PERSONAL ASSETS TRUST PLC

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A SEA-CHANGE IN POLITICS?

'There are times, perhaps once every thirty years, when there is a sea-change in politics. It then does not matter what you say or what you do. There is a shift in what the public wants and what it approves of. I suspect there is now such a sea-change and it is for Mrs Thatcher.'

James Callaghan, 1979

It wasn't just Mrs Thatcher. Ronald Reagan was elected President of the United States the next year, whereupon Arthur Scargill did his best to make our flesh creep with threats of *'President Ray-Gun and the Plutonium Blonde'*. Likewise, it's not just Mr Trump now. Startling as his election victory was, it was no bolt from the blue. If we saw it as such (and I confess I was not one of those who predicted it) we had surely overlooked how *'the sheeted dead had squeaked and gibbered in the Roman streets'*[1] as an omen of what was to come.

Political commentators are increasingly warning us that there is a sea-change taking place today across much of the developed world. They point not only to widening rifts within the EU and the Eurozone but also to a remarkable series of individual electoral surprises and a widespread and pervasive mood of distrust of the current political establishment.

In addition to President Trump and Brexit Britain we have the rise of the populist right in France and Germany; a similar development in such smaller states as the Netherlands and Austria as well as in newer EU member countries like Poland and Hungary; a forthcoming referendum in Italy in early December which may bring down the government, creating an opening for Beppe Grillo and his populist, environmentalist, Eurosceptic, anti-globalist Five Star Movement; and the rise of the populist left in Spain and Greece. In the last Quarterly I wrote rashly that people would be surprised if they knew how little the stock market is affected by purely political news. As if to prove me wrong, politics has dominated the scene ever since and looks likely to continue to do so for some time yet.

POPULISM AND *'POST-TRUTH'*

If the commentators are correct about the new political backdrop, there are bound to be implications for the financial markets. Some of these will emerge only over time, but others we can guess at right away. Populism is a dangerous and double-edged sword which in the past has slain many who had unsheathed it with the intention of slaying others. It can bring with it not only useful practical boosts to the economy such as tax cuts and higher spending on infrastructure but also such financial and economic horrors as protectionism and capital controls. Perhaps it will just fizzle out. Here in Britain, populism of the extremer sort has never really caught on — partly because of our first-past-the-post voting system, partly because we have a Head of State who is above and outside politics and partly, I like to think, because of our national sense of humour and distrust of demagogues.[2] But there's at least a chance that it's here to stay.

A whole new layer of uncertainty now sits on top of the familiar worries about market valuations, inflation or deflation, interest rates and currency movements. *'Post-truth'* has been hailed as the Word of the Year for 2016 by Oxford Dictionaries. It is defined as *'an adjective relating to circumstances in which objective facts are less influential in shaping public opinion than emotional appeals'* — in other words, when the heart rules the head. When this happens (and we can see it all around us), political upsets are to be expected.

It is comforting, however, to keep in mind that the results of changes in the political world are seldom either as good as we hope or as bad as we fear. My earlier reference to *'President Ray-Gun and the Plutonium Blonde'* is a reminder of how ill-advised it can be to give way to knee-jerk panic. Interesting though political speculations may be (to the writer, at any rate, if not to the reader), I therefore don't intend to dwell further on them here. What I *would* point out is that, just as there can be sea-changes in the political mood, so there can be such turning points in the mood of the financial markets, sometimes linked to politics and sometimes not. It is for these that we need to be on the lookout.

CHANGES IN MARKET MOOD

I've lived through at least three of the most memorable of them. My earliest stock exchange recollections are of the long bull market in equities which ran from the beginning of the 1950s until the oil shock of 1973, when the first great mood change took place and we suffered the ghastly 1974 market crash, followed by talk of the formation of private armies and the possible collapse of civil society. The lesson? Nothing dominates the market, or sets its mood, for ever. Like a spotlight in a prisoner-of-war camp, the focus constantly shifts. The private armies of the

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[1] From Shakespeare's *Hamlet*, referring to the fall of Julius Cæsar. No further comparison between Mr Trump and Julius Cæsar is intended, Cæsar having been famously bald. As Suetonius wrote, *'He was embarrassed by his baldness, which was a frequent subject of jokes on the part of his opponents; so much so that he used to comb his straggling locks forward from the back.'*

[2] The 1930s cry of "*Hail Mosley!*" sounds just as ridiculous to today's inhabitants of these islands as does the "*Hail O'Duffy!*" salute of General Eoin O'Duffy's contemporary Irish Blueshirts.

mid 1970s are as forgotten today as the threats of nuclear war which gave rise to the 1980 election joke, '*What's flat and glows in the dark?' 'Teheran, five minutes after Ronald Reagan gains office.'*

After a few years of sideways markets during which I learned my trade at Baillie Gifford from investors like Max Ward and Douglas McDougall, another seismic mood change took place in around 1982, when investors became convinced that Thatcherism was here to stay and a further long bull market began. This came to an end in 2000 (the so-called *'Crash of 1987'* is now difficult to spot on a long term chart and 1987 in its entirety was an up year for the UK market) and we embarked on a complex period of market ups and downs until the third great mood change, at the time of the banking crisis in 2008. The lesson? Things do come in cycles, but not necessarily nice neat ones that are predictable in length or in severity.

One thing these changes had in common is that they occurred at times when the prevailing market mood, whether of optimism or of weary resignation, had come to feel so entrenched that anything else was inconceivable. Ian Rushbrook, the founder of Personal Assets, was fond of saying that change at such times would come only when the market as a whole had ceased to believe that change was possible. History proved him right, and I believe the future will too. Today we have become so thoroughly accustomed to a world of zero or negative interest rates, quantitative easing, feeble growth and fears of deflation that it's hard to imagine anything else. Might it be that another mood change is just round the corner? If so, it is important for us to recognise it and to be prepared to respond to it in such a way as to benefit shareholders.

THE PERILS OF FORECASTING

Firstly, let me be a spoilsport and prick the brave balloon of economic and market forecasting. Much of the forecasting we encounter — whether it comes from banks, broking houses, think tanks, the academic world or the Bank of England, and irrespective of how dense and complicated is the algebra in which it is dressed up — is not new or original, but at bottom consists of extrapolating present trends.

Forecasts produced by this method are usually either useless or downright misleading. You know the kind of thing: if present trends continue, within half a century Germany will be a country with a Muslim majority while the Church of England will be extinct and everyone living in Britain will be clinically obese. This is good for headlines in the *Daily Express* and *Daily Mail*, but not much else.

And if the extrapolation of present trends is of little use, so, too, is much of what is somewhat optimistically called the 'science' of futurology. This, too, is inescapably in thrall to today's trends. For instance, the science fiction author Isaac Asimov was also an academic scientist and a world renowned populariser of scientific research. However, his famous *Foundation* trilogy, written in the 1940s and published between 1951 and 1953, purports to describe the future history of the galaxy over tens of thousands of years but contains no mention of computers. And similarly, when we were busy with our Filofaxes and Betamax video recorders in the early 1980s few of us conceived of the Internet. It seems to me that Henry Ford had the last word on innovation when he allegedly said that, *'If I had asked people what they wanted, they would have said* [not automobiles but] *faster horses.'*

'EUREKA!'* VS *'THAT'S FUNNY…'

Waiting for the market mood to change is like waiting for water to boil when you don't know what the barometric pressure is and have no means of finding out. You know the water will boil at some point, but you haven't got enough information to tell exactly when. What those involved in managing money have to do in times like these is avoid the mechanical extrapolation of today's prevailing tendencies and instead keep their eyes wide open for hints of developments that are genuinely different or new.

That is how money is to be made and losses avoided. But what sort of developments might there be? In the coming months I shall continue to be on the lookout for a number of things: the beginnings of a pick-up in inflation; a sustained, even if modest, rise in interest rates; and — in the UK, at least — a flattening out of, or fall in, house prices.

There is already news on the interest rate front. The 10-year American Treasury bond yield bottomed at 1.4% earlier in 2016 and by 22 November had risen to 2.3%. The 10-year German bond yield hit a low of minus 0.2% and at 22 November was 0.3%. 10-year UK gilt yields are up from 0.5% to 1.4%.

UK inflation, too, is also showing signs of edging up, both in itself and in the way it is calculated. The October annual increase of 0.9% in the CPI was slightly below what had been expected, but in March 2017 the government's preferred measure will become the CPIH — that is, the CPI including owner-occupier housing costs. The October figure for the CPIH was 1.2%. All this, however, is only half of the story. I shall also be looking out for the unexpected — the *'unknown unknowns'*, as Donald Rumsfeld famously called them.

It is recognised that in the scientific sphere discoveries are sometimes preceded not by an examination of results producing an Archimedes-like cry of '*Eureka!*', but by an examination of results giving rise to much head-scratching and a puzzled remark, '*That's funny . . .* ' The same is true of the economy and the financial markets. I was always rather proud of myself for having turned bearish on Japanese equities in 1989. My *'that's funny'* moment was to do with a market on 65 times earnings and the popular opinion that the grounds of the Imperial Palace in Tokyo were worth more than the sum of all the real estate in California.

If you thought them through (and an essential task of those who manage money is to think things through), these things weren't just *'funny'*. Like conventional long bond prices today, they made no sense. And the price-earnings multiples we saw at the height of the dotcom boom in 2000 made no sense either, but began as *'funny peculiar'*, then became *'funny ha ha'* and in the end proved tragic.

CHALLENGES AHEAD

The last decade and a half has been a bizarre period for market watchers. It could even form the basis for a boxed set streamed on Netflix and entitled *The Curse of the Central Bankers*, in which the economy of the developed world has become so infected with the poisonous virus of cheap money that, like society after the *'zombie apocalypse'* in the TV series *The Walking Dead*, only a few still hold fast to the ancient ways — in this case, that the use of money should command a fair price and that investments should provide a fair return.

I see great challenges ahead for the next couple of decades in that investment Bermuda Triangle wherein economic, financial and social factors meet and interact. Perhaps the one that concerns me most is the need to recover the true meaning of capitalism, which has been obscured by well-meant but clumsy and misplaced intervention by governments and central bankers.

Capitalism is about risk and reward. You can't have one without the other. Do away with reward, and after a while no-one will take risks. The result? Stagnation. Do away with risk, and after a while there will be no reward. The result? Stagnation again.

Since the banking crisis and the birth of quantitative easing — or, indeed, since Alan Greenspan's reign at the Fed — governments and central bankers have done their best to abolish risk. Terrified of the electoral consequences of a recession and disbelieving my maxim that *'recessions are good for you'*, they have consistently denied the system the chance to clear itself.

The result? A financial system that is out of kilter; a market which has moved so far ahead of the growth in the underlying economy that a lengthy catch-up period is required; and a range of returns on offer as meagre and unappetising as the breakfast buffet in a cut-price hôtel once the coach parties have eaten their fill and departed.

POTTINESS ABOUT PENSIONS

A further challenge we face today is that of pension provision. Following two decades of tinkering by doubtless well-meaning Chancellors of the Exchequer, the pace of interference has accelerated. Have things gone too far? Will making possible the premature raiding of pension pots by savers who are already inadequately provided for mean that overstretched sixty-somethings will find themselves with no alternative but to drive their newly-acquired red Lamborghinis to the Post Office to pick up their basic state pension? How much will people now in their 20s and 30s need to live on when they reach pension age, and how are they going to build up the necessary capital sums to escape being the *'squeezed centenarians'* of the later twenty-first century?

A huge amount of capital will have to be accumulated and then held on to, and we are living in a world of low returns and plenty of risks.The answer to the pensions problem, however, need not be pensions. It may lie in capital accumulation in the broader sense, maybe by means of ISAs. They are simple in design, easy to understand and free of hidden pitfalls. Furthermore, the ISA limit will increase to £20,000 annually from April 2017. More and more savers will find them a serious investment vehicle for serious money, and by the end of October 2016 over £105 million worth of shares in Personal Assets were held in the Company's own ISAs alone, in addition to those held in ISAs offered by other providers.

WHAT CAN WE DO ABOUT IT?

People have been complaining that Mrs May will not spell out the details of her Brexit negotiating aims. She would be very silly if she did, and she doesn't give me the impression of being silly. It's perfectly legitimate, however, to ask what her general approach will be. The same inquiry might be made of the Board of Personal Assets about its approach to the economic and financial circumstances of today.

I've already mentioned that there are signs of a rise in inflation and interest rates in the UK. If the process takes hold, will the government and the Bank of England learn by the mistakes of the last 15 years and allow market forces to take their course? And if so, what are the implications for the UK equity market?

Suppose I'm right in saying that inflation and interest rates are picking up and that this may be the start of a return to normality in the capital markets. This wouldn't necessarily have anything to tell us about the short-term outlook for markets. We don't expect someone convalescing from a long illness to leap out of bed and start bouncing around like Boris Johnson.

To begin with, therefore, we are wary of conventional long bonds. There has been a 35-year bull market in these and I wouldn't be surprised if a lengthy bear market succeeded it, although it might contain as many overshoots and temporary reversals as the bull market did. Inflation-linked bonds are part of our armoury, as are short-term Treasury Bills in lieu of cash; but conventional long bonds are not.

Moving from bonds to equities, the economy and the equity markets have diverged. Built in to the rating of the equity markets in the UK and the USA are several years' worth of prospective earnings and dividend growth we haven't yet seen. My fear is that we are facing a long, slow grind before the market and the economy are back in step. Our investment policy is to protect and increase *(in that order)* the value of shareholders' funds per share over the long term. Over the period between 30 April 1990 and 31 October 2016 we achieved an average annual capital return on net assets of 7.6%. (The annual returns when Ian Rushbrook managed the trust and when Troy was Investment Adviser were almost identical — 7.6% and 7.5%.)

I can't promise such returns over the next few years. And I certainly can't promise that during those years there won't be spells in which our NAV actually falls. Apart from the risks attaching to other classes of investment, prudent diversification requires us in all but the most extreme circumstances to hold a certain percentage of equities and I've already mentioned our fears that equity valuations in the developed world are vulnerable. We promise, however, to do our very best to protect our capital, however testing the investment environment may be.

ROBIN ANGUS

Personal Assets Trust Performance

	Value 31 Oct 2016	Percentage Changes 1 Year	3 Years	5 Years	10 Years
Share Price	£397.00	12.6	17.9	17.9	52.4
NAV per Share	£394.85	13.2	18.0	20.2	52.8
FTSE All-Share Index	3,768.14	8.1	5.1	31.7	20.0
NAV relative to FTSE All-Share Index		4.7	12.3	(8.7)	27.3

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 Oct 2016 £'000	Shareholders' funds %
Philip Morris International	USA	Tobacco	35,446	4.9
British American Tobacco	UK	Tobacco	34,892	4.8
Coca-Cola	USA	Beverages	28,048	3.9
Nestlé	Switzerland	Food Producer	28,034	3.9
Microsoft	USA	Software	26,284	3.6
Altria	USA	Tobacco	20,521	2.8
Sage Group	UK	Technology	19,467	2.7
Colgate Palmolive	USA	Personal Products	16,494	2.3
Berkshire Hathaway	USA	Insurance	15,018	2.1
Dr Pepper Snapple Group	USA	Beverages	14,914	2.1
			239,118	**33.1**

Portfolio Analysis

	Valuation 31 Oct 2016 £'000	Shareholders' funds %
Equities	337,790	46.8
US TIPS	152,328	21.1
UK Index-Linked Gilts	31,362	4.4
Gold Bullion	83,239	11.5
UK Cash and Cash equivalents	116,557	16.1
Overseas Cash and Cash equivalents	410	0.1
Shareholders' funds	**721,686**	**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