PERSONAL ASSETS TRUST PLC

SEPTEMBER 2016 QUARTERLY REPORT Nº· 81

A TURN-UP FOR THE BOOKS

'In his first week as Prime Minister Mr Corbyn is scheduled to have talks in Washington with President Trump and in Paris with President Le Pen before flying to Dublin to try to settle the details of Ireland's humiliating €13 billion bail-out of the UK, which is to be funded by Apple's EU imposed tax settlement. The terms of the Irish loan include a commitment by the UK to join the lengthening list of countries introducing capital controls . . . '

Well, it seems that anything can happen nowadays. Brexit took me by surprise. Like most people, I had expected the Remainers to win. But Lord Melbourne's observation on the passage of the Catholic Emancipation Act in 1829 shows how history can repeat itself:

'What all the wise men promised has not happened, and what all the damned fools said would happen has come to pass.'

Was Michael Gove on to something when he suggested that the British people had had enough of 'experts'? Distrust of *bien pensants* and the *cognoscenti* may be one of our national traits. (Note that we have had to borrow the words from foreign languages, since no English terms properly express their meaning.) And Lord Salisbury, as eminent and as quotable a Prime Minister as Lord Melbourne, had arrived at the same conclusion when he wrote in 1877:

'No lesson seems to be so deeply inculcated by the experience of life as that you should never trust experts. If you believe doctors, nothing is wholesome: if you believe the theologians, nothing is innocent: if you believe the soldiers, nothing is safe. They all require their strong wine diluted by a very large admixture of . . . common sense.'

DON'T OVERSTRESS POLITICS

In short, Michael Gove, Lord Melbourne and Lord Salisbury agree in pointing out that John Bull can be unpredictable when he wants to be. And if I was unprepared for Brexit, I was even less prepared for all the political shenanigans that followed — weeks of ever more sensational headlines suggesting that not only the Conservatives but also Labour and perhaps the British political party system itself would implode.

Fortunately, such shenanigans need not much concern us. Most people would be surprised if they knew how little the stock market is affected by purely political news. Elections come and elections go, but it's the economy, and the markets which reflect it, that go on for ever. With a few notable exceptions, like Gordon Brown's short-sighted and disastrous raid on the pension funds in 1997, the damage even the most meddlesome of politicians can do is blessedly limited.

One of the reasons I came into the business was curiosity about what moved the market. Again and again I would hear or read in the daily stock market reports that shares in London had *(say)* fallen because of riots in Ecuador or risen because of peace talks in Yemen. I found such explanations unconvincing at the time, and I soon discovered that they seldom came anywhere close to the truth. They were just well-meant attempts to explain complicated happenings in the context of the day's news headlines.

In my time I've seen the stock market compared to anything from a mettlesome stallion to a hyperactive child. How might we personify it today? Given all its unpredictability and capriciousness, perhaps as Boris Johnson. Certainly his namesake, Edward Crosby Johnson II, founder of Fidelity Investments, summed things up accurately half a century ago when he described the market as *'endlessly fascinating, endlessly complex, always changing, always mystifying'*.

EXPLAINING THE *'BREXIT BOOM'*

What, then, of the *'Brexit Boom'* or *'Brexit Bounce'* which, after weeks of gloomy predictions of financial meltdown if we voted to leave the EU, saw the FTSE 100 Index rise by 9.5% between 23 June and its post-Brexit peak on 15 August? It would be nice to think this was because voting to leave the EU had instantaneously unleashed within Britain a new dynamism, a new entrepreneurial spirit and a new drive to succeed. Well, perhaps. But even if it *has* done, we won't see the evidence for a few years yet. In the short term, the explanation for the recent stock market bounce is very simple and has nothing to do with the (as yet) unknown terms on which Brexit will eventually take place: *'It's the currency, stupid!'*

Floating exchange rates mean that today we don't need old-style devaluations like Harold Wilson's *'pound in your pocket'* exercise of 1967. But a short, sharp fall in the currency, in whatever way it comes about, acts as a short-term tonic. It makes exports cheaper to foreigners and hence more competitive, and makes imports dearer in the home market and hence less tempting. This is what caused the recent market upsurge, and as we get used to the lower exchange rate for Sterling the tonic effect will wear off.

What of the longer-term outlook? Recently I came across the maxim, *'Never trust a forecast with a decimal point'* — in other words, beware the false precision that the Chairman calls *'spurious accuracy'*. (It applies to performance statistics too.) Long-term forecasts of Brexit's effect on the economy are not just inaccurate. They are worse than inaccurate. They are useless and hence dangerous. I can't say at this stage whether leaving the EU will make us better off or worse off once the full consequences of exiting are clear. It might go either way. In the long run, however, I have no doubt that the UK economy will manage to survive whatever Brexit throws at it.

Where Are We Now?

During the recent market bounce Personal Assets achieved more or less the same gain as the FTSE 100. When, as I expect, there is a reaction, we will hope to fall by considerably less and so be better positioned to exploit the bull market which will one day come. Until then, we are still having to operate within an increasingly surreal investment environment.

There has never been a time like this before. Our maps are inaccurate, our compasses no longer work and our investment SATNAV (dare I say PATNAV?) is defective and keeps going on the blink. I've often poured scorn on the idea of a *'new paradigm'* in the investment world such as the one mistakenly identified in the late 1990s, when everyone was talking about the *'new economy'* and *'clicks not bricks'*. But today I'm forced to recognise that there *is* a new paradigm, and it's a most depressing one — no interest rates and next to no growth, and spreading worldwide economic stagnation out of which it is difficult to see an escape route.

Andrew Sentance, who is Senior Economic Adviser to PricewaterhouseCoopers and was regarded as an inflation hawk during his 2006-11 stint on the Bank of England's Monetary Policy Committee, accurately identifies the problem as one of disappearing interest rates:

'After more than seven years of economic recovery, interest rates have not yet risen — and now they are being cut further. The interests of savers seem to be totally disregarded in the calculus of the Monetary Policy Committee, while the need to keep down the cost of borrowing is the top priority. In this environment, can there be any confidence that interest rates will return to any sort of normality? A healthy well-functioning economy should have a level of interest rates which at least offsets the expected rate of inflation.'[1]

The Fatal Cure

I would go even further than Dr Sentance and say that the near demise of interest rates is a moral issue. Lenders should be entitled to a fair return on money which they allow others to use, and the government and central banks are preventing it. This cannot be good for the long-term health of the economy, which depends on the efficient and appropriate use of capital.

Where have we gone wrong? The financial crisis of 2007-8 was so grave that co-ordinated remedial action by governments and central banks was probably unavoidable. But in Quantitative Easing ("QE") governments and central banks managed to come up with a cure that was worse than the disease.

QE was meant to stimulate the real economy. The idea was that the purchase of bonds by central banks from the clearing banks which held them would give the clearing banks more free cash to lend to productive enterprises, thus fostering economic growth. But it didn't work. The clearing banks collected the cash from the sale of bonds they held but then sat on it, increasing the money supply but slowing down its velocity of circulation. One might say that, as a cure for economic stagnation, central bankers acting as doctors to the economy prescribed more money in circulation — *'money pills'* — but alas! the clearing banks collected the pills from the chemist and stockpiled them uselessly in the bathroom cabinet (the bank vaults), where they remain to this day.

Maybe QE did work at the very beginning, when the world's financial system seemed on the brink of collapse. But other than that, it hasn't worked and it won't work. Its symbol should be not a blood transfusion apparatus but a bicycle pump, and its theme song should be *I'm For Ever Blowing Bubbles*.

One of these has been a bubble in house prices caused by mortgage interest rates so low that they are more a financial inducement than a fair price for the use of borrowed money. What will happen to prick the bubble? Either mortgage rates will rise, wrecking the household budgets of Generation Y, or (more likely) a lengthy spell of inflation will, over several years, reduce the real value of mortgage debt to affordable proportions.

Bloated Bonds

Even more worrying has been a bubble in bonds. By buying them in huge quantities (£375 billion so far in the UK with up to £60 million more to come, and a total of $8.7 trillion worldwide since 2008) central banks have forced bond prices up and bond yields down — in both cases, to unprecedented and ridiculous levels.

Central banks are now glutted with bonds, while elsewhere there is a bond famine. Pension funds, prisoners of actuarial assumptions, struggle to compete with central banks in the bond market and are bidding for bonds at any price, rather than at anything approaching historical fair value. The long-term risks of this are frightening. It used to be said that compound interest was the world's greatest discovery. Now it is only a beautiful memory. How are pensions to be paid when pension funds cannot compound upwards, as before, but either stay stuck or compound downwards? Jim Grant of *Grant's Interest Rate Observer* spelt out the tragic truth when he said that US Treasuries *'used to offer risk-free return but now offer return-free risk'*.

Is our QE-ravaged financial system past mending? It is time to be on the alert, because some commentators are already predicting a major shock. As Russell Napier warned in his review *The Solid Ground*[2]:

'All global monetary systems fail and investors had to cope with such a failure in both the 1930s and the 1970s. While our current system has no name, it is a system nonetheless and it is failing. There were forty years from the failure of the Gold Standard to the collapse of the Bretton Woods agreement. It has been forty-five years since the collapse of Bretton Woods. Sometimes it's the business cycle that counts but sometimes, if rarely, it's a structural break in the system that counts. That is what we are living through and that is what investors have to prepare for if they are to fulfil their fiduciary duty to their clients.'

The Need for Inflation

Having hated inflation during most of my working life, I don't like writing those words. However, we are entering a world in which cen-

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[1] *Daily Telegraph*, 5 August 2016.

[2] Orlock Advisors Limited, Q2 2016 Quarterly Report.

tral banks are struggling to bring about inflation — the reverse of what has been done in recent decades. Japan has for some years targeted an inflationary number to the upside but has failed (although by another measure there has actually been some modest inflation there).[3]

Why do we now need some inflation? Inflation provides lubrication for the engine of the economy, which has today become clogged and, if not attended to, could seize up altogether. As I pointed out in September 2009, in Quarterly Nº. 54, deflation has its initial attractions for the already solvent. If it lasts for a long time, however, it causes the economy to start shutting down. (We had expected QE to be inflationary, but it has unexpectedly proved deflationary as the extra liquidity has become stuck at the commercial banks.)

Might the last remaining way forward be the distribution of *'helicopter money'*, or what Jeremy Corbyn has called *'People's QE'* — in other words, the creation of money specifically intended to be spent on goods and services, rather than on bonds? This would certainly be inflationary, and would also be what Sir Humphrey in *Yes, Minister* would call *'very brave'*. But something of the kind is not beyond the bounds of possibility. The overhang of government debt — it is easy to forget that the 2008 crisis was a debt crisis — is so great that the only way to get out of the current debt problem is to inflate our way out, and five or six years of high single digit inflation would ultimately get debt under control.

SO WHAT DO WE DO?

Inflation on this scale is not what we want, but it may be what we get. It may also be the least of an array of evils. In a world of inflation, Personal Assets would have to invest differently and would hold a higher percentage of equities. But the time has not yet come to pre-empt this by stocking up on equities, not only because the ones we like are too dear but also because deflation will precede inflation, and deflation is both theoretically and empirically bad for equities.

In this world of (almost) zero interest rates, zero growth and zero returns, what do we do? There's not much point in speculating further about the reasons for today's economic stagnation. Our task is a practical one — to operate within whatever the investment conditions are at the time to produce the best results for shareholders.

Investment conditions at present are patchy. It's not as if the whole world were mired in recession. In places there is growth to be found, including in the US and the UK. But often the growth has been feeble and of low quality. New jobs have been created, but usually not very good ones. Equities may be less in bubble territory than bonds, but even so they are too highly priced for the returns they offer.

The essential qualities for a successful defensive investment manager just now are patience and a high boredom threshold. Courage is also needed, to withstand accusations of being inert, too risk averse, lacking ideas and being idle.

Here are my current thoughts:

- The first and most important thing is to hold on to what we've already got — our *'irreplaceable capital'* or *'sacred savings'*.
- Stay short. This is a time to be liquid and flexible. The long end of the conventional bond market is today's entrance to Hell.
- Asset classes are not homogeneous. There is a world of difference between conservative and racy equities as well as between long term and short term bonds.
- Go for companies which are kind to their shareholders. (We always do this — it's a house rule.)
- Once again, remember and make use of the merits of cash. Returns on cash today are minimal or even negative, so at first glance cash seems unattractive. But it doesn't carry the same capital risks as bonds. To be cautious today means going into cash, not bonds.
- We don't have to jockey for position in the performance tables. Absolutes interest us, not relatives. In the past we have already been as much as 100% liquid.
- We are no longer handicapped by the need to earn income out of which to pay dividends in yield-starved markets.

A DISQUISITION ON DIVIDENDS

If we need cash to live off, as inevitably we will, we must take it in the most conservative way. For Personal Assets this means temporarily 'borrowing' from capital to maintain the level of our dividend.

It took time for me to be persuaded of this, so ingrained is the taboo about spending capital. But it's far better to realise a small portion of high quality investment profit than to risk one's *'sacred savings'* by switching them into lower quality, higher-yielding stocks. Sometimes true total return investing means being prepared to dip into capital for living expenses rather than reduce portfolio quality.

A SCEPTIC WRITES . . .

Following the publication of Quarterly Nº. 80 a shareholder of many years' standing wrote to me:

'It would seem to me that [in the Board's opinion] *the time will never be right for Personal Assets to buy a substantial amount of equities. When equities have low multiples you wouldn't be prepared to take the risk. You would always be behind the game in a rising market. You make money in a falling market, but you are still hedging your bets. You have to take risks. There are always risks in life. If you are not prepared to take risks you shouldn't invest in the stock market.'*

I can see why he wrote this. Since Personal Assets became independently managed we have never been fully invested in equities. We have, however, in times past been significantly more fully invested than may have appeared, through investing in highly geared investment trust warrants and investment management companies and, later, by using FTSE 100 Futures.

Sebastian and I have often said that we are frustrated bulls and look forward to being fully invested in equities, or even geared. We mean it. Oh yes, we mean it. We do indeed. And we accept that an equity investor has to take risks. Be assured that when the time is right, we'll do so. The shareholder I mentioned *(he knows who he is)* can hold us to account if we don't.

ROBIN ANGUS

[3] Unlike the comparable US figures, the Japanese core inflation figure includes energy prices; if the fall in these had been stripped out, the Japanese inflation figure would have been positive.

Personal Assets Trust Performance

	Value 31 Aug 2016	Percentage Changes 1 Year	3 Years	5 Years	10 Years
Share Price	£400.00	18.2	17.7	19.0	56.4
NAV per Share	£392.57	15.7	17.1	19.2	54.1
FTSE All-Share Index	3,697.19	7.6	8.4	32.0	22.9
NAV relative to FTSE All-Share Index		7.5	8.0	(9.7)	25.4

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 2016 £'000	Shareholders' funds %
British American Tobacco	UK	Tobacco	35,145	4.9
Philip Morris International	USA	Tobacco	34,220	4.8
Nestlé	Switzerland	Food Producer	28,649	4.0
Coca-Cola	USA	Beverages	26,766	3.8
Microsoft	USA	Software	23,487	3.3
Sage Group	UK	Technology	19,548	2.8
Altria	USA	Tobacco	19,114	2.7
Colgate Palmolive	USA	Personal Products	16,014	2.3
Dr Pepper Snapple Group	USA	Beverages	14,834	2.1
Berkshire Hathaway	USA	Insurance	14,607	2.1
			232,384	**32.8**

Portfolio Analysis

	Valuation 31 Aug 2016 £'000	Shareholders' funds %
Equities	327,507	46.2
US TIPS	121,366	17.1
UK Index-Linked Gilts	31,522	4.4
Gold Bullion	79,839	11.3
UK Cash and Cash equivalents	144,946	20.4
Overseas Cash and Cash equivalents	4,116	0.6
Shareholders' funds	**709,296**	**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