PERSONAL ASSETS TRUST PLC

FEBRUARY 2015 **QUARTERLY REPORT No. 75**

'IF WINTER COMES . . .

. . . can Spring be far behind?' Shelley's upbeat conclusion to his *Ode to the West Wind* may seem an odd introduction to a Quarterly weighted down with dreary words and phrases such as *'gloom', 'stagnation', 'deflation'* and *'a barren wasteland'*. But the strange thing is that despite being fed up with stale and indecisive equity markets (as I write, the FTSE 100 has at last managed to close above its December 1999 level after umpteen unsuccessful tries over the years), I nevertheless feel quite cheerful.

Of course the snowdrops and crocuses may have something to do with it, but there's more to it than that. As Marshal Foch is reputed to have said at the Battle of the Marne in 1914, *'My centre is yielding. My right is retreating. Situation excellent. I'm attacking.'* Yes, the times are out of joint. Apart from property developers and investors, private individuals don't seem to want to borrow money any more, even if they're paid to do so. Is it because timid banks are afraid to lend? Or maybe it's because the value of money, which has kept on falling throughout the lifetimes of most of us, has stabilised for the moment and may even be starting to rise. It's certainly the case that while artificial earnings growth has risen thanks to share buybacks and the like, real growth is hard to find.

So why the cheerfulness? It's because the less encouraging that things become and the less justified today's high asset prices appear, the nearer we come to Personal Assets' next leap forward. We've outperformed UK equities in general over the long term not by stellar stockpicking or by spurts of outperformance in rising markets but by the boring expedient of protecting the value of our shareholders' funds when indices fall. This we did in the year to 30 April 2003, and over the two years to 2009, and in the year to April 2012.

Of course, we don't always get it right. The recollection of the year to 30 April 2014 still hurts and will continue to do so. We were hit by what would nowadays be called a *'perfect storm'*. Many of our favourite equities were dull performers; our index-linked bonds had a painful fall as they moved more in line with conventional bonds than we'd expected; and our gold bullion, a poor enough performer in US dollar terms, did even worse in sterling terms. But our style and strategy are unchanged. For reasons I shall spell out later in the Quarterly, a market fall is coming — and we are ready for it. Whether you think of Personal Assets as a stopped clock that's right twice a day or a lily that flowers only once in a decade (and we've been called both), our next spell of outperformance (or market *coup*, as we might call it if we felt like employing an untypically swashbuckling turn of phrase) draws ever closer.

A TOPSY-TURVY WORLD

Now let's look at our reasons for expecting a market fall. To begin with, the world has turned topsy-turvy and negative interest rates are straight out of *Alice in Wonderland*. We expect to be paid for lending, just as we expect to be paid for working. It's part of the natural order of things. We don't expect to have to pay people to use our money for their own profit.

True, there have been times when, in reality if not in appearance, we've had to pay to be allowed to lend. Much of the 1970s, the decade in which I entered the world of investment trusts, saw high nominal interest rates but even higher inflation. This meant that real interest rates were negative. For instance, at the end of 1974 the Bank of England's Minimum Lending Rate ("MLR") was 11½%. If you had lent someone £100 for twelve months at that rate, you'd have got £111.50 back before tax. But given that the Retail Price Index at the end of December 1975 was up by 24.9% year on year, your £111.50 would by then have been worth a mere £89.27 in December 1974 terms and lending the money for a year would have cost you £10.73.

That would have been painful enough, but now we're being asked not only to pay to lend but also to be *seen* to do so. We are starting to experience a world of negative *nominal* interest rates — something we'd previously thought of only as a weird anomaly in a particular time and place, like Switzerland in 1979. But such weirdness is rapidly becoming conventional wisdom.

Taking central banks first, in January 2015 the Swiss National Bank set rates at minus 0.75% and the Danish National Bank followed suit, cutting its rates from minus 0.5% to minus 0.75% in an attempt to weaken the Krone. Among government bonds, yields on ten-year German Bunds have fallen below the equivalent Japanese yields — at the time of writing, 0.35% compared to 0.42%. The yield on Swiss ten-year bonds is close to negative, while Finland and Sweden have recently issued new debt at zero or even slightly negative yields.

Compared to this, a 1.5% yield on ten-year UK gilts and a 1.8% yield on ten-year US Treasuries (which a generation ago would have looked wrong by a factor of eight, since during 1982 US Treasuries briefly yielded over 14%) now seem wildly generous. And for high quality corporate credit the picture is similar. In January, for instance, Unilever, blue chip of blue chips, issued a seven-year €750 million bond with a coupon of just 0.5%.

INTEREST RATES STAY LOW

Interest rate expectations have changed dramatically over the past six months. Although some economists are still forecasting a Fed rate rise in 2015, this is looking less and less likely. In the UK, rate rises were dangled temptingly before investors by the Bank of England as recently as last June but now appear to be off the menu for 2015. Indeed, there is even a slight possibility of a rate *cut* in the UK, if the Bank of England follows other European central banks.

What has happened? It's very simple, really. If nobody wants to borrow money, nobody will pay money for the privilege and so the price of money will remain low. Today we're in a world still awash with money but sadly short of growth.

STALLING EQUITY MARKETS

Moving from the bond markets to the outlook for equities, we find ourselves confronted by two problems, one 'top down' and the other 'bottom up'. The 'top down' problem is that equity markets in general are overvalued, whereas our 'bottom up' problem is that more or less all the individual stocks we like are overpriced. Against today's background of very low (and sometimes negative) bond yields and zero interest rates, equities are still benefiting from being seen as the least bad option. But for how long can this continue?

It can't go on indefinitely, that's for sure. High stock prices need growing earnings to support them, but earnings growth, which has been very low since 2012, is turning negative. Top line growth has been ever harder to generate in a stagnant world and such earnings growth as we've seen has (as mentioned before) been driven not by higher profits but by financial engineering: increased borrowing at ever lower levels of interest to fund share buybacks. Among our equity holdings, for instance, 2015 earnings from Unilever and Philip Morris are expected to be little higher than they were four years ago.

GLOOM . . .

For some time now, equities have been propped up not by corporate earnings but by the magnetic force of ever lower bond yields. It is noteworthy how bond proxies such as utilities and staples (a number of which feature in Personal Assets' portfolio) have performed well despite deteriorating fundamentals. However, the corporate earnings picture is speedily getting worse. This stems from a combination of energy sector downgrades and currency translation, but there is no denying that earnings support for the stock market has turned much weaker at the very time when, following a substantial re-rating of earnings, it was necessary for continuing strength in equity markets that corporate profits would rise vigorously and keep on rising.

If you want to depress yourself, turn to the economic and financial indicators page towards the back of *The Economist* (something I do every week) and run your eye across the line for the Euro area. On 21 February 2015 you would have seen such gloom-inducing statistics as the following: GDP up only 0.9% year on year; industrial production down 0.2%; consumer prices down 0.6%; unemployment at 11.4%; and the yield on ten-year government bonds at 0.38%.

And if you want to depress yourself even more, look at the forecasts from GMO. Founded by Jeremy Grantham and others in 1977, GMO (which manages $120 billion of assets) publishes seven-year forecasts for major asset classes which in the past have proved very accurate. They now predict negative real returns from US large cap stocks (an annual decline of 1.4%) and US small cap stocks (an annual decline of 2.6%). For high quality US equities (to which Personal Assets would be most likely to be exposed) GMO forecast an annual real return of 0.9% over seven years compared to annual returns of minus 1.5% for Treasuries and minus 3.7% for International Bonds. Taking bond markets as a whole, only emerging market debt is forecast to earn real, albeit modest, returns.

. . . STAGNATION . . .

Economies are stagnating in Europe and Japan and there is evidence pointing to China slowing as well. Unsurprisingly, competitive devaluations are now the order of the day. The race to debase which we have discussed for so long took a turn for the worse in January when, as we noted earlier, the Swiss National Bank surrendered the Swiss Franc's peg to the Euro in response to the European Central Bank's determination to see the Euro lower. The breaking of the peg, which had been in place for over three years, shows how currencies will be caught in the crossfire. For stock pickers this makes forecasting corporate earnings increasingly difficult.

In past years currency manipulation has been veiled, but truth will out. Now we are caught up in open warfare and currency volatility has picked up sharply. Is this the first sign that hitherto all-powerful central bankers are losing credibility? Meanwhile, debt-financed fiscal stimulus, like credit market expansion, has probably reached its limit in western economies. Historical studies show that government debts tend to become insupportable when they approach 100% of GDP, a level they have reached or exceeded in many developed countries.

We therefore find ourselves stuck in a barren wasteland which promises us either very low or negative returns in the future. Oscar Wilde famously described a cynic as someone who knows the price of everything and the value of nothing. I wonder if today's definition of a cynic, at least in the world of investment, might be someone who knows the value of everything and therefore can't believe the prices?

. . . AND DEFLATION

Negative real interest rates and a stagnant equity market make for an investment environment which is frustrating and puzzling enough, but now we may be facing deflation for the first time since the 1930s. Deflationary forces, most notably a sharply falling oil price, have been building up. In January 2015 UK inflation as measured by the Consumer Price Index fell from December's 0.5% to an all-time low of 0.3%. (The Office for National Statistics began to publish the Consumer Price Index in 1997.) The Retail Price Index fell from 1.6% in December to 1.1%. The fall came after the Bank of England warned earlier this year that the UK was likely to slip into deflation at some point during 2015.

Now there is talk of 'good deflation' (a spell of falling prices combining with rising wages to boost spending power) versus 'bad deflation' (what has happened to Japan over the last two decades). Deflation sustained over long periods has been rare in the past. This time, however, it may be harder to spring free from the deflationary trap.

Quantitative easing ("QE") averted deflation in 2009/10 because it was used to give the banks liquidity rather than debase the currency (sterling actually strengthened during the QE years to 2012). In the case of Japan and the ECB today, however, QE is specifically intended to debase the currency. Japan and the Eurozone are more competitive exporters than the US and UK, so Japan and Europe will export deflation as their exports become more attractive to buyers in US dollar terms. Interest rates are already scraping along what we assume has to be rock bottom, so a return of inflation is likely to come not from monetary policy, as previously, but from direct government action.

HIGHER RISK, LOWER RETURNS

This is an extremely challenging environment in which to try to preserve capital. Markets are highly dependent on stimulus from central bankers and here we have for some time been seeing the effect of the law of diminishing returns. Valuations, of course, can always go higher. In the late 1990s the valuations of blue chips like Coca-Cola and Colgate were considerably in excess of today. Earnings growth was much stronger then, however. Equities are becoming less attractive relative to cash, and the old adage still resonates with us: when risk outweighs reward, don't buy.

The quality equities we like are too dear and our portfolio is probably as expensive as it has ever been. As a first step, therefore, we have cut back our equity weighting from 44.5% at 31 January 2015 to 40.8% currently by reducing our holdings of **Sage**, **Imperial Oil**, **Altria**, **Dr Pepper Snapple**, **Microsoft** and **Berkshire Hathaway**.

The prices of conventional bonds are poor value in the short term and terrifying in the long term, so we are avoiding them while holding on to our Index-Linked in the expectation that although deflation is the risk in the short term, inflation will return in the medium term.

We are also hanging on to our gold (which gets relatively less expensive to hold as interest rates turn negative) and may add to it. Much of our cash is in UK and Singapore T-Bills, not only because the risk of default is less than with banks but also because banks themselves are more and more reluctant to accept deposits on worthwhile terms, or indeed on any terms.

THE DIVIDEND DILEMMA

In a recent note for the Board on our revenue shortfall compared to the sum required to maintain the dividend at the current rate, I said we were faced with three choices: increasing the portfolio yield; cutting the dividend; or taking powers to 'borrow' from capital reserves.

- Increasing the yield on the portfolio is something many Boards in a similar position have chosen to do. We believe, however, that at this stage in the investment cycle it would almost inevitably lower the quality of the portfolio and, as a result, risk lowering the total return.
- Cutting the dividend might seem the cleanest approach, and thanks to our discount and premium control mechanism it would have no adverse effect on the share price. However, we are conscious of the value placed on our unbroken record of paying either an increased or a maintained dividend ever since 1990. Is there any way that this can be preserved without imperilling our prospects of protecting and increasing *(in that order)* the value of shareholders' funds per share over the long term?
- In 2012, changes to the law made it possible for trusts to seek authority from shareholders to distribute realised capital profits as dividend, and many trusts have taken advantage of the new rules. We were clear from the beginning that this would be a less bad option in terms of protecting and increasing shareholders' funds per share than 'buying' income by acquiring equities we would not otherwise choose to own. But could we reconcile ourselves to the principle of distributing capital as dividend?

A TOTAL RETURN SOLUTION

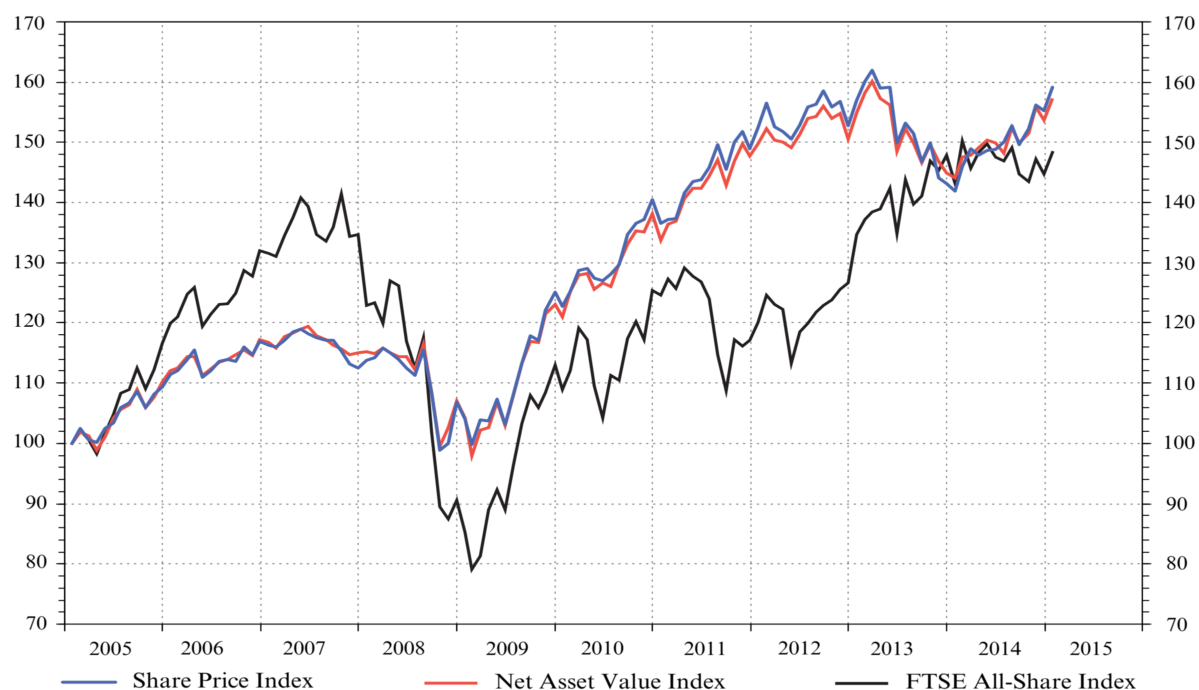
At first we rejected the idea of distributing capital profits in this way. But three considerations have now persuaded us to seek shareholders' permission to do so.

- By paying dividends partly out of revenue reserves we are already, in a sense, distributing capital. Extending the principle to paying out an element of capital profits as dividend would be a genuine total return solution to the dividend problem, doing in a small way what the Cash Withdrawal Option does on a larger scale — paying out a percentage of the total return from a high quality portfolio, rather than reducing the quality of the portfolio in order to maintain the dividend from higher income receipts.
- Compared to net asset value per share ("NAV"), the sums involved are tiny. Constant earnings per share of £4.21 and a maintained dividend of £5.60 would exhaust our revenue reserves in 2016 and in 2017 necessitate a transfer of £1.39 per share from capital. A shareholder liable to pay tax at the top rate of 45% would suffer extra tax of £0.42 per share (30.56% of £1.39, or 27.5% of the grossed-up amount of £1.54) compared to what he would have to pay if we distributed as dividend only our earnings of £4.21. Compared to net assets of £351.89 per share at 31 January 2015, this would cost him less than 0.12% of NAV.
- We intend to draw on capital profits only to maintain the dividend at the present £5.60 per annum, not to increase it; and, unlike other trusts, *we will undertake to treat capital paid out as dividends as a temporary 'borrowing' from capital*. We look forward to when we are fully invested, interest rates are no longer at zero and we are drawing a higher income from our portfolio. Then if in future years we have earnings in excess of £5.60 per share the surplus will be used first to 'repay' the full capital amount distributed before we declare an increased dividend.

A Special Resolution to this effect will be put to you either at the 2015 AGM or at an earlier General Meeting called for the purpose.

ROBIN ANGUS

Personal Assets Trust Performance



	Value 31 Jan 2015	Percentage Changes 1 Year	3 Years	5 Years	10 Years
Share Price	£357.50	12.2	4.5	29.8	59.2
NAV per Share	£351.89	9.2	5.0	30.0	57.3
FTSE All-Share Index	3,621.81	3.6	23.5	36.1	48.4
NAV relative to FTSE All-Share Index		5.4	(15.0)	(4.5)	6.0

Past performance is not a guide to future performance. The value of investments may go down as well as up and you may not get back the full amount originally invested.

Top 10 Equity Holdings

Company	Country	Sector	Valuation 31 Jan 2015 £'000	Shareholders' funds %
British American Tobacco	UK	Tobacco	29,322	4.8
Nestlé	Switzerland	Food Producer	24,025	3.9
Coca-Cola	USA	Beverages	22,134	3.6
Microsoft	USA	Software	21,109	3.5
Philip Morris International	USA	Tobacco	21,088	3.5
Dr Pepper Snapple Group	USA	Beverages	18,974	3.1
Sage Group	UK	Technology	18,444	3.0
Altria	USA	Tobacco	18,230	3.0
Imperial Oil	Canada	Oil & Gas	16,093	2.6
Becton Dickinson	USA	Pharmaceuticals	13,429	2.2
			202,848	**33.2**

Portfolio Analysis

	Valuation 31 Jan 2015 £'000	Shareholders' funds %
Equities	271,689	44.5
US TIPS	106,356	17.4
UK Index-Linked Gilts	28,554	4.7
Gold Bullion	67,011	11.0
UK Cash and Cash equivalents	107,030	17.6
Overseas Cash and Cash equivalents	29,302	4.8
Shareholders' funds	**609,942**	**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