PERSONAL ASSETS TRUST PLC

FEBRUARY 2014 QUARTERLY REPORT N°. 71

LONDON 2014

On 22 January we held our annual London Shareholder Meeting. We have subsequently conducted our usual in-house post mortem (special thanks to Sebastian's colleague Sean Beck of Troy for his comprehensive and skilful note-taking) and this Quarterly aims to bring those shareholders who couldn't be present at the meeting up to date with the Board's thinking. (Sebastian's presentation slides are on our website at www.patplc.co.uk.)

There isn't space here to deal with everything that arose, from Junior ISAs (too expensive for Personal Assets itself to set up, but available through external providers) to a share split (not just now, but reviewed regularly by the Board) and the relevance or otherwise of total return statistics to Personal Assets (an ongoing debate between the Chairman and me, to which I may return in a future Quarterly). Here I look at four main themes: our alleged institutional bearishness; our investment style and whether we should change it; our investment parameters and whether we should extend them; and our views on QE, deflation and inflation. Then I shall touch on three other topics which came up at the meeting: the dividend; the possibility of Scottish independence after this year's referendum; and the comparison some have made between Personal Assets and Scottish Mortgage.

INSTITUTIONALLY BEARISH?

Has Personal Assets become so institutionally bearish that we have joined those curmudgeonly trolls who predicted ten out of the last two recessions? One questioner did wonder if there were truth in the accusation, and several others also raised the subject of our alleged persistent gloom.

The truth of the matter is that we have been bearish not because we wanted to be (what sort of person would *want* to be bearish?) but because we felt we had to be. Ian Rushbrook and I were snorting bulls during the first half of the 1990s. Even when we began to go more liquid later in the decade in response to what Alan Greenspan called *'irrational exuberance'* in the financial markets, we counterbalanced this optimistically — and highly profitably — with holdings in investment management companies and investment trust warrants.

In Quarterly N°. 51, written just after Ian Rushbrook's death in October 2008, I was at pains to emphasise that we remained, at heart, long-term equity investors:

'As investment conditions gradually return to normality, our aim would be to start building a solid equity portfolio which will not only offer scope for steady capital appreciation but also will produce a growing stream of tax efficient income . . . We acted boldly and decisively when we believed markets to be unsustainably overvalued and thought the world financial system was riding for a fall. The corollary is that we will be equally bold and decisive when we believe that recovery is on its way, that markets are attractively cheap and that the time is right to buy. We can hardly wait.'

At that time our equity portfolio was heavy in oils and banks and light in almost everything else, and we relied on our FTSE 100 Futures to provide us with some diversification within the UK. As for our holdings of overseas equities, they were all in the US and accounted for only a tiny percentage of shareholders' funds. But over the next few months, first the Board acting on its own and then, following his appointment as Investment Adviser in March 2009, Sebastian with the Board's support began to construct a more diversified equity portfolio.

Our list of investments today combines a broad base with a sharp focus on companies which are genuinely growing their earnings rather than just passively benefiting from the expansion in price/earnings ratios that has driven equity markets in general. In January there were signs that investors were rethinking risk in relation to equities in general and emerging markets in particular. Although this has since faltered, Sebastian and I look forward eagerly to a time when we can be fully invested in equities and maybe even geared. At the London meeting Sebastian said he had no wish to spend the rest of his career running funds that were an alternative to equity investing and that his aim was to advise on a fully equity invested trust. The corollary of this is that one day we will not be invested in gold or index-linked securities, which (however much I love the yellow metal) have never been other than a means to an end.

STICKING TO OUR STYLE

Perhaps it's unsurprising that we quite often get asked these days if we plan to change our investment style in the light of our 2013 experience. It's reassuring, however, that most of those asking the question seem to hope we won't rather than hope we will. When a questioner raised the subject at the London meeting, Sebastian's answer was a firm 'NO'.

There's no way that Personal Assets is going to abandon its principles, or its Board and Adviser throw away the experience of a lifetime, because of a year's bad results. That wouldn't be a considered reaction. It would be panic, and panic is the worst possible reason for investing. Besides, anyone who has followed Personal Assets for any length of time knows that we are not the panicking kind.

EXTENDING OUR REMIT?

Another questioner asked if we would consider new sectors for investment, making specific mention

of infrastructure and 'fracking'. While we regularly review which sectors we invest in and which we don't, it is unlikely that we would diversify into those particular industries. For a start, we don't like investing in capital intensive businesses. Furthermore, infrastructure plays like utilities suffer from political interference and heavy regulation. This minimises the returns on capital they are able to generate. Profits can all too easily be regulated away, and the often tempting yields on such stocks are therefore not risk-free. We feel more comfortable investing in companies run by entrepreneurs, rather than by politicians and civil servants.

As regards 'fracking', falling gas prices have led to falling returns and share prices. The shares of AJ Lucas, the Australian company which owns 42% of Cuadrilla, the UK's biggest shale player, are now worth only a quarter of their 2009 value. In addition, there have been big write-offs on shale from BP, Encana and Shell. We shun bandwagons on principle, and although we hesitate to speak of a shale bandwagon at the moment, we are unsure as to the long-term profitability of the shale gas industry.

Also questioned was Personal Assets' lack of exposure to emerging markets and to the 'BRIC' countries (Brazil, Russia, India, China). The Chairman mentioned the latest acronym, 'MINT' (Mexico, Indonesia, Nigeria, Turkey), and noted that the economies, currencies and stock market performance of those countries had deteriorated since the acronym was first coined. Personal Assets, he promised, would never be *'all things to all men'*.

Speaking for myself, I expect such acronyms to proliferate. Might we see 'GAMBLE' (Gambia, Albania, Moldova, Burundi, Laos, Eritrea) and 'LOTTERY' (Lesotho, Oman, Togo, Tonga, Ecuador, Rwanda, Yemen)? Personal Assets' equity investments will continue to be in the developed markets we know and where we benefit from management access, higher standards of law and accountancy, political stability and generally better corporate governance.

Emerging markets are usually higher risk and are not an asset class in which we have expertise. Investors wanting direct exposure to them would in our view be better served by using other trusts specialising in these markets. We do, however, have some indirect exposure to developing countries through our holdings of companies like BAT, Nestlé and Unilever.

The Adviser and Board were then asked about the use of derivatives and property. Ian Rushbrook did sell FTSE 100 Futures very successfully to protect investors' capital in the unusual circumstances of 2007 and 2008, but in today's conditions we think it would be dangerous to sell futures into a strong market, given that the composition of our underlying equity portfolio is very different from that of the FTSE 100 Index.

The performance of Personal Assets in 2013 would have been considerably worse had we elected to sell stock market index futures. This is because we were long of parts of the market that advanced at only a pedestrian pace while being underweight in those parts that raced ahead. We would be more comfortable buying market futures when we felt markets were deeply undervalued and wanted to gain increased exposure through the use of liquid and accessible instruments. (Sebastian did this for Troy in 2002/3 and again in 2008/9.)

What about property investment as a hedge against stock markets? Most Personal Assets investors are already long of property through the houses they own. Furthermore, property prices are generally positively correlated to stock markets and are therefore a poor hedge. Property in 2008 offered no diversification benefit and we do not believe that it would do so today.

QE: Deflation vs Inflation

Has quantitative easing ("QE") impeded economic recovery? In a sort of *Game of Thrones* fantasyland in which the magic fire of QE will hatch the dragons' eggs of growth, the Bank of England has tried to stoke up the economy with £375 billion of newly-minted money, or around 25% of UK GDP. Where has the money gone?

Even now, despite a modest economic recovery, you don't see much of it in higher real output, or in higher employment, or in higher real incomes — average real pay, according to the TUC late last year, has fallen by 7½% since 2008. How can you get strong and sustainable growth if real wages have fallen like that — not to mention zero yields on savings and slashed pension annuity rates, both of which reduce real spending power?

Driving down yields on government bonds was expected to encourage investors, beginning with the banks, to seek out productive new investments offering higher returns. But they didn't. They used the cheap money to bid up the price of existing assets, like bonds, equities and property, just as I fear will happen with Mr Osborne's *'Help to Buy'* scheme.

In the USA, Janet Yellen, who has replaced Ben Bernanke as head of the Federal Reserve, still has her foot on the accelerator and is not reaching for the brakes. QE will not be reversed quickly, either in the UK or in the US. The Bank of England holds one third of all outstanding gilt issuance and if these were reissued it would cause chaos in the bond markets. Moreover, despite all the QE we have experienced and the stored-up inflation we fear will have resulted, we are still vulnerable to a surprise deflationary shock. Emerging countries are struggling because the weakness of the Yen has rendered their exports less competitive compared to Japan, and emerging markets are exporting deflation to the West.

Our holding of gold bullion is our each-way insurance policy against a violent unwinding of QE. How would gold perform in (a) an inflationary or (b) a deflationary environment? Again to quote Sebastian, central bankers are inching along a wobbly rope with a deflationary *dénouement* on one side of the possible fall and an inflationary abyss on the other. The worst of all outcomes would be debt deflation. Index-linked bonds fared poorly last year because of disinflationary developments. If this regressed into full-blown deflation, the stock market would perform very badly. Index-linked bonds would be hit, but not by as much, because conventional bonds would perform

well and index-linked are a hybrid of a conventional bond and an inflation option.

Gold would protect capital in both extreme monetary outcomes, as it tends to rise in value in periods of monetary instability. Sound money goes along with positive real interest rates and unsound money with negative real rates. The 1980s and 1990s were a period of relatively sound money, so holding gold was not necessary. Since 2000 we have had unsound money, monetary policy is rudderless, Mark Carney's forward guidance seems already to have been abandoned, and so gold is today a prudent investment.

One shareholder asked if holding gold were contradictory to a true 'value investing' approach to running money and would be useful only in the most extreme of times, Sebastian replied that *'money is being played with'*. The inflation and currency collapse in Zimbabwe should be lessons for those who tinker with money. We hold gold against the risk of inflation and think that gold will perform better than stock markets if there is an inflationary surprise. If bank lending picks up, then so too will the velocity of money and the inflationary genie will be out of the bottle.

After all that, what about the Euro? Are we as pessimistic as we were? The break-up of the Euro which we thought possible hasn't happened yet, thanks largely to the ECB's governor, Mario Draghi, and to German political will. An eventual break-up is still more likely than not. As regards our own vulnerability to such an outcome, Personal Assets has no direct Euro exposure through Euro denominated holdings. Moreover, Southern Europe is such a small part of our investee companies' operations that even a 40% devaluation by countries there exiting the Euro would cause only a modest hit to profitability — perhaps low single digits for the majority of our investments.

The spotlight this year on Scotland's independence referendum shouldn't obscure the possibility that in 2017 the UK may have its own 'independence referendum' on withdrawing from the EU. The investment implications of this are murky, but the direct effects would be felt most by car manufacturers and UK exporters that are not typical PAT shareholdings.

THE DIVIDEND

Firstly, the facts. On 22 January we declared a fourth quarterly dividend of £1.40 in respect of the year to 30 April 2014 and also indicated that, barring unforeseen circumstances, we intended to maintain the dividend at the current year's rate of four quarterly dividends of £1.40 each for the year to 30 April 2015, making a total of £5.60.

At the EGM on 21 December 2012 shareholders voted to break the link between the dividend and the RPI/CPI and to give the Board flexibility to put capital considerations ahead of revenue. The Circular describing the revised dividend policy did, however, affirm the Board's intention not to overlook the importance to some shareholders of a regular stream of dividends, and the forecast of a maintained dividend for 2015 is a token of our commitment to this.

Given that Personal Assets has chosen not to take advantage of trusts' new freedom to pay dividends out of capital, dividends will ultimately depend on the revenue we earn. At present our net distributable revenue does not cover the dividend, so we are dipping into revenue reserves (revenue earned in past years but not distributed at the time) to make up the £5.60 total. Looking beyond 2015, what might the future hold?

Our revenues over the next two or three years will depend on various things, some of which might work in our favour. Interest rates may rise, allowing us to earn a worthwhile amount on our cash deposits for the first time in years. If, as we expect, the stock markets in which we invest experience a significant fall from their recent levels, we shall add to our equity holdings and so earn more dividend income.

At some time in the future we may also reduce or sell our holding of gold (which produces no income) and index linked bonds (which give us only a low yield) and reinvest the proceeds in higher yielding investments. Lastly, if share buybacks continue, this will be positive for our revenue reserves.

No guarantees can be given. Circumstances may lead us to alter the balance of our portfolio in such a way as to make it hard to sustain our current level of dividend. However, the future is not without hope, although rebuilding our revenue reserves would probably be a higher immediate priority than increasing the dividend.

SCOTTISH INDEPENDENCE

18 September 2014 sees the referendum on Scottish independence. Opinion polls have consistently pointed to a NO vote. However, should the result be YES, it would take at least 18 months before separation became a reality. Complicated international arrangements would have to be worked out and finalised, such as Scotland's prospective membership of the EU and NATO, and further work would also be needed to prepare for the proposed currency union with the rest of the UK.

Independence, if voted for, would become a reality only by 2016 at the very earliest. Shareholders can be confident that in the event of a YES vote the Board would act impartially and do whatever seemed in shareholders' best interests as regards managing their tax affairs and maximising dividend receipts.

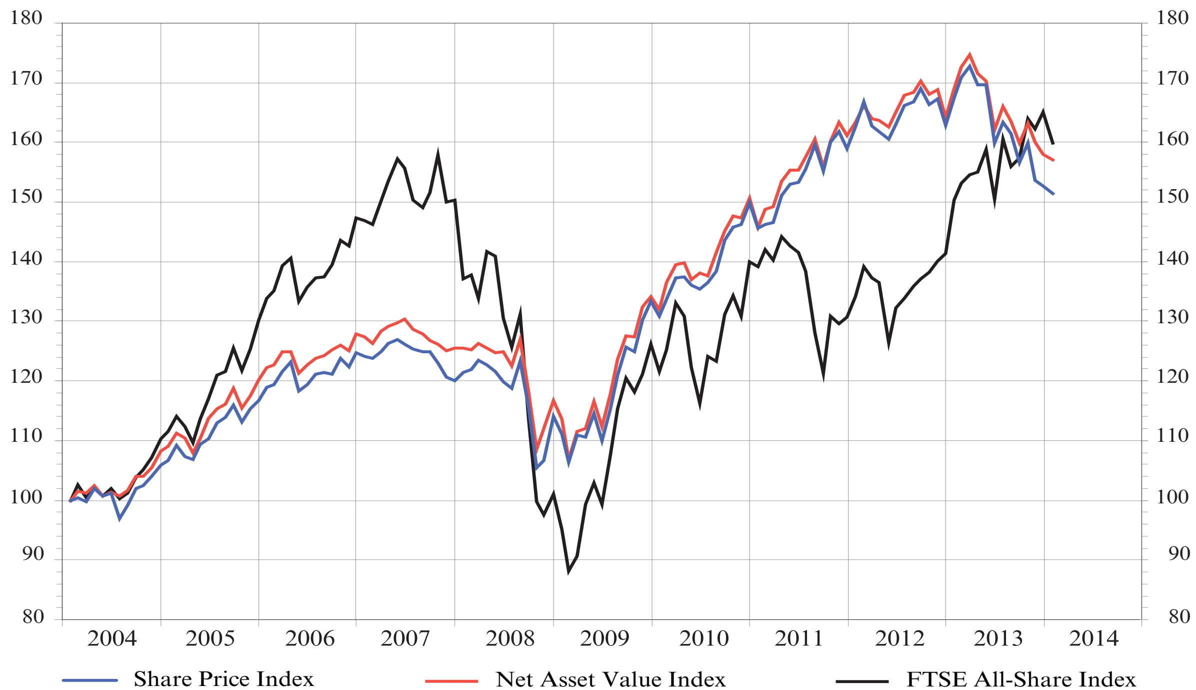
SCOTTISH MORTGAGE

Finally, an interesting comparison several shareholders made in questions submitted for the London meeting was with Scottish Mortgage, recently a star performer. I learned my trade in the late 1970s at Baillie Gifford by helping to manage it, and my wife and I have held shares in it for many years.

While Scottish Mortgage is in the same AIC sub-sector (Global) as Personal Assets, they are very different companies and their performance differs markedly too. Scottish Mortgage has performed spectacularly well in strong markets but suffered steep falls in weak markets, while Personal Assets has consistently demonstrated lower volatility and generally given investors a smoother ride. Many investors hold both trusts as part of a 'barbell' strategy and I have always regarded them as complementary rather than as rivals.

ROBIN ANGUS

PERSONAL ASSETS TRUST PERFORMANCE



	Value	Percentage Changes			
	31 Jan 2014	**1 Year**	**3 Years**	**5 Years**	**10 Years**
Share Price	£318.60	(9.6)	4.0	36.3	51.4
NAV per Share	£322.23	(7.0)	7.7	38.3	57.1
FTSE All-Share Index	3,496.51	6.4	14.9	68.2	59.9
NAV relative to FTSE All-Share Index		(12.6)	(6.2)	(17.8)	(1.7)

TOP 10 EQUITY HOLDINGS

Company	Country	Sector	Valuation 31 Jan 2014 £'000	Shareholders' funds %
Nestlé	Switz	Food Producer	20,891	3.8
British American Tobacco	UK	Tobacco	20,569	3.7
GlaxoSmithKline	UK	Pharmaceuticals	18,288	3.3
Microsoft	USA	Software	18,123	3.3
Coca-Cola	USA	Beverages	16,429	3.0
Sage Group	UK	Technology	16,302	2.9
Imperial Oil	Canada	Oil & Gas	16,221	2.9
Becton Dickinson	USA	Pharmaceuticals	14,814	2.7
Philip Morris International	USA	Tobacco	13,315	2.4
Dr Pepper Snapple Group	USA	Beverages	11,981	2.2
			166,933	**30.2**

PORTFOLIO ANALYSIS

	Valuation 31 Jan 2014 £'000	Shareholders' funds %
USA equities	116,843	21.1
UK equities	74,058	13.4
Swiss equities	22,816	4.1
Canadian equities	19,819	3.6
Australian equities	3,285	0.6
Gold	60,990	11.0
Index-Linked Government Securities	123,327	22.3
Cash and cash equivalents	132,399	23.9
Shareholders' funds	**553,537**	**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