PERSONAL ASSETS TRUST PLC

FEBRUARY 2016 QUARTERLY REPORT No. 79

A DATE FOR YOUR DIARY

In place of the Personal Assets London shareholder meeting we have held in recent years, this summer our friends at Troy are hosting an investment trust presentation featuring Personal Assets Trust and Troy Income & Growth Trust. This will take place at 2.30 pm on Thursday 14 July 2016 at the Royal Institution of Great Britain, 21 Albemarle Street, London W1S 4BS. To indicate an interest in attending, please contact Troy directly on troy@taml.co.uk

A TURBULENT START TO 2016

January 2016 was quite a month in world markets *(although February bids fair to be more extraordinary still)*. Oftener than not (19 times out of 33 since its launch in 1984, to be exact) the FTSE 100 has risen during January, but not this time. Having ended 2015 at 6,242.32 (a level it hasn't managed to claw its way back to since), by close of business on 29 January 2016 it had fallen to 6,083.79 after having hit a low of 5,673.58 on 20 January.

As is so often the case, the price of Personal Assets held up while the UK market fell, reminding investors that, while Personal Assets may not make you a fortune, it *will* help you hold on to whatever in the way of a fortune you've already got. During January our share price rose by 1.2% while the FTSE 100 fell by 2.5% and our comparator, the FTSE All-Share, was slightly weaker and shed 3.1% of its value.

Over the nine months since our 30 April 2015 year end the picture for Personal Assets in relative terms looks even healthier, although we try always to keep in mind the maxim of Bobby White, our Chairman between 1994 and 2009, that you can't eat relative performance. While our share price barely moved over the period, rising from £350.70 to £353, the FTSE All-Share dropped by 11.3%. This means that by 29 January 2016 we had succeeded in outperforming our comparator by 13.5% over our financial year to date.[1]

ANATOMY OF OUTPERFORMANCE

How did we achieve this degree of outperformance — or, perhaps better, how did we succeed in protecting shareholders' funds as markets fell? Since this edition of the Quarterly stands on its own and is not accompanied by an annual or half yearly report, it may be useful to examine our nine months' performance figures in some detail.

(Please note that all percentages shown below for market or stock performances are in Sterling.)

Our net asset value per share ("NAV") rose by 1.9% between 30 April 2015 and 29 January 2016 while the FTSE All-Share, as noted earlier, fell by 11.3%. With the exception of our tiny Canadian equity portfolio (3.1% of shareholders' funds at the beginning of the nine month period, 2.6% at the end of it), in which **Imperial Oil**'s 24.7% decline far outweighed the 6.0% rise in **Agnico Eagle** to result in a drop of 18.9% overall, every other segment of the portfolio comfortably outperformed our comparator.

While the figures I'm about to quote are not exactly comparable with one another (they take no account of purchases and sales during the period), they do give shareholders a general indication of how and where we held our ground and even made progress during a spell of falling markets.

- Our most powerful engine of outperformance was our US equity stake. It grew in value by 15.0% over the period and increased from 21.2% of shareholders' funds at 30 April 2015 to 24.7% at 29 January 2016, propelled upwards by sizzling performances from some of our US blue chips such as **Dr Pepper Snapple** (up 36.3% since 30 April 2015, and on which we have already taken some profits), **Altria** (up 32.3%), **Microsoft** (up 22.7%), **Philip Morris International** (up 16.8%) and **Coca Cola** (up 14.6%). These highly gratifying price gains compare with a rise of only 0.8% in the S&P 500 and demonstrate how the upward rerating of stocks offering quality earnings and decent dividend streams continued undiminished during the period.
- The 21.6% of our portfolio invested in index-linked bonds at 30 April had grown to 22.9% by the end of the period, helped by rises in value of 0.4% in the UK and 6.0% in our proportionately much larger holding of US TIPS.
- Cash and treasury bills remain essentially unchanged in price and thus will inevitably outperform a falling market. At 29 January 2016 we held 21.5% of our shareholders' funds in cash and treasury bills compared to 28.2% at 30 April 2015. The drop of 6.7% reflected some modest purchases of equities in the US and UK (our total equity percentage rose from 40.1% at 30 April 2015 to 45.3% at 29 January 2016 as a result of both price appreciation and net new investment) together with price appreciation in other segments of the portfolio.
- At 29 January 2016 we had 14.0% of funds invested in UK equities compared to 11.8% at 30 April 2015. Over the period our UK holdings rose in value by 17.2% overall, particular bright spots being gains of 27.8% from

[1] At the time of writing (16 February 2016) the FTSE All-Share is down 14.7% since 30 April 2015 while our share price is up 0.9%, giving us an 18.3% outperformance over the period. Markets have been so volatile in 2016 so far, however, that by the time you receive this Quarterly the figures may be startlingly different.

Sage Group (we've taken some profits on Sage) and a solid 8.5% and 7.6% respectively from those blue chips *par excellence*, **British American Tobacco** and **Unilever**. We also acquired holdings in **A G Barr** and **PZ Cussons**.

- Our holding of gold bullion, 10.1% of shareholders' funds at 30 April 2015, edged up by 1.5%, to 10.3% of funds at 29 January 2016.
- **Nestlé**, our only Swiss holding, gained 1.3% in value to stand at 4.0% of funds (same).

As I've remarked before, my answer to investors who ask me what I expect from markets over the next year is to tell them to look at the portfolio as it currently stands. We're a little more bullish on equities than we were at our 30 April 2015 year end (and hope to be a lot more bullish on a twelve month view as prices fall further); we're nevertheless prepared to take profits on stocks that have got ahead of themselves; gold bullion, our insurance policy against a loss of faith in central bankers, has started to rise from its recent lows; we still have plenty of buying power in the form of cash and treasury bills; and our index-linked investments provide us with ballast in stormy seas while also being a potential source of additional buying power.

What Has Been Happening?

What has caused the recent turmoil in world markets? China has never been out of the news, and China today (to borrow Churchill's famous description of Russia) is *'a riddle wrapped in a mystery inside an enigma'*. In recent years many investors and commentators have got into the habit of holding up China as the answer to all the problems of the world economy — the unstoppable engine of growth and the universal balancing item to even out the deficits of the West. Now, however, economic growth is faltering and the default answer to all our troubles has become the default question mark.

Today we inhabit a low growth world in which trade has collapsed to near 2008 levels, commodity prices have crashed and corporate profitability has fallen. In the vivid words of Nigel Wilson, chief executive of Legal & General:

'We are heading for a world of zeros, including zero inflation, zero growth in per capita GDP, and zero growth in productivity.'

And it might be even worse than that. We already have negative interest rates in some countries. Negative inflation (better known as deflation) and economic contraction may not be likely but are not impossible. To illustrate our current thinking, here are four areas of concern that have hit the headlines (or, at least, featured in the news pages) in January and seem to me significant for the future:

- The protracted and seemingly unstoppable upward re-rating of blue chip equities.
- The ever more thinly stretched and vulnerable level of cover for UK equity dividends.
- The weapon of negative interest rates the Governor of the Bank of Japan has chosen to use in Japan's battle against deflation.
- The increasingly pessimistic chorus of market comment we are experiencing, occasionally tipping over from doom and gloom into outright scaremongering.

The Re-Rating of Blue Chips

During the early weeks of 2016 the re-rating (especially in the US) of high quality, cash generative businesses which was so prominent a feature of 2015 scarcely hiccupped. It's important to grasp what a striking feature of markets this has been in recent years. According to Andrew Lapthorne of Société Générale, the entire 44% rise in the Morgan Stanley Capital International ("MSCI") World Index between 2011 to 2015 can be explained by increases in valuation — corporate earnings during those years actually *fell*. As Sebastian Lyon, our Investment Adviser, ruefully remarked, it seems that 20 times earnings is the new 15 times.

A trend is a trend only until it stops, and eventually trends always do. While many predict that this particular trend can go on for a bit longer, it can't go on for ever. Re-ratings rightly occur when the quality of earnings improves, but this is not what is happening today. Instead, judging by the lack of growth and increasing leverage the quality of earnings has deteriorated since 2011. Our view is that most of these recent re-ratings will not, and cannot, be maintained. They will correct themselves, and it is our hope that the downswing of the pendulum will be as unreasonably exaggerated as the upswing has been. Should this be the case, we will be gleeful buyers of our favoured stocks.

Doomsday for Dividends

A substantial, well-covered and growing dividend stream to which a company's management is firmly committed ranks high among the criteria I look for in an investment, and the yield on the UK market has always been for me an important buy or sell signal. As I write, the yield on the FTSE All-Share has topped 4%, which many regard as a green light for buying. On past form I should be getting excited. Why, then, am I entirely unmoved?

Rather than being a buy signal, a high yield (whether on a single stock or on the market as a whole) can also be a warning sign. This is what we believe is happening today. Again according to Andrew Lapthorne of Société Générale, payout ratios in the UK are at their highest for 40 or 50 years. Even so, the payout ratio may go still higher in the short term. This is because, like the banks in 2008 or insurance and telecommunications shares in 2002, the mining and oil companies may pay one last dividend before making the cut they know to be inevitable.

In the UK, 25% of all dividend income comes from oil and mining. **Glencore** and **Anglo American** have already indicated that they will pass their dividends altogether and on 11 February **Rio Tinto** announced that it was abandoning its progressive dividend policy and would cut its dividend by just under 50% in 2016. **BHP Billiton**'s 11.5% yield is a clear signal that investors expect the dividend to be slashed. That is also what the consensus on **Royal Dutch Shell**, **BP** and **Antofagasta** is telling us.

What's more, there is a risk that the cuts may be more radical than forecast — something that savage action from companies reporting early would make it easier for the rest to do.

Nor are dividend worries confined to oil and mining stocks. My colleague Charlotte Yonge of Troy recently produced a review of likely dividend cuts which makes chilling reading. In addition to those mentioned earlier, there have been cuts from FTSE 100 stocks like **Standard Chartered**, **Rolls Royce** and **J Sainsbury**, and others are likely to follow. If we factor in potential cuts over the next few years, the real market yield could be as much as 1% lower than its apparent level.

We must also bear in mind that many companies during this cycle have increased their payout ratios. Even BAT, a long term favourite of ours which we have always seen as a sustainable payer, has reduced its dividend growth rate from high single digits to low single digits. Investors' increasingly desperate scrabble for income has meant that company managements in this cycle have pumped up shareholder rewards as far as they can go.

The same is true of the US, where over 100% of free cash has been used up on dividends and buybacks. As cash flow is affected by a cyclical downturn, something has to give. For many companies that do not cut their dividends, growth is likely to be much slower. If companies were to pay out more normal earnings percentages (i.e. at the 10 year average median payout ratio), the yield on the UK market would be more like 2.4%. Beware of the effect this would have on the level of the equity market. Adjustments to more normal valuations combined with earnings falls lead to materially lower prices.

THE COST OF NOT INVESTING

Those who feel it incumbent on them to be fully invested in equities at all times, take note — cash is such a valuable investment resource that sometimes you have to pay to hold it. On 29 January 2016 Haruhiko Kuroda, Governor of the Bank of Japan — Kamikaze Kuroda, as he has been dubbed — surprised world markets and set the Nikkei (temporarily) skyrocketing by cutting Japanese interest rates to a negative 0.1%.

Why did he do this? Because, in the words of Kiichi Murashima, an economist at Citigroup in Tokyo:

'Experience over the past few years suggests lower rates do not transmit strongly to growth and inflation.'

Conventional weapons had failed and the Bank of Japan believed that something more was needed. By his action, Mr Kuroda has not only caused Japan to join the club of existing negative interest rate countries like Switzerland and Sweden but has also opened the door to a further expansion of negative interest rates and a further reduction on interest paid on commercial bank deposits — the Bank of Japan has stated that *'it will cut the interest rate further into negative territory if judged as necessary'*. Such further action is seen as likely, if not inevitable, the general expectation being that the measures so far are unlikely to prove effective.

I used to visualise the Japanese market as lying gasping in an oxygen tent — the oxygen being quantitative easing. These days, markets increasingly remind me of TV hospital dramas in which anxious medics use defibrillators to deliver electric shocks to patients' chests in a desperate attempt to revive them. And on 9 February, in a CNBC article headed *From ZIRP to NIRP* (i.e. from Zero Interest Rate Policy to Negative Interest Rate Policy), I read as follows:

'Negative interest rates in the US may seem like a far-fetched idea, but the Federal Reserve is telling banks to prepare, just in case. For the first time ever, the governing agency and US central bank is requiring banks to include, in a round of stress tests commencing this year, to prepare for the possibility of negatively yielding Treasury rates. The scenario is purely hypothetical and not a forecast, according to a January 28 Fed news release. However, the development is part of a larger scenario of a world where zero rates are morphing into negative rates.'

Lord Turner, Chairman of the then Financial Services Authority 2008-13, warned on the same day that without *'radical policies'* the UK economy could be stuck with low interest rates almost indefinitely, commenting that *'interest rates in the UK may not go up beyond 2% by 2020'*. At the time of writing, even interest rates of 2% seem like a happy dream — except, of course, if you are a borrower.

THE BEARS ARE GROWLING

Meanwhile, the mood in the market place has increasingly become one of alarm. It was no surprise when the notoriously pessimistic Albert Edwards of Société Générale (Sebastian and I are cock-eyed optimists compared to him) predicted that this year the US stock market will fall by 75% and that we may be heading for another massive global recession. He also claimed China is running out of spare capacity in its foreign-exchange reserves and will have to float the renminbi as a free currency. It was, however, a shock when on 12 January a research note from the Royal Bank of Scotland told investors to run for cover because 2016 would be a *'cataclysmic year'* for markets. The note urged:

'Sell everything except high quality bonds. This is about return of capital, not return on capital. In a crowded hall the exit doors are small.'

Then Russell Napier, author of *Anatomy of the Bear: Lessons from Wall Street's Four Great Bottoms*, overrode his usual two-week publication cycle for the first time ever to warn that Christine Lagarde, Managing Director of the International Monetary Fund, had made a speech indicating that we are much nearer to the imposition of capital controls as part of a new structure for the global monetary system than had been previously recognised. Russell also warned that calls upon the capital of the World Bank and the IMF were already growing, making capital controls more likely and increasing the pressure for *'safer capital flows'*.

Given that my early years in the investment world were stifled by the suffocating effects of capital controls, the thought of their return does not cheer me. And there are other worries lurking in the shadows, like the troubles of Deutsche Bank and the twin possibilities of BREXIT and President Trump. But we are working hard to protect our capital so that we have the maximum possible stake money to hand when the next bull market begins. At first only in relative terms, but then (we hope) in the form of solid capital gains, there should be more outperformance on the way.

ROBIN ANGUS

Personal Assets Trust Performance

	Value 31 Jan 2016	Percentage Changes 1 Year	3 Years	5 Years	10 Years
Share Price	£353.00	(1.3)	0.2	15.2	41.1
NAV per Share	£356.54	1.3	2.8	19.2	42.1
FTSE All-Share Index	3,335.90	(7.9)	1.5	9.6	13.9
NAV relative to FTSE All-Share Index		10.0	1.3	8.8	24.8

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 2016 £'000	Shareholders' funds %
British American Tobacco	UK	Tobacco	30,440	5.0
Philip Morris International	USA	Tobacco	28,431	4.7
Nestlé	Switzerland	Food Producer	24,400	4.0
Coca-Cola	USA	Beverages	24,400	4.0
Microsoft	USA	Software	20,748	3.4
Sage Group	UK	Technology	16,754	2.8
Altria	USA	Tobacco	16,280	2.7
Dr Pepper Snapple Group	USA	Beverages	13,701	2.3
Colgate Palmolive	USA	Personal Products	13,410	2.2
Becton Dickinson	USA	Pharmaceuticals	12,039	2.0
			200,603	**33.1**

Portfolio Analysis

	Valuation 31 Jan 2016 £'000	Shareholders' funds %
Equities	273,757	45.4
US TIPS	110,145	18.2
UK Index-Linked Gilts	28,324	4.7
Gold Bullion	62,525	10.3
UK Cash and Cash equivalents	121,205	20.0
Overseas Cash and Cash equivalents	8,684	1.4
Shareholders' funds	**604,640**	**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