PERSONAL ASSETS TRUST PLC

JUNE 2014 QUARTERLY REPORT No. 72

A TALE OF TWO TRUSTS

An old friend of mine with a fondness for investment trusts comes to see me for a coffee every so often and to pour out her miseries and regrets. This might seem an odd thing for her to do, because she's done rather well from her investments over the years (she's also one of the most intelligent people I know), but she suffers from what might be called *'chronic comparisonitis'* — a common condition among investors, and a side effect of the otherwise excellent practice of portfolio diversification.

She has two main investment trust holdings. One is Personal Assets, and the other is a large and well-regarded Scottish generalist. As is only to be expected, her two trusts never perform exactly in line with each other. They have different investment philosophies and aim to fulfil complementary needs. Personal Assets has its cautious, low-risk approach to investment while the other trust is managed more conventionally and sits somewhere in the middle of the risk spectrum.

Alas! As soon as you hold more than one investment, one of them is an underperformer. Your portfolio has become a league table. Accordingly, always in my friend's mind is the nagging thought that if only she had invested entirely in the trust which has recently performed better, she herself would be better off. She is one of those investors who tends to see things not in terms of risk avoided, but rather of opportunity missed and price appreciation foregone. Diversification of risk is a principle designed to bring peace of mind. In my friend's case, however, it seems to bring mainly vexation and stress.

RISK VS OPPORTUNITY

Nearly 40 years in the investment business have taught me that there is a surprising number of investors who, despite paying lip service to the importance of diversification and minimising risk, worry scarcely at all about risk except during actual market collapses, when it is impossible to ignore it. Instead, they worry that they aren't making as much money as they might, or that other investors may be doing better than they are. Opportunity lost, not danger avoided, is what is generally uppermost in their minds.

THE 'LEAGUE TABLE' PROBLEM

That's why it's so important not to become fixated on the 'league table' approach to performance. If Wisden ranked cricketers only by the number of runs they scored and ignored everything else, the results would doubtless be eye-catching but they would be very misleading. Likewise, it wouldn't make much sense to say that Gordon Banks or Neville Southall were rotten footballers because they never scored goals. They were goalkeepers, and it wasn't their job to score goals.

It isn't enough to look at a portfolio and see which holdings did best and worst. It's also important to look at each holding in the context of why it was bought. Blessed John Henry Newman famously wrote of himself that *"God has created me for some special service; God has committed some work to me which has not been committed to another."* Whether or not that was true of Cardinal Newman, it's undoubtedly true of the constituents of Personal Assets' portfolio. Each asset class and individual stock is designed to do us a special service.

Take our US TIPS and gold bullion, for instance. Last year their lustre was dimmed, but we didn't buy them merely as a speculation, hoping they would go up in price. Rather, we bought them because we wanted them to do a specific job for us — to protect us from inflation and currency debasement.

THE NEED FOR INSURANCE

As it happened, inflation has been quiescent, so our insurance policy against it didn't pay out last year. But that doesn't mean we were wrong to have it. We continue to need it, and that's why we're holding on to our TIPS and gold. Their work for us isn't yet done.

Inflation, in abeyance during recent months, must be lurking somewhere. Nothing is surer that it will rear up and attack us, but we don't know when. If it had emerged during the year to 30 April 2014 we should have been glad of our gold and index-linked bonds, just as if, had there been a falling equity market, we should have been glad of our consumer staples like British American Tobacco ("BAT"), Philip Morris International, Coca-Cola, Unilever and Diageo, which fell in price last year but might well have outperformed an imploding market. And Russia's unforeseen annexation of Crimea and the subsequent events in Ukraine have reminded us that we live in an uncertain world where nasty surprises may be just around the corner.

THEORY VS COMMON SENSE

Troy Asset Management ("Troy"), our Investment Adviser, produced a paper recently on its investment philosophy and the expected return profile from its investment process. The paper began as follows, with words that Ian Rushbrook and I might as easily have written in 1990, when Personal Assets became a self-managed trust:

'Our most important principles are that those who have money should concentrate on not losing it and positive returns should be sought only when the risk/reward profile is attractive. In order to deliver returns to our investors with these absolute characteristics we must consider risk mitigation in similarly absolute terms, as the avoidance of permanent capital loss. It is this investment philosophy that un-

derpins our process and the returns we aim to deliver across all mandates.'

To my delight, the paper took a practical approach to investing and went on to expose with great clarity the flaws in some of the common methods of valuing markets and measuring risk. It concluded that such concepts as the Efficient Market Hypothesis[1], Beta[2], the Sharpe Ratio[3] and the now fashionable Smart Beta[4] reinforce the mind-set that cares about relatives rather than absolutes.

These concepts also suggest that risk is easily isolated, quantified and compared. But risk cannot be captured fully by such measures. We believe that when we analyse stocks there are three primary areas of risk to look for, which James Montier, when at Société Générale, christened *'The Unholy Trinity'*:

- **Valuation Risk** (stocks with qualities we like, but which are too highly priced in the market place);
- **Financing Risk** (companies which we believe to be too highly geared for comfort); *and*
- **Franchise Risk** (companies which have business models that lack staying power).

Excessive risk in any one of these areas has the capacity to lead to permanent capital loss.

THE JOY OF 'COMPOUNDERS'

Let's move on from abstract concepts expressed in algebraic formulæ to stock selection and some good old-fashioned objective value. Among the things that give me joy are the gains generated from the kind of stocks we like to call 'Compounders' — not usually the most immediately exciting investments, but often among the most rewarding ones over the long term.

'Compounders' are typically long established, tried and tested businesses, often but not necessarily international, with strong franchises, conservative balance sheets, positive free cash flow, good dividend records and a history of *'paying their shareholders to own them'*. By this we mean a corporate culture of recognising that the company is in business not to grow as big as possible or diversify as much as possible or aggrandise and incentivise its directors and senior employees (we don't hesitate to vote against incentive schemes that we believe to be too generous, and did so recently in the case of Coca-Cola), but to reward shareholders through growing dividends, share buybacks and other means of enhancing shareholder value.

In late 2008 the Board decided to start building up a portfolio of such stocks. Troy took over as Investment Adviser in March 2009 and by 30 April of that year we had added two notable examples of 'compounders', **BAT** and **Nestlé**, to our long-standing holding in what subsequently became **Philip Morris International**. By 30 April 2010 we had added **Coca-Cola**, **Diageo** and **Colgate Palmolive**, and our portfolio at 30 April 2011 also included **Unilever**.

If to these holdings we add stocks with similar characteristics, such as **Altria**, **Dr Pepper Snapple**, **Sage**, perhaps **Becton Dickinson** and possibly even **GlaxoSmithKline** ("GSK") they accounted at 30 April 2014 for nearly 30% of our shareholders' funds. *(GSK has been one of our duller holdings over the years, but it yields an attractive 4.8%.)* Together they form a solid and dependable core of equities which exceeded comfortably in value our holdings in US TIPS and gold bullion combined.

WHERE ARE WE GOING?

Now is the time to examine our portfolio. Every portfolio tells a story — and if it doesn't, it should do. A portfolio is greater than the sum of its parts. It is an organic whole — not just a basket of individual ingredients but a blend of those ingredients to produce something with a life of its own. It is structured to be able to capitalise on foreseen opportunities and protect against foreseen shocks, but also to have the resilience to respond to the unforeseen. If people ask me what we expect to happen in the next few months, I usually point them to our portfolio and tell them that this is their answer.

What does our portfolio as of 30 April 2014 tell us? What are our hopes and fears, and how does our portfolio demonstrate these? The portfolio consists of five classes of risk assets, together with a sixth asset class consisting of UK cash and cash equivalents. In order of size as at 30 April 2014 the six 'pillars' of our portfolio were as follows:

- **Equities.** 44% of our shareholders' funds was invested in equities, made up of 22% in the US, 13% in the UK, 4% in Canada, 4% in Switzerland and 1% in Australia — all of which are countries with whose politics, law, accounting and corporate governance we feel at home. Holding 44% in equities implies that we are cautious about markets but are not oblivious to the attractions of stocks with solid value and dependable yields which will undergird our performance in the falling market we expect to see sooner or later.
- **UK Cash and Cash Equivalents.** The greater part of the 19% of shareholders' funds represented by this asset class consisted of UK Treasury Bills ("T-Bills"). We do not hold these as investments *per se*, but as another way of holding cash after the Board decided, following 2008, to reduce our amount of cash on deposit in banks. UK T-Bills carry minimal price risk, no interest rate risk and no currency risk, and are the safest way for us to hold large sums in cash.
- **US TIPS.** US Treasury Inflation Protected Securities made up 17% of shareholders' funds. Holding TIPS implies that we are nervous about inflation in the US and about the trouble that Quantitative Easing ("QE") may have stored up for the future. Our US TIPS, like 33% of our holdings of US equities, are hedged against movements in the US Dollar against Sterling.
- **Gold Bullion.** Gold bullion represented 11% of shareholders' funds. It is perhaps Personal Assets' best known investment and is regarded either as the ultimate in uselessness or as the only means of

---

[1] In its strongest form, this suggests that security prices reflect all publicly available information, instantly change to reflect new public information and instantly reflect even hidden or 'insider' information.

[2] A measure of volatility compared to that of the market as a whole.

[3] This measures the expected value of the excess return, or risk premium, per unit of deviation in an investment asset.

[4] Investing in line with an index, but divorced from the size weightings of the constituent stocks — beautifully described by one commentator as *'active management in drag'*.

exchange that has been acceptable at any time and in any place and for any amount throughout recorded history. We see it as money that can't be printed, and notwithstanding the likelihood of volatility in the short term we are holding on to it in the firm belief that the preconditions for a secular bull market in gold remain in place.

- **Overseas Cash and Cash Equivalents.** This was in Singapore T-Bills and accounted for 5% of shareholders' funds. We hold the Singapore Dollar as *'the Swiss Franc of the Far East'* but, like the Swiss Franc in 2011, it surprised on the downside — a reflection of Sterling's strength over the year to 30 April 2014, which inevitably hurt our unhedged foreign currency investments. But the strength of Sterling won't last for ever, and meanwhile we remain glad of the currency diversification our Singapore T-Bills provide.

- **UK Index-Linked Gilts.** These accounted for another 5% of shareholders' funds and we hold them for a reason which corresponds to our reason for holding US TIPS — we are nervous about inflation in the UK as well as in the US, and are concerned that QE may have stored up problems for the future.

'Up, Up and Away . . . '

'Would you like to ride
In my beautiful balloon?
Would you like to glide
In my beautiful balloon?'

The words of the 1967 hit often come to mind when I think of today's markets, and of the US equity market in particular. The chart below shows vividly how it has soared while earnings per share have scarcely moved. More recently, initial public offerings ("IPOs") have proliferated and the delightfully named Alibaba, which controls 80% of all e-commerce in China and in terms of value of goods sold is bigger than eBay and Amazon combined, is tipped to become America's biggest IPO ever. Meanwhile, the Buttonwood column in *The Economist* for May 10 2014 had this to say about the US market's overvaluation:

'GMO, a fund-management group, uses a combination of measures to argue that American equities are 65% overvalued. John Hussman, author of a well-known newsletter, thinks that the range is between 75% and 125%. None of this means the market is about to fall immediately; equities were overvalued for much of the late 1990s but kept on rising. Jeremy Grantham of GMO thinks the S&P, currently between 1,800 and 1,900, may reach 2,250 before the inevitable retreat.'

Interest rates may start to rise next year. How will markets, consumers and governments cope? It is far from clear that investors could handle interest rates that would in the past have been classed as modest — 3% to 4%, say — or, indeed, that governments would welcome bond yields of that level and above. Pent-up inflation from QE may appear on both sides of the Atlantic. And the economic recovery which is already priced into markets may prove more faltering than hoped, while fears of a weakening and slowing down of Chinese growth are nearly universal.

Why Are We Waiting?

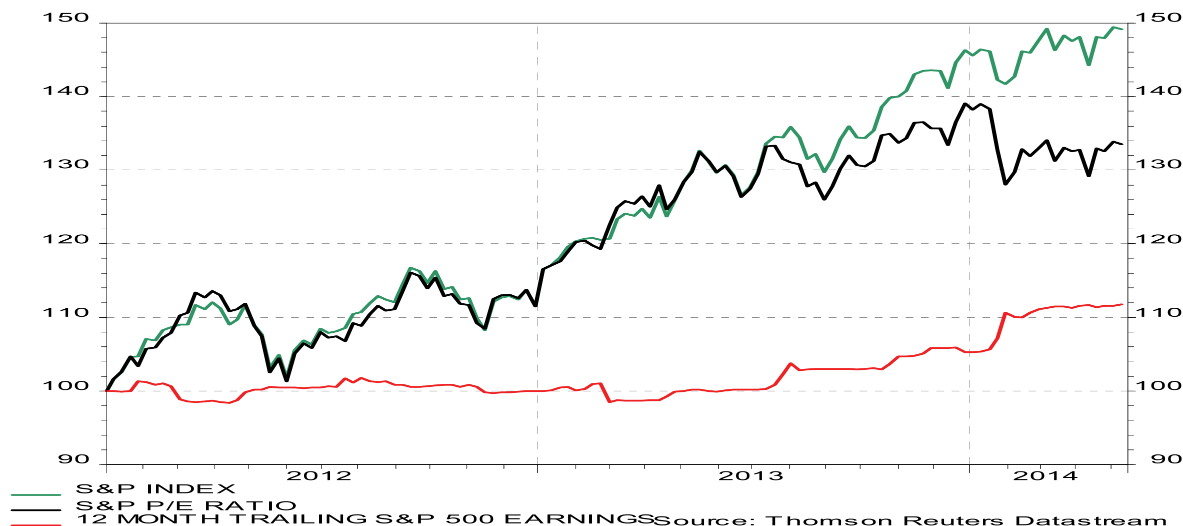
The economy is recovering a bit, we want to buy equities, but at present are holding off. Why? It's because we care about value, not momentum, and we don't believe the multiple expansion we've seen in equity markets is sustainable in the long term. The expectation that material earnings growth will be delivered by the current hesitant recovery is, we believe, at best premature and at worst mistaken.

Markets can remain mispriced for long periods of time. But what we are poised for is our next spell of outperformance, when we will hold our own against falling markets and then use our protected capital to invest in equities at what will again be attractive prices. I can't do better than echo Neil Woodford's sentiments in the *Financial Times* for May 3/May 4 2014:

'My style is to buy more risk-averse and lower volatility stocks and this does not work well in a strong bull market. Central bank money printing has lifted all boats, but that is coming to an end. I'm looking forward to a market driven more by fundamentals and earnings, where there is differentiation between stocks.'

We're looking forward to it too. And when it happens, the friend I referred to at the start of the Quarterly will be so delighted that her Personal Assets shares have started to outperform that she will feel the good news calls for champagne rather than coffee — and, who knows, may even arrive clutching a bottle to show her gratitude . . .

Robin Angus



Personal Assets Trust Performance

	Value 31 May 2014	Percentage Changes 1 Year	3 Years	5 Years	10 Years
Share Price	£333.70	(6.6)	3.6	38.5	57.4
NAV per Share	£336.53	(3.7)	5.6	40.7	62.8
FTSE All-Share Index	3,655.01	5.2	17.1	62.3	66.0
NAV relative to FTSE All-Share Index		(8.5)	(11.5)	(14.7)	(5.2)

Top 10 Equity Holdings

Company	Country	Sector	Valuation 31 May 2014 £'000	Shareholders' funds %
British American Tobacco	UK	Tobacco	25,402	4.4
Nestlé	Switz	Food Producer	22,151	3.9
Microsoft	USA	Software	19,226	3.3
Imperial Oil	Canada	Oil & Gas	19,214	3.3
GlaxoSmithKline	UK	Pharmaceuticals	18,727	3.3
Coca-Cola	USA	Beverages	17,434	3.0
Becton Dickinson	USA	Pharmaceuticals	15,808	2.8
Philip Morris International	USA	Tobacco	14,801	2.6
Dr Pepper Snapple Group	USA	Beverages	14,170	2.5
Sage Group	UK	Technology	13,698	2.4
			180,631	**31.5**

Portfolio Analysis

	Valuation 31 May 2014 £'000	Shareholders' funds %
Equities	256,969	44.7
US TIPS	96,936	16.9
UK Index-Linked Gilts	26,729	4.6
Gold Bullion	59,808	10.4
UK Cash and Cash equivalents	106,227	18.5
Overseas Cash and Cash equivalents	28,447	4.9
Shareholders' funds	**575,116**	**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