PERSONAL ASSETS TRUST PLC

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YOUR QUESTIONS ANSWERED

In this digest of questions from our recent shareholder meetings I'll start with someone who e-mailed me after the London meeting to say that while he would never advocate buying shares that did not fundamentally represent reasonable value, he queried the wisdom of selling companies because they or the market looked expensive. He wondered why we didn't adopt the *'don't know what the market or share price is going to do, so as long as business remains attractive we will hold'* approach, rather than our usual *'the market or the individual share looks overvalued, so let's sell and sit on cash'*.

There are problems about *'buy and hold'* as a strategy, even when one is confident that the businesses one has invested in remain attractive. For instance, if I'd left on a 10 year trip to Outer Space in 1999 I might well have decided to invest some of my personal wealth in Sage and Microsoft, two consistently good-quality businesses. However, over the decade from 1999 they would have lost me 71% and 48% respectively of my capital. Even good businesses generate poor returns, if bought at the wrong price.

Identifying fair value is the key to successful investment. Sometimes, however, the market demands a higher price than even the best quality investment is worth. This was shown in the early 1970s by the 'Nifty Fifty' – a selection of 'one decision' growth stocks that were thought always to be worth buying and holding, whatever the price. (One of them was Polaroid, a good example of a stock that was first a beneficiary and then a victim of technological change.)

There is also the simple arithmetical fact that if a stock falls in price by one third, say from 100p to 67p, to get back to one's starting price requires a price increase not of 33% but of 50% — something much harder to achieve.

LET THE STOCKS COME TO US

Has today's widespread market belief that there is no alternative to paying up for top quality stocks made classic Personal Assets-type stocks more risky? The likes of Unilever, Colgate and Nestlé have indeed become riskier, because the upwards re-rating of their earnings has left less of a 'value cushion' within their stock prices. We are very conscious of this and have been trying to reduce the extra risk through asset allocation, which has necessitated judicious profit-taking when appropriate (some of these stocks are now only modest holdings within the portfolio).

As a general rule we are happy to wait to be *'paid to own'* stocks — in other words, to be able to enjoy the comfort of that 'value cushion'. Rushing out to embrace prevailing valuations is not our style. We can stand aside because Personal Assets possesses one great strength that many other trusts lack. At any given time we don't have to be fully invested in equities, or indeed in any other investment class. Instead, we are free to buy and sell when we think it most advantageous, not because everybody else is doing so. We have never been scared of being different.

MANAGING OUR HOLDINGS

What valuation method do we use when deciding whether to add to or reduce a holding? First, new holdings have to pass the old Ian Rushbrook test of being of a meaningful size, and a normal investment unit would be 2% of NAV. Now let's take two examples: Microsoft and Dr Pepper Snapple. We first bought Microsoft in the summer of 2010 on less than ten times earnings, a balance sheet full of cash and a *rationale* that the business was more resilient than the bears had suggested. The holding was increased over the years as our confidence remained constant and the valuation remained tempting.

We first reduced it after the Nokia acquisition was announced. We felt at the time that this was a bad allocation of capital, and Microsoft subsequently wrote off the entire $7.6 billion acquisition less than 18 months after acquiring it. More recently, as sentiment dramatically improved and the shares were re-rated to 18 times earnings, we reduced the holding by one third. Similarly, we bought Dr Pepper Snapple at a valuation which, we thought, paid us to own the shares. This holding has been reduced recently on the back of strong share price performance and a material re-rating (in other words, because thanks to our analytical criteria we got our initial purchase right).

HAVE WE A US/UK BIAS?

Does Personal Assets have a bias to the US at the expense of Europe? Throughout its history the trust has typically invested in both UK and US companies, and Ian never held European equities (we did have two small holdings in French companies in the 1980s, before Ian became Managing Director in 1990). At the moment the only European stock we hold is Nestlé, but this does not mean that we will not hold others in the future. If we can buy European stocks we like and which are not, (unlike most of them today) more highly valued than comparable stocks in the US, we will gladly do so. Personal Assets also has the advantage here of being able to draw on the advice and insight of Frank Rushbrook, a Director with many years' experience of successful investing in European stocks.

It's worth adding, however, that where a company is geographically

registered is nowadays of diminishing importance, given the diversity of places from where revenues are generated. We prefer to think along industry lines and less in terms of geographical boundaries. For instance, our long-standing stake in Nestlé is not held as a play on the Swiss economy!

Why Index-Linked Bonds?

At its April 2015 year end, Personal Assets held £132.1 million of index-linked bonds in the US and the UK. Why do we hold them, given that inflation has been so subdued? Because of the prevailing low levels of inflation and their resulting niggardly yields, conventional bonds possess 'asymmetric risk' (no 'value cushion' if inflation and interest rates start rising again). In contrast, index-linked bonds provide inflation protection. It's easy to forget that as recently as 2010/11 the RPI was consistently between 5-6%.

Inflation is not dead, only resting. It may yet surprise on the upside because of:

- a tight labour market as a result of a rise in employment;
- demographics and skill shortages;
- after years of stagnation, consumers are at last enjoying higher spending power; *and*
- the promotion of higher wages by corporations and governments, as with George Osborne's embrace of the 'living wage'.

Index-linked bonds are a store of value and ultimately a source of liquidity as and when we become more positive on equity markets.

Direction of Interest Rates

Had someone ten years ago told me what interest rates would do over the coming decade I wouldn't have believed him. What has happened shouldn't have happened. No-one predicted it and no-one can point to precedents for it. For nearly 40 years I have been reiterating my belief that *'it is never different this time'*. Could I be wrong? Could it be different this time — and not in a good way? For the first time, I seriously wonder.

But that is for another Quarterly. There currently seems to be both a possibility and a desire on the part of the authorities to put up interest rates and begin the reversal of the cycle that has lasted since 2009. Since 2010 there has been plenty of talk of 'renormalisation'. In the UK Mark Carney has had to row back from forward guidance and in the US an increase in rates has been deferred from April to June and now to September. If official interest rates do finally go up it is likely to be via 'baby steps' in increments of 10 or 20 basis points. Too much fuss is made about these immaterial moves; we are unlikely to reach rates of 2 or 3% in the near term.

Might central banks cancel (in effect) the money they are owed? In February a conversion into a perpetual zero coupon bond was mooted in a McKinsey debt study, and Paul Krugman has suggested that the US should mint a $1 trillion coin and deposit it at the Fed as another way of writing off the debt. As governments grow frustrated with central banks' inability to inflate economies, it's likely that they'll direct central banks to print more money to fund infrastructure investments etc. (Yes, just like Jeremy Corbyn's *'People's QE'* . . .)

Gold . . .

Investment trusts are often associated in the popular mind with individual stocks or types of investment — what might be called 'signature stocks'. For instance, when I was starting out in the sector in the late 1970s Edinburgh Investment Trust was known for its holding of London and Scottish Marine Oil ("LASMO"), while in the early 1980s Ian Rushbrook's Atlantic Assets (from which Personal Assets emerged in 1983) was famed for its technology stocks, like Hewlett-Packard and Shared Medical Systems. Personal Assets is widely known today for its holdings in gold and tobacco stocks, even though the two together account for only around 20% of shareholders' funds. It is important, therefore, to make it clear why we hold these investments.

Sometimes people talk about our holding of gold as if we regarded it as a commodity. We don't. To us it is liquidity and we hold it because we don't see an end to central banks' monkeying around with fiat money (money issued by sovereign states). Gold doesn't default or impair, and now that negative *real* interest rates have morphed into negative *nominal* interest rates, holding gold has no opportunity cost when compared to cash deposits. We believe that when faith in central bankers is put to the test, people will return to gold as they lose faith in sovereign money. Furthermore, the recent period of dollar strength has shown gold in a poor light, but when priced in euros, yen or other major currencies gold has looked less vulnerable. Finally, in an environment of rising asset price correlations gold is a valuable diversifier if and when all other asset prices fall together.

. . . Tobacco . . .

Mark Twain, that devoted tobacco-smoker, famously remarked that reports of his death had been greatly exaggerated. The same could be said of the long-predicted demise of tobacco stocks as profitable investments. People were writing the industry's obituary half a century ago, but tobacco shares are still paying high dividends and enhancing their owners' prosperity.

Just as we hold gold from caution, not love, we're not in love with tobacco. We own tobacco stocks solely because of their characteristics as investments; if other investments had the same characteristics, we would hold them just as gladly. The sector typically causes concern because it has done so well for investors for so long. What has been the single best US equity investment over the last 46 years? Altria, the parent company of Philip Morris USA, which has compounded at over 20% per annum. Can it repeat the trick? Tobacco stocks have benefited from being perennially cheap, which means that share buybacks have not only gone a long way but may still have further to go; but we've locked in some of our profits on Altria by reducing our holding following a material rerating from 14 times earnings to 20 times and a yield which has fallen from 5% to 3.5% since we bought it in February 2012.

Are politics making holdings less safe? Tobacco regulation has progressively heightened the barriers to entry and there has been no new competition to incumbents for dec-

ades. Positively, the managements of these companies recognise that they operate within a mature environment and are not chasing growth, instead returning cash to shareholders. If other companies with more favourable growth prospects became cheaper, our tobacco exposure could be a source of funds for such investments.

. . . Pharmaceuticals . . .

Sebastian was asked about pharmaceutical stocks. He replied that he has invested more heavily in the sector in the past, but today he makes no such commitment. Investing in pharmaceutical companies is analogous to investing in oil companies. They are very R&D intensive and it's difficult to replace revenues once a patent has expired. In 1999/2000 many companies undertook M&A in an attempt to overcome this and cut costs to compensate for the lack of growth. Balance sheets have deteriorated over the years and it is very hard to pick the winners from the losers when it comes to successful R&D. The GlaxoSmithKline share price, at around £13-14, is the same as it was 15 years ago, highlighting the poor returns from the stock.

. . . and Technology

Should Personal Assets be investing more in the sort of technology stocks that are changing the world around us, as these seem to be 'under-owned' by investors?

This has not been a cycle in which to be a contrarian. In the technology sector we like investing in software businesses enjoying stable cash flows, such as Sage. Popular technology stocks are 'growing like charities': revenue growth is not equating to profit growth. It is difficult to value stocks of this type and there have been two recent cycles in 2000 and 2008 during which such 'story stocks' fell by amounts within or even exceeding the 40-60% range. IT hardware we wouldn't touch. Product cycles are too short, and the eventual fate of Polaroid (referred to earlier) is always in our minds.

Missing Out on Small Caps?

Does our understandable caution mean that Personal Assets risks missing out on opportunities in small and mid cap stocks? We do look for opportunities in this market segment, but more at mid caps than small caps given our £600 million size, otherwise we would have to buy big stakes in small companies with unacceptably low levels of liquidity. Mid caps have market caps typically between £600 million and £4 billion, and Troy's focus is more at the top of the range. Two areas that have caught our eye are specialist mid cap engineering and chemicals businesses. We are moving through a down cycle, but valuations are still too high and are not reflecting likely earnings downgrades.

What About A Share Split?

Now we have accepted the principle of distributing an element of capital profit as dividends, should we be equally bold and do something about our heavy share price?

It's not the first time we've been asked about this, but is our share price really a problem? Uninvested cash balances within individual investment plan accounts are typically very small. The average value of a Personal Assets ISA is £50,715 and of an Investment Plan £61,610, while the average uninvested cash balance in the former is £279 and in the latter £216. In the present zero interest rate environment investors are not missing out to any significant extent by holding these small cash balances within their Plans rather than in banks or building societies.

The positive aspect is that the heavy share price signals to potential investors the kind of investment Personal Assets represents — a serious commitment of capital by serious long-term investors.

What About A UK Split?

Politics is full of surprises. We never imagined that George Osborne, in his first all-Conservative Budget, would make the taxation of dividends for larger private investors higher and more complicated than before, or that 30 years after 'Gorbymania' Britain would be gripped by 'Corbymania'. We did, however, think that the question of Scottish independence would have died down, for some years at least, after the referendum in September last year delivered a 55/45 victory for those seeking to continue the union between Scotland and the rest of the UK. Few predicted that in the May General Election the SNP would all but sweep the board in Scotland, albeit with the support of just 50% of votes cast north of the border and only 36% of those registered to vote.

The Board's primary concern is protecting shareholders' interests. While Personal Assets may be registered in Scotland, it is listed on the London Stock Exchange and we estimate that at least two thirds of the shares are held south of the border. Moreover, we don't at present own any public companies registered in Scotland. The discussions about matters of common interest that have been taking place with other Scottish-based investment trusts will undoubtedly continue, and if ever Scotland were to separate from the rest of the UK the Board would have ample time — years, not months — to deliberate on the question of residence.

Yes, The Past IS A Guide

I'll end with a shareholder who asked why, given the incessant repetition in investment documentation of the mantra that *'past performance is no guide to the future'*, the Adviser's presentation was full of material relating to the past.

As it happens, I disagree with conventional wisdom on this point. Past performance can indeed be a guide to the future, although neither an infallible nor a universally applicable one. Every political pundit, stock analyst and racing tipster acts on the belief that the past can guide us, and 'horses for courses' is here applicable metaphorically as well as literally. I can make a fair stab at predicting how Personal Assets will do in both absolute and relative terms in different types of market. In 2013-14 I would have got it wrong, but long-term holders will vouch for the essential predictability of our returns most of the time, as well as the predictability of the returns from other trusts which have a consistent investment approach. Investment management is hard enough without ignoring the lessons the past can teach us — and when history is forgotten, people make mistakes.

Robin Angus

Personal Assets Trust Performance

	Value 31 Aug 2015	Percentage Changes 1 Year	3 Years	5 Years	10 Years
Share Price	£338.50	(1.3)	(3.6)	16.2	41.2
NAV per Share	£339.45	(0.5)	(1.7)	16.9	42.5
FTSE All-Share Index	3,434.66	(5.6)	15.5	27.4	29.2
NAV relative to FTSE All-Share Index		5.4	(14.9)	(8.2)	10.3

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 Aug 2015 £'000	Shareholders' funds %
British American Tobacco	UK	Tobacco	27,161	4.6
Philip Morris International	USA	Tobacco	23,490	4.0
Nestlé	Switzerland	Food Producer	22,642	3.8
Coca-Cola	USA	Beverages	20,751	3.5
Sage Group	UK	Technology	16,442	2.8
Microsoft	USA	Software	15,324	2.6
Altria	USA	Tobacco	15,201	2.6
Dr Pepper Snapple Group	USA	Beverages	14,023	2.4
Becton Dickinson	USA	Pharmaceuticals	13,593	2.3
Imperial Oil	Canada	Oil & Gas	12,094	2.0
			180,721	**30.6**

Portfolio Analysis

	Valuation 31 Aug 2015 £'000	Shareholders' funds %
Equities	240,348	40.6
US TIPS	101,965	17.3
UK Index-Linked Gilts	27,915	4.7
Gold Bullion	59,077	10.0
UK Cash and Cash equivalents	141,292	23.9
Overseas Cash and Cash equivalents	20,874	3.5
Shareholders' funds	**591,471**	**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