1970s). Or I can buy high-yielding investments which, although not wasting assets *per se*, have some of the same characteristics — say, shares in mature companies returning capital to their shareholders by overdistributing *via* dividends and/or share buy-backs. But another way has appeared — quality stocks which offered a mix of income and capital growth but are now too dear to offer an adequate margin of safety.

Stocks in the last of these categories have moved from being what are known as 'GARP' stocks (**G**rowth **A**t a **R**easonable **P**rice) to what I would call 'GAWP' stocks (**G**rowth **A**t the **W**rong **P**rice), at the price of which one can only gawp while studiously refraining from buying. If I buy growth at the wrong price — for instance, by buying a stock on a yield of 3% when, in my opinion, it would be fairly valued on a yield of 4% — I am turning capital into income as surely as if I were to buy a gilt selling at above par, with the difference that I can't even amortise the implicit premium on the equity, although I can amortise the actual premium on the gilt.

Some may object and say value shouldn't be looked at in this way — that the same stock may at different times be dear when it yields 4% and cheap when it yields 3%, depending on the level of the market. This we deny. While it is true that sometimes the particular characteristics of an investment may be worth more to me than they are to you, this is because you and I may have different needs and wishes, and has nothing to do with the level of the market. Pope Benedict XVI during his reign spoke and wrote much about *'the tyranny of relativity'*. Whether or not this is true of faith and morals, it is certainly true of investment, in which there *are* absolute truths and absolute values, and where relative market judgements are often more misleading than useful.

'JUST A WEE DRAM LEFT?'

Let's look at an example. At our London shareholder meeting in January, Sebastian drew attention to one of our long term holdings, Diageo, the distiller and marketer of alcoholic beverages. Despite the company's silly modern made-up name, compounded in 1997 from elements of bad Greek and worse Latin, many of its brands, such as Johnnie Walker, have been with us for decades or even centuries *('Born 1820, Still Going Strong').* Diageo fits our investment criteria of high returns on invested capital, excellent geographic diversification (including access to emerging markets) and a robust dividend record. But all things have their correct price. What about Diageo today? The shares have doubled over the past four years and the yield has fallen to a miserly 2.4%, the lowest since the merger between Guinness and Grand Metropolitan that formed the company in 1997. Diageo, which offers quality and growth, but now *not* at the right price, is a microcosm of the yield hungry market most of today's investors are foraging in.

If I needed a cash income from my investment portfolio (and one day I doubtless will), which would be least harmful to my total wealth — 2.4% from Diageo, 2% from 10-year UK gilts, 4.75% from Bolivian bonds, or 4% from the Personal Assets Cash Income Option? You won't be surprised to learn that I'd choose the last of these.

THE MAGIC POTATO FIELD

A shareholder recently tackled me about the Cash Income Plan concept. It was, he argued, fundamentally flawed. To illustrate his point, he took the example of a potato field which produced a yearly crop for sale. It was right to sell the crop, but wrong to sell a bit of the field each year because eventually the field would all be sold and there would be neither land nor potatoes left to live off.

But all analogies, metaphors and similes are flawed — and sometimes the better they seem to fit, the more misleading they are, because the flaw is not so obvious. The shareholder I spoke to assumed that a holding in Personal Assets shares was, like a potato field, fixed in size. But had you bought £100,000 worth of Personal Assets shares in April 2002 it would have grown to about £170,000 in capital terms today — the equivalent of some magic potato field in the fairy tales of the Brothers Grimm *(an appropriate nickname for Sebastian and me*

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[2] In case I'm accused of comparing apples and pears by quoting the FTSE 100 Index and the FTSE All-Share yield, the FTSE 100 currently yields 3.5%, which would be 3.2% if the index rose 10%, and yielded 2% at its 1999 peak.

just now?) that has expanded from ten acres to 17 acres. The figures from April 1992 are even more reassuring for Cash Income Option investors, rising from £100,000 to nearly £550,000 in capital terms, or an expansion in our magic field from ten to 55 acres.

Of course, the magic potato field, being magic, can shrink too. But if we drop the metaphor, anyone who believes that our shareholders' funds are an inert sum and we are likely to fail to make them grow over the longer term should not be holding our shares.

The Four Pillars of Wisdom?

In our Personal Assets Interim Statement to 31 October 2012 Sebastian and I wrote that our portfolio was built on four *'pillars'*: blue chip equities; index-linked bonds; gold bullion (including gold mining shares); and cash. How firm are these pillars today?

I have already written about ***blue chips.*** While we added to Imperial Oil recently, we sold our holdings of Centrica and Vodafone and cut back on our Diageo. We currently have just under 40% of shareholders' funds in blue chips: 19.9% in the US, 13.1% in the UK, 3.8% in Switzerland and 2.9% in Canada. (This excludes the 4.8% represented by Newmont Mining in the US, Newcrest Mining in Australia and Agnico-Eagle in Canada.) Given our uneasiness about equity valuations, we are more likely to reduce our equity holdings than to make new acquisitions.

We hold ***index-linked bonds*** to the value of 23.1% of shareholders' funds — 19.3% of shareholders' funds in the US and 3.8% in the UK. These are straightforward investments. They do what they say on the tin. To change the *(only slightly flawed)* metaphor, I sometimes think of them as a great fortress, kept safe by unscalable walls. They are there to defend the value of our irreplaceable capital, and that is exactly what they do.

I have been asked a lot recently about our holding of ***gold bullion***, which represents 12.7% of shareholders' funds. (Mining shares add a further 4.8%.) Yes, the gold price has been weak in US Dollar terms of late, but it is not always recognised that gold has been doing much better in Sterling terms. Over the last three months gold is down by 7.9% in US Dollar terms but by only 2.5% in Sterling terms, and over the last month gold has actually made us money in Sterling terms (up 1.0%) despite being down 3.3% in US Dollar terms.

Cash accounts for 19.7% of our shareholders' funds. It was once held for safety, convenience and assured (if usually modest) returns. Now it presents difficulties undreamt of a few years ago. We hold our Singapore Treasury Bills on their own merits, for exposure to *'the Swiss Franc of the Far East'*. But the UK Treasury Bills are a relatively new asset class for us, and we hold them not for their yield or their potential for capital appreciation (they have none of the former and very little of the latter) but because we feel unjustified in keeping, as we used to, large sums on deposit at banks because of the risk this involves.

Playing the Long Game

My wife (a Russian speaker) and I recently watched the restored Russian film of *War and Peace*, and I was struck by the contrast between Napoleon, the glamour boy and risk taker, and Kutusov, the old, lumbering, unfashionable but wily Russian general who opposed him and, in the end, defeated him. Kutusov's secret weapon was that he was prepared to wait — and wait, and wait. His motto was *'Patience and Time*'. Like Kutusov, we are not afraid to look foolish or inert in the short term, even when the short term seems never-ending.

Some longer-standing Personal Assets shareholders north of the Border may remember this:

'On Friday the FTSE 100 closed within a whisker of 6,100. The broader FTSE All Share Index has continued to barnstorm, rising by 7.4% in the first quarter of the year alone, its strongest start to a year since 1998 . . . PAT's performance by contrast has been lamentable . . . Yet is there surely not a limit to this reverential worship of the emperor's new clothes? Underperformance of this magnitude by fund managers in some other companies would be regarded as grounds for dismissal. . . . The annual meeting is due on 14 July. This would be a useful opportunity for the Board to indicate whether it continues to wait for Armageddon, or if there may be some moderation in its position.'

That is an extract from an article in *The Scotsman* for 8 May 2006, at a time when, because we were being true to ourselves and sticking to our guns, our performance was dreadful and Ian Rushbrook and I were almost afraid to venture out on the streets of Edinburgh.

As it happens, it was just as well we stuck to our guns.

- Yes, in NAV terms we did underperform the FTSE All-Share by 15.4% between 2003 and 2006.
- But this followed outperformance of 48.0% between 2000 and 2003 — and then we outperformed by 26.8% between 2006 and 2009.
- Thus, over the nine years from 2000 to 2009 we outperformed the FTSE All-Share by 58.8% in total.

In the space of less than a decade we therefore went from heroes to idiots and back to heroes again.

True to Ourselves

As I wrote earlier, however, what really matters to us is not outperforming an index but protecting capital. The 12 years since 30 April 2000 saw us suffer a negative price total return in only three years (each time in single figures) compared to the six (three of them in double figures) suffered by the FTSE All-Share.

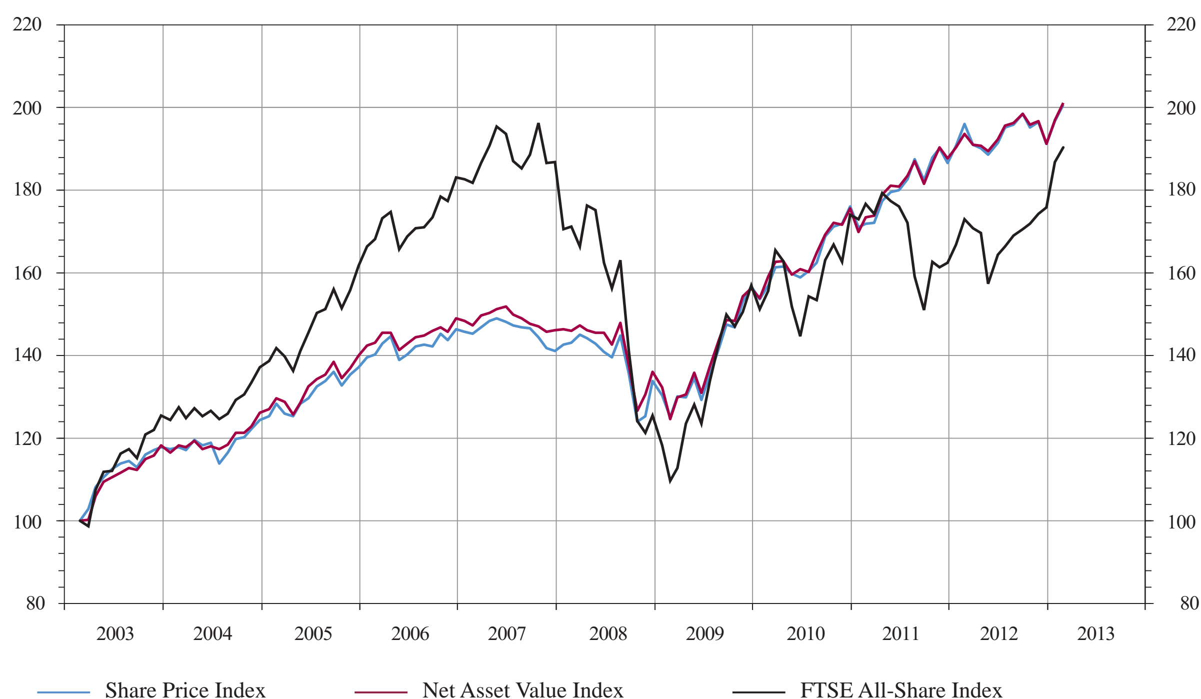
I quoted from that 2006 article not to point out that things came right for us in the end, but to remind shareholders (as well as myself) that there can be difficult times as well as good times for a trust which has a distinctive investment philosophy like ours. And in fact I would have been wrong to claim that things came right for us in the end, because we have not yet reached the end.

Earlier, I wrote that all analogies, metaphors and similes are flawed. To take one example, it has often been said (by me as well as by others) that *'investment management is a marathon, not a sprint'*. But it isn't a marathon either, because even marathons come to an end whereas investment management never does.

So now it's back to work.

Robin Angus

PERSONAL ASSETS TRUST PERFORMANCE



	Value 28 Feb 2013	1 Year	3 Years	5 Years	10 Years
		Percentage Changes			
Share Price	£359.60	2.4	27.8	39.9	100.6
NAV per Share	£354.12	3.9	26.4	37.8	101.2
FTSE All-Share Index	3,349.39	10.0	22.4	9.6	90.4
NAV relative to FTSE All-Share Index		(5.5)	3.3	25.7	5.6

TOP 10 EQUITY HOLDINGS

Company	Country	Sector	Valuation 28 Feb 2013 £'000	Shareholders' funds %
British American Tobacco	UK	Tobacco	24,227	4.2
Microsoft	USA	Software	23,374	4.0
Nestlé	Switz	Food Producer	21,797	3.8
Becton Dickinson	USA	Pharmaceuticals	17,719	3.1
Imperial Oil	Canada	Oil & Gas	16,863	2.9
Coca-Cola	USA	Beverages	16,453	2.8
Philip Morris International	USA	Tobacco	14,715	2.5
Sage Group	UK	Technology	14,276	2.5
Newmont Mining	USA	Mining	13,275	2.3
Diageo	UK	Beverages	11,478	2.0
			174,177	**30.1**

PORTFOLIO ANALYSIS

	Valuation 28 Feb 2013 £'000	Shareholders' funds %
US equities	128,494	22.2
UK equities	75,695	13.1
Canadian equities	21,882	3.8
Swiss equities	21,797	3.8
Australian equities	9,744	1.7
Gold	73,601	12.7
Government bonds (USA, Singapore and UK)	245,184	42.4
Net current assets	2,335	0.4
Shareholders' funds	**578,732**	**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.