PERSONAL ASSETS TRUST PLC

AUGUST 2013 QUARTERLY REPORT No. 69

A SHAREHOLDER WRITES . . .

'I am a holder of your shares. Despite the strong performance of the market during the last year, your performance has been abject. What are you going to do about it?'

That was quite an e-mail for us to have received less than a fortnight before the Annual General Meeting ("AGM"). It concentrated the mind wonderfully as we prepared to meet the shareholders on 25 July. Such a frank and straightforward question called for an equally frank and straightforward response, and I'll begin this Quarterly with a summary of my reply. Then I'll report on some of the topics raised at the AGM and conclude with some thoughts regarding one of the most searching questions we were asked — namely, about the criteria used by Troy when selecting equities.

My answer to the shareholder who asked what we were going to do about our performance won't surprise you. It was that we would do nothing beyond what we were doing already. We would stick to our guns and refuse to be deflected from pursuing our long term strategy by short term underperformance. I pointed out that in frothy and volatile markets like these it is usual for us to underperform the FTSE All-Share, sometimes very substantially so, and that it would be a surprise not only to ourselves but also to many of our shareholders if we didn't. This, I continued, was because, as a matter of principle, we don't invest in what we believe to be seriously overpriced assets which carry a risk of serious and perhaps permanent capital loss.

What's more, we don't invest on a one-year view, or anything like it. We may not think in centuries, as the Vatican is supposed to do, but we do think in decades. I reminded my correspondent that since 30 April 1990, when Ian Rushbrook and the Board took direct responsibility for the management of Personal Assets, our net asset value ("NAV") has grown at a compound rate of 8.3% per annum compared to 5.3% for the FTSE All-Share Index and 3.0% for the RPI.

Consistency over the long term is what matters to us. It explains why we the Directors, Sebastian Lyon, our Investment Adviser, and our families at the date of the 2013 AGM held shares worth £25 million in Personal Assets. It's impossible to overemphasise that Sebastian and the Board are not just hired hands, managing money for other people. *It is our own money that is at stake.* This is the key to everything we do. If the shares of Personal Assets fall in value, so does our own net worth — and, ultimately, our future security and that of our families is put at risk.[1]

THE COST OF CAUTION

Now, of course you have heard all this before, so let me spell out what it means in practice. At 30 April 2012 we the Directors, Sebastian and our families held 69,423 shares in Personal Assets. The value of these shares on the stock market rose from £23.7 million to £24.8 million over the year, so we succeeded in our first objective of protecting our capital. But had we converted Personal Assets into an index tracker and invested its entire funds in the FTSE All-Share Index, our £23.7 million stake would have grown to £26.9 million.

In other words, sticking to our policy instead of investing Personal Assets' funds in line with the index reduced our own potential wealth by over £2 million. To my correspondent who described our recent performance as *'abject'* (to say nothing of another shareholder who wrote that *'the trust's performance over the past four months has been spectacularly dreadful'*), I could have replied perfectly truthfully on behalf of Sebastian and the Board with the trendy and toe-curling cliché, *'We share your pain.'*

But such apparent missed opportunities on paper are the price we willingly pay for long-term stability and for dependable and sustainable capital protection and growth. To be fully invested in equities today would, we believe, be too great a risk. Forecasts of corporate earnings, having peaked in late 2011, are beginning to come under pressure and we feel sure that the profit cycle has turned.

Equities may look cheap compared to conventional bonds, but conventional bonds are so overpriced that the comparison is meaningless at best and dangerous at worst. We can find no compelling reasons to take a positive view on stocks and have therefore been gradually reducing our equity holdings.

LAGGING A RISING MARKET

My questioner responded to my comments about short-termism by posing another question. While accepting in general terms the principles underlying our investment policy, he was curious as to why a cautious, low risk investment approach should lead to underperformance in buoyant markets.

In response I cited two reasons. The first was that when markets are buoyant the likelihood is that we will not be fully invested in equities, because at such times we will think them too dear and too risky. Therefore, if equities across world markets rise by, say, 20% and only half of our shareholders' funds is invested in equities, our NAV would *(other things being equal, which they never are)* rise by only

[1] This is perhaps the best answer to a question that was asked at the AGM about how we measure Troy's performance as Investment Adviser. It is not an adversarial relationship. Running Personal Assets is a co-operative enterprise between the Board and Troy and when we measure Troy's performance we are also measuring our own.

10% and we would underperform the global equity market. The corollary of this, of course, is that if equities across world markets fall by 20% and only half of our shareholders' funds is invested in equities, our NAV would fall by only 10% and so we would outperform the global equity market.

The second reason I gave as to why a cautious, low risk investment approach leads to underperformance in buoyant markets was that, as a general rule *(although not invariably)*, in buoyant markets the pace is set by riskier, more volatile shares whereas the shares we like to own tend to be less risky and less volatile than average. Therefore even the shares we do hold will tend to rise by less than average, or *(of course)* fall by less than average if the market starts declining.

ASKING THE OBVIOUS QUESTION

In the highly unlikely event that the next question hasn't occurred to you, I'm going to take the (market) bull by the horns and ask it myself. When equity markets are buoyant, why on earth don't we hold riskier shares — and more of them — on a short term basis, perhaps using borrowed funds to invest in additional equities as some trusts do, to make hay while the sun shines before reverting to type and becoming conservative and cautious investors again when the market stops being buoyant and starts to fall?

This is a question we are often asked by shareholders and others who sympathise with our investment approach but are puzzled as to why we can't capture a bit of short-term performance as well. It is a question I, too, used to ask during my impatient younger days back in the late 1970s and early 1980s. How easy it looked, to run with the market for short-term gains while still sticking to our long-term principles! And how inexplicably mulish and stick-in-the-mud were my superiors, who refused to do what to me, in those days, seemed so obvious.

AN INCONVENIENT TRUTH

The inconvenient truth I learned painfully over subsequent years is that while it is not too difficult to tell when equity markets are undervalued or overvalued, it is virtually impossible to tell when a buoyant market will stop rising and start falling — just as it is virtually impossible to tell when a depressed market will stop falling (or stagnating) and start rising.

Sebastian and I accept that we have a fair idea of when equities are cheap or dear but no idea at all about timing. We also know that panicking into a soaring market is a recipe for disaster, because we have seen it happen. So we stick to what we understand, making some money *(if not as much as our more aggressive rivals do)* when markets are rising and then holding on to it when markets are falling and others are seeing their gains evaporate.

Panic is the enemy of successful investment. Again and again I have seen investors panic, buy at the top and lose a fortune. This happened during the dot.com bubble in 2000, when investors who had missed the rise in technology stocks bought too late and were speedily disappointed. It is the price paid for a stock that largely determines the returns earned from it. To reverse the old market adage, *'You make money when you buy, not when you sell.'* That is why we aim to buy the stocks we like when their price is low, rather than try to keep up with markets in the short term.

WHAT HURT US IN 2012-13?

In preparing for the AGM we decided to lead with the bad news and describe as fully and frankly as possible why our short term results were so disappointing. Experience has shown that this is the best as well as the most honest approach.

Not everything went against us. Most obviously, we benefited from rising equity markets. We saw particularly strong performances during the year from Diageo, Unilever, Johnson & Johnson, Colgate Palmolive and Becton Dickinson. We also benefited from currency movements, as both the US Dollar and the Singapore Dollar appreciated against Sterling. But in his AGM presentation Sebastian focused purposely on the negatives.

- **Gold** fell conspicuously, but holding it is something we are convinced we still need to do. We have seen falls in the past. During the last secular gold bull market of the 1970s and over the gloriously hot summer of 1976, the price of a troy ounce of gold melted from $187 to $105 before beginning its ascent to $850. The recent move from the August 2011 peak of $1,908 to under $1,300 seems to be a similar test of resolve, and while we must accept the possibility of a further correction we have begun to increase our holdings on weakness.
- **Index-linked bonds** have until recently traded broadly in step with conventional bonds, so their sudden fall came as a surprise given that we expect inflation to be above the levels that have prevailed for the past decade or two. As always, the problem is timing. Since the year end, index-linked bonds have headed downwards as inflation expectations have dampened. A further deflationary shock may push them lower, but we would not expect them to revisit their 2008 low, the result of a policy hiatus (pre-QE) and aggressive forced selling.
- **Cash** is the most criticised of all investments. Wealth managers and private client stockbrokers are reluctant to hold any cash for clients, particularly in a zero interest rate world. But the virtue of cash is seriously underrated at present, just as it was in 2007 and 1999, and we have increased our level of cash liquidity. This shift is more tactical *(on a short to medium term basis)* rather than strategic. In the longer term *(i.e. on a ten year view)* cash is almost certain to lose a significant amount of its value in real terms, but so too may equities, while conventional bonds are a bear market waiting to happen. Cash has an important rôle as a diversifier in today's highly correlated, low return world. It should not be a permanent holding, but it is dry powder to be deployed when value once again presents itself.

LOOKING TO THE FUTURE(S)

One shareholder at the AGM recalled how Ian Rushbrook used FTSE 100 Futures rather than cash or near cash as a way of increasing the trust's liquidity and asked if Personal Assets might do so again. Sebastian replied that he was not keen to go short of FTSE 100 Futures but would be happy to go long when the time was right.

Given the pressure there has been recently on our revenue account and hence on our dividend-paying capacity, another obvious question is whether it would make sense for us to hold more equities and draw the income from them to distribute as dividends while making use of FTSE 100 Futures to increase or decrease our level of exposure to equities. Such a course would in my view be riskier than the one we are currently following, and securing a dividend yield of a mere 1.6% or so pales into insignificance before the risk of capital loss which might in percentage terms extend into double figures.

SCOTLAND THE BRAVE?

Another kind of 'future' that came up at the AGM was the future of Scotland, given the referendum on independence scheduled to take place on 18 September 2014. Perhaps unsurprisingly, it was a shareholder domiciled in England who asked this question, and some other English-based shareholders have e-mailed me with more specific queries about how residency would be defined and whether Personal Assets would be an allowable holding within ISAs should an independent Scotland not be part of the EU.

These questions can't be answered yet. As far as membership of the EU is concerned, it all depends on whom you believe. Would it be decided by the exact terms of treaties, or would it be seen by the EU as a political matter calling for a pragmatic solution? As regards the possibility of Scottish independence itself, the Board would approach it in a practical way and would concern itself only with the interests of shareholders as a whole. But it is important to recognise that even if there were a Yes vote in the referendum it would not bring about instant change but would almost certainly be only the beginning of a long process of consultation, planning and negotiation which could last for several years.

DOES SIZE MATTER?

The question of whether we will ever reach an 'optimum' size for Personal Assets comes up quite often in discussions with shareholders and *(especially)* outside trust-watchers. The Chairman went a long way towards answering it during the AGM when he paid a retirement tribute to Martin Hamilton-Sharp, our longest-serving non-executive Director, who joined the Board in November 1990 and did much to shape and guide Personal Assets' values and style.

In so doing, he quoted figures to illustrate Personal Assets' progress over the period. When Martin became a Director, the share price (adjusting for the 1 for 100 consolidation in January 1993) was £35 and the NAV was £49. The discount was 28.5% and there were 149,313 shares in issue. The trust therefore had assets of £7.3 million and a market capitalisation of £5.2 million compared to the end July 2013 figures of £590.1 million and £596.1 million respectively.

That is a striking tale of expansion, but whatever other problems we may have encountered over the period I can honestly say that we have never faced a problem with size. While stock selection matters to us *(see the next topic I deal with in the Quarterly)*, Personal Assets' portfolio is run with a 'top down' rather than 'bottom up' approach and will continue to be so.

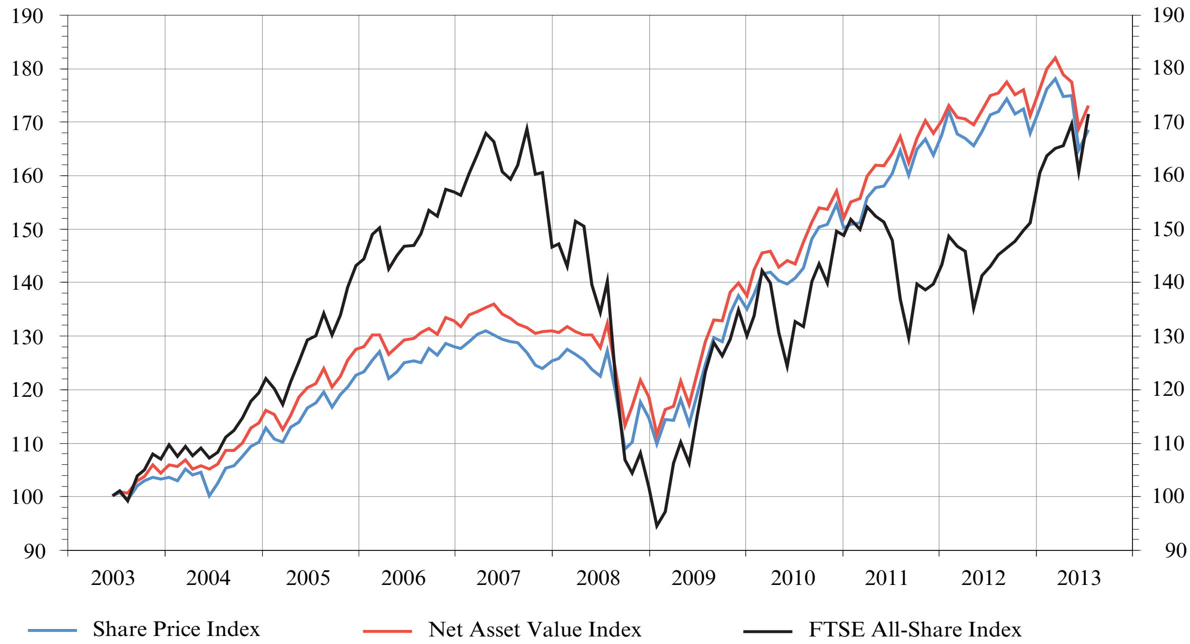
HOW TROY CHOOSES EQUITIES

Now to stock selection, which remains important despite our 'top down' approach. Here are some guidelines Troy, and hence Personal Assets, follows:

- ***Invest only in companies with growth in revenues per share.*** We avoid companies that 'grow' by acquisition. Mere growth in size is of no benefit to us. What matters is not the total value of a company, but the value of each of the company's shares. And the value of the shares is determined not by the size of the company as a whole but by revenues, earnings and dividends ***per share***, and their rate of growth.
- ***Avoid highly geared companies like the plague.*** It is important that businesses are self-financing. Debt is crippling to management flexibility and corporate growth. The financial scrap-heap is littered with companies which borrowed too much and came unstuck. In running a company, the interests of the shareholders should always be paramount. But if a company is highly geared, this cannot be the case: the interests of the creditors will be paramount. Who wants to rank second, third or fourth in a Board's order of priorities?
- ***Make sure managers act like owners.*** It is vital that the managers of businesses understand how value is created — not by issuing equity but by jealously guarding it. We prefer to see genuine share ownership by Boards (as we practice at Personal Assets!) instead of the '*heads I win, tails you lose*' self-issuance of share options.
- ***Invest in companies with high total return on capital employed.*** Avoid cyclical businesses, especially those with high capital intensity. Recovery situations offer borrowed performance. While investors may make money in the short term, someone else will give it back eventually, as and when the economic cycle turns down again. These companies tend to gobble up cash and will turn to shareholders time and again for more. We want to invest in companies that ***pay us to own them***, not vice versa.
- ***Don't ignore history.*** Many analysts and investors focus far too much on the next quarter, or the coming year. Equities are long duration assets. When we buy stocks we consider the outlook for the next decade or more and ask if the business will remain resilient. Financial performance over the previous 10 years is a more important indicator than short term earnings forecasts. The track record shows both how growth has been financed and how shareholders were rewarded by dividends or buybacks.
- ***That which looks statistically cheap is probably dear and vice versa.*** Cheap stocks are usually cheap for a reason. The market can sniff out low quality earnings and will value them accordingly. A low P/E tells you more about the quality of the business than its worth. Great stocks are rarely cheap but they can sometimes be discovered selling at reasonable value, which is when we look to buy them. We are patient. Opportunities will present themselves and, when they do, we make them count by buying percentage holdings, not fractions.

ROBIN ANGUS

Personal Assets Trust Performance



	Value 31 July 2013	1 Year	3 Years	5 Years	10 Years
		Percentage Changes			
Share Price	£344.00	(1.7)	19.7	37.6	68.6
NAV per Share	£340.52	(1.1)	20.7	35.5	73.2
FTSE All-Share Index	3,509.94	19.9	29.3	27.7	71.6
NAV relative to FTSE All-Share Index		(17.5)	(6.6)	6.1	0.9

Top 10 Equity Holdings

Company	Country	Sector	Valuation 31 July 2013 £'000	Shareholders' funds %
British American Tobacco	UK	Tobacco	24,735	4.2
Microsoft	USA	Software	24,407	4.1
Nestlé	Switz	Food Producer	21,060	3.6
Imperial Oil	Canada	Oil & Gas	18,268	3.1
Coca-Cola	USA	Beverages	16,983	2.9
Becton Dickinson	USA	Pharmaceuticals	15,341	2.6
Philip Morris International	USA	Tobacco	14,293	2.4
Sage Group	UK	Technology	13,994	2.4
GlaxoSmithKline	UK	Pharmaceuticals	12,710	2.2
Altria	USA	Tobacco	11,927	2.0
			173,718	**29.5**

Portfolio Analysis

	Valuation 31 July 2013 £'000	Shareholders' funds %
US equities	114,942	19.5
UK equities	71,593	12.1
Canadian equities	21,813	3.7
Swiss equities	21,060	3.6
Australian equities	4,625	0.8
Gold	66,254	11.2
Government bonds (USA, Singapore and UK)	274,703	46.5
Net current assets	15,106	2.6
Shareholders' funds	**590,096**	**100.0**