PERSONAL ASSETS TRUST PLC

MARCH 2017 QUARTERLY REPORT No. 83

A DATE FOR YOUR DIARY

This year, as last year, Troy Asset Management Ltd is hosting an investment trust presentation featuring Personal Assets Trust and Troy Income & Growth Trust. The presentation will take place at 2.30 pm (doors open 2.00 pm) on Wednesday 12 July at the Royal Institution of Great Britain, 21 Albemarle Street, Mayfair, London W1S 4BS. To indicate an interest in attending, please contact Troy directly at troy@taml.co.uk

GOODBYE TO THE EXPERTS

The more I think about it, the more it seems to me that Michael Gove was on to something when he said towards the end of the EU referendum campaign that *'people in this country have had enough of experts'*. Few would disagree that in the months leading up to the referendum facts were in short supply as attempts at objective analysis were increasingly drowned out by pro- or anti-EU slogans. Many on both sides of the argument, to say nothing of those who were undecided, felt themselves to be worryingly ill-informed. Meanwhile, the tenor of debate grew ever more bad-tempered and emotional as argument in the political arena gave way to mere assertion. The public mood has become restive. To take just one example, regular viewers of *Question Time* on BBC1 will have noticed how audiences since the referendum have had a tendency to become noisier and more truculent.

Nor is this change of public mood peculiar to the UK. We are having to get used to less predictable and more idiosyncratic leadership in a large part of the developed world. People are now prepared to think the previously unthinkable, which might be considered healthy, and to say the hitherto unsayable, which can be less healthy and does not always make for pleasant hearing. More specifically, the Euro looks increasingly unstable and the EU itself may be in genuine peril.

President Trump has proved that it is possible for a politician to be even more entertaining than Boris Johnson.[1] And imagine if history had permitted a summit meeting between Mr Trump and Russia's Boris Yeltsin! But political activity is not primarily about entertainment. Where will recent political developments lead us, and what are the implications for the financial markets? The subject is a serious one which requires serious examination, and in this Quarterly I want to update you on our latest investment strategy discussions with Sebastian Lyon, our Investment Adviser, and to share with you the Board's current thinking.

THE BOARD DEBATES STRATEGY

I've often been asked to describe how the Board sets about debating and deciding on investment strategy. Personal Assets has five full Board Meetings annually, each taking the best part of a day — although it might be said without too much exaggeration that the Board is in continuous session throughout the year by means of telephone calls and e-mails. The subjects covered at each Board Meeting should be familiar from the diagram on page 27 of the 2016 Annual Report. You will see from it that our two major discussions of investment strategy are held in September and February, and since the February 2017 meeting has just taken place this seems a good opportunity to report back to you on what we talked about and what conclusions we came to.

The format of our strategy sessions is that Sebastian and his colleagues at Troy prepare a comprehensive and detailed discussion paper to which I and sometimes other Personal Assets Directors also contribute. (This time, one of the Directors submitted a paper about the pros and cons of liquidity, the challenge of preserving capital within the financial system and aspects of the financial system which worried him. This gave rise to some vigorous and intense debate, insights from which are to be found in the final section of the Quarterly, headed *Doing What We Want* and discussing the characteristics, size and scale of the businesses in which we choose to invest.)

The finished strategy paper, which covers not only markets in general but also the individual stocks in which we invest or may in the future invest, is next sent to the Chairman and the other Directors, typically a week in advance of the meeting, and at the Board meeting itself Sebastian and his colleagues make a detailed presentation which expands into a searching and often lively discussion with the Board.

'CHANGING OF THE GUARD'

In his February strategy paper Sebastian wrote that as a result of the transfers of power which occurred in 2016 after the Brexit vote and the US Presidential Election we were experiencing a *'changing of the guard'* from the existing liberal establishment towards more popu-

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[1] Recently President Trump seemed to mistake a Swedish television competition to pick the performer to represent Sweden in the Eurovision Song Contest for a terrorist outrage. Followers of the Eurovision Song Contest may consider the misapprehension understandable. As for the investment opportunities that the new President may bring, a godson of mine once held units in the Rupert Fund, named after Rupert the Bear, through which people were able to invest on their children's behalf. (The fund is now known as the Invesco Perpetual Children's Fund.) I'm thinking of starting the Nellie the Elephant Fund, through which you can invest in construction companies on the US-Mexican border. Its advertising jingle will be: *'Off we go with a trumpetty Trump, Trump, Trump, Trump.'* If you find the concept interesting, give me a ring. But it'll be a trunk call.

list leaders. This, he believes, is a belated reaction to the financial crisis and to the policies which have been put into effect since 2009, whether by central banks or by governments which decided to delegate economic policy to them.

He went on to write:

'Populism is spreading through Europe with the veiled yet realistic threat of a break-up of the single currency . . . The single currency was always a political ideal and not an economic one. Any financial historian knows that currency unions have all ultimately failed without fiscal union.' [2]

Investors have interpreted today's resurgence of populism as a buy signal because it brings with it an immediate prospect of reflation through tax cuts and increases in government spending. The Dow Jones has powered ahead, hitting 21,115 on 1 March — up 34.8% from its February 2016 low point of 15,660. Similarly, much has happened in the UK market in a short time. The FTSE 100 was as low as 6,021.09 on 17 June 2016, the week before the referendum, but on 1 March 2017 it stood at 7,382.90 — 22.6% higher.

Yes, it's been enjoyable so far. But those who are hurrying to join in today's culinary successor to the Tea Party should carry with them a long spoon and a quantity of salt sufficient for a few prophylactic pinches. Historically, jingoism has proved damaging to financial assets. Populism traditionally goes hand in hand with unpredictability of policy, rising inflation and bond yields (yes, a little inflation might be nice, but it's often self-feeding and in the end addictive) and greater risk aversion.

Just as in the UK we have had a 'Brexit boom', so the US market has been enjoying a Trump honeymoon. Neither of these will last. Watching Mr Trump make policy on the hoof has been exhilarating, but his erratic and unpredictable announcements are of no help to those whose job it is to allocate capital. In the long run they will seek predictability and consistency — qualities foreign to Mr Trump's nature and which today's populist politics cannot supply.

Comparisons are Odious

In Quarterly N$^{o.}$ 82 I recalled the fears that quite a lot of people had after the election of *'President Ray-Gun'* in 1980. We can't tell what the eventual consequences of the Trump Presidency will be for the US economy and stock market, let alone for the geopolitical outlook. What we can say, however, is that the difference between the economic and financial conditions at the time of the inauguration of Mr Reagan and those of today could scarcely be more striking.

- In November 1980, when Mr Reagan was about to take office, US 10 Year Treasuries were yielding 12.6%, the Fed Funds short term rate was 14.0%, US inflation as defined by the US GDP deflator was 8.9%, the US total public debt was 31.3% of GDP and the US stock market's cyclically adjusted price/earnings ratio was 9.7x.
- The corresponding statistics when Mr Trump took office were 10 Year Treasuries 2.3%, Fed Funds 0.7%, inflation 1.3%, debt to GDP 105.7% and P/E 28.5x.

Despite the surface similarities between Mr Trump's pledges to cut taxes and increase spending and the 'Reaganomics' of the early 1980s, we were at the beginning of a cycle when Mr Reagan took office. Today, under Mr Trump, we are close to the end of one.

Ronald Reagan became President at a serendipitous time. Although they didn't always see eye to eye, he was also fortunate in having Paul Volcker as Chairman of the Federal Reserve. It remains to be seen how President Trump will get on with Janet Yellen, but he has had nothing like Mr Reagan's luck with the investment fundamentals.

The Benefit of Hindsight

If I'd been really smart 30 years ago I would have asked myself what a world in which US 10 Year Treasuries yielded 2.3% would look like. Had I done so I could have made a fortune by participating in the Great Bull Market in bonds, but the idea of a bull market of any kind in bonds would at that time have seemed as detached from reality as a British departure from the EU or the election of Donald Trump as US President seemed a couple of years ago.

If I were to speculate publicly today about the possibility of a world in which US 10 Year Treasuries would again yield 14% my colleagues might send for the men in the white coats. But a prudent investor should be prepared for all eventualities, and it seems to me almost inevitable that at some point in the next few years (and I'm not going to be more specific than that) interest rates will start to rise again.

The howls of indignation this will evoke from today's long-pampered borrowers will, I trust, be drowned out by the whoops of joy from battered, broke, beleaguered savers. But what will be its effects on the markets in which we invest? Bad for medium to long term conventional bonds/gilts? Of course, but we don't hold any. Quality blue chip equities with decent yields and growing dividends? Despite what is sometimes supposed, an inflationary environment wouldn't be ideal for them; but at any rate they would do better than long bonds. It would be good for gold, as long as rising short rates didn't make holding gold an opportunity cost for income, and rising inflation should make our index-linked stocks (currently at 23.5% of shareholders' funds) look even more attractive.

Sebastian summed it up neatly in his February 2017 strategy paper:

'Today, asset classes are overvalued with low prospective returns. The temptation, for investors, is to reach for yield and add additional risk to portfolios. Personal Assets will do the opposite. More capital than ever is chasing investment returns. For example, in recent years in the insurance and the oil sectors capital flows have rushed to find a perceived short term price anomaly. Price dislocations which offer respectable returns are rare when investor behaviour is in the habit of buying the dips. Our allocation to risk assets is low by historical standards while the emphasis remains on quality in equities and short duration in index-linked.'

I should also say a word here about what I might call the 'European delusion'. Fund managers have been keen to buy European equities because of what looks like a tempting

[2] A shareholder recently sent me a delightful and thought-provoking e-mail upbraiding me for writing 'populist' where he thought I should have written 'popular'. Here, however, the choice of word is Sebastian's, not mine.

arbitrage opportunity against US stocks, but European earnings have fallen for five years running. High quality companies such as the three French stocks Essilor *(ophthalmic equipment)*, LVMH *(luxury goods)* and L'Oréal *(cosmetics and beauty products)* remain on valuations similar to, if not higher than, their American counterparts. This is why we are not tempted to buy European stocks at this stage.

Kraft Heinz vs Unilever

Meanwhile, Kraft Heinz's bid for Unilever has reminded us that big blue chips can be exciting as well as rewarding, even if in this case the excitement lasted for only 52 hours and ended, as we hoped it would, in Kraft Heinz's speedy withdrawal from the battlefield.

If I worked for Unilever I would be fed up seeing my company characterised in the media by photos of jars of Marmite, sales of which are worth a mere £28 million annually compared to Unilever's 2016 turnover of £43 billion. There's much more to Unilever than the yeast-flavoured spread you either love *or* love to hate, and we are happy holders of the shares.

Unilever is a strong, well-managed company with an enviable culture of treating its customers, employees and suppliers well. We believe it will continue to grow and prosper over the long term, and accordingly we were unenthused by what seemed to us the opportunistic and short-term motivation propelling Kraft Heinz's bid.

In rejecting the approach, Unilever pledged to continue its efforts to enhance shareholder value and improve returns on capital and sales. We welcome this, but nevertheless hope that the management will not be tempted to offer sops to short-term shareholders who had looked for a quick killing. Good companies which are run for long-term growth and steady returns deserve the support of long-term investors.

Unilever is investing in new business categories and retail channels to secure sustainable growth in the years ahead. This is in contrast to 3G's approach — the Brazilian/US private equity firm which, after allying itself to Berkshire Hathaway to acquire Burger King and the Canadian fast food chain Tim Horton's, brought together Kraft Foods and Heinz to create Kraft Heinz.

3G believes in 'zero based budgeting', whereby companies ask employees to justify even the smallest expense so as to strip out costs and boost earnings. It seeks short term returns while possibly risking long term returns — at worst, a kind of corporate crash dieting which eliminates not only fat but muscle and can be as detrimental to a company's long term health as crash dieting is to the long term health of the body. It's not particularly new — James Hanson started doing essentially the same thing with Hanson Trust in 1964 — and if taken to extremes is harmful. Yes, costs must always be addressed; but the war on costs should never be allowed to compromise long term prospects.

Doing What We Want

My earlier comments about Unilever touch on some of the things we look for in the businesses in which we invest. These businesses can be very large, like Unilever itself, or relatively small, like A G Barr. The qualities they possess are much more important to us than their size, and if opportunities presented themselves we would be happy to be committed to entrepreneurial, conservatively financed and possibly family owned businesses as long term co-investors.

We would, of course, need to ensure that this did not clash with our discount and premium control policy, which requires a high degree of portfolio liquidity. If only for this reason, Personal Assets is unlikely ever to hold a high proportion of unlisted or illiquid stocks. But it's important to strike a balance and have room in the portfolio for stocks which may be the A G Barr or Greggs of tomorrow as well as for the Unilevers, Nestlés and Colgate Palmolives of today.

Unlike the dot.com bubble, which was sustained (until it imploded) by a relatively narrow range of specialised stocks, in the current bull market a rising tide really has floated all boats and only a very small number of large cap stocks (ones in which we don't particularly want to invest at present, like Apple or IBM) look cheap. After almost eight years of rising stock prices, a bargain-hunter in today's market feels rather as Ross Poldark must have done in fictional nineteenth century Cornwall when contemplating a worked-out tin mine.

What, then, do we do? It's not very encouraging when the UK market has been reaching all-time high after all-time high and the best you can say about the US market is that it looks somewhat less expensive than it did in 1929 and 2000. Let me, therefore, end with an observation about Personal Assets and its investing style that I believe it's impossible to overemphasise.

As regards managing the portfolio we are our own masters and we do what we want, rather than what others say we ought to do. When we buy stocks, we do so because we positively want to buy them — not because we haven't bought any for a while, or because we're embarrassed about holding so much cash, or because we're nervous lest shareholders or the stock market in general will think us idle or devoid of ideas. We don't do it to please the market, or investment commentators, or 'experts' of any kind. We need please only the shareholders, and we do so first and foremost by protecting their capital and only then, if possible, making it grow.

I've often said that a holding in Personal Assets is designed not just to allow you to sleep but actually to send you to sleep. Sometimes I get asked about our 'heavy' *(i.e. high)* share price by shareholders or, more often, outsiders who find it puzzling, and I reply that we prefer this to a stock split because it says something about Personal Assets and those who hold it.

It's rather along the lines of the old advertisement for Stella Artois:

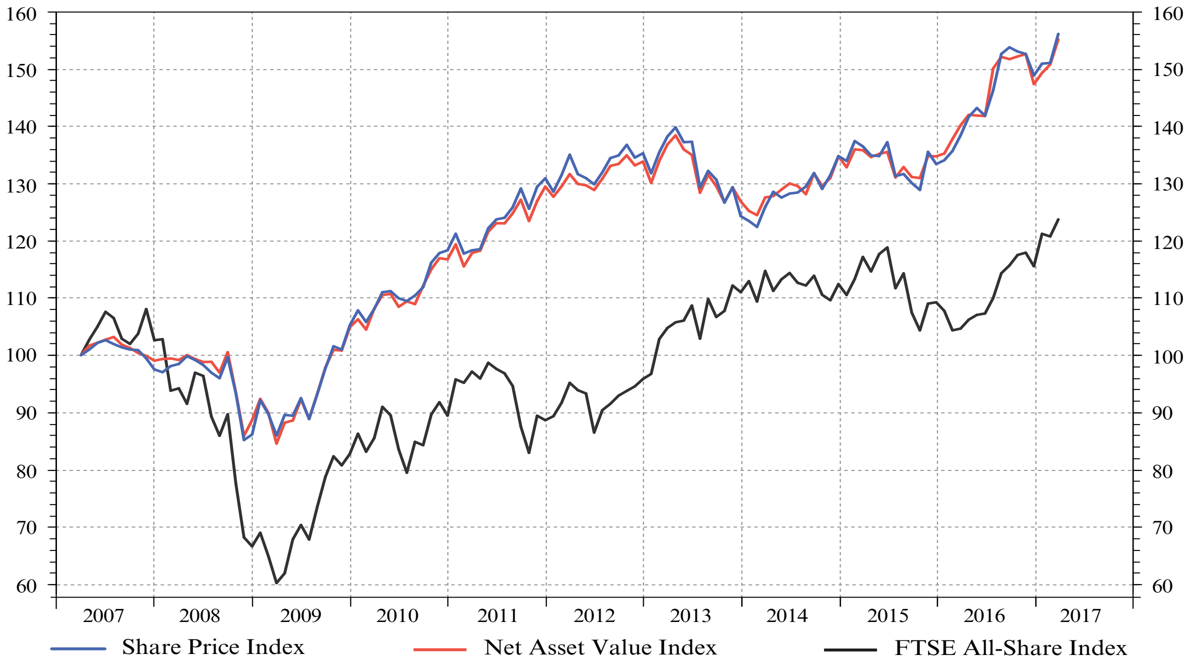
'Personal Assets shares — reassuringly expensive'.

I wish I'd thought of that first. But even more to the point is what I think would be the most appropriate slogan if we were ever to advertise (which we've never done). It's borrowed from the well-known Patek Philippe advertisement:

'You never actually own a Personal Assets share, you merely look after it for the next generation.'

Robin Angus

Personal Assets Trust Performance



	Value 28 Feb 2017	Percentage Changes 1 Year	3 Years	5 Years	10 Years
Share Price	£406.10	12.2	24.0	14.9	55.9
NAV per Share	£401.48	10.6	21.6	17.4	54.9
FTSE All-Share Index	3,953.42	18.2	18.2	28.7	23.6
NAV relative to FTSE All-Share Index		(6.4)	2.9	(8.8)	25.3

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 28 Feb 2017 £'000	Shareholders' funds %
Philip Morris	USA	Tobacco	39,791	5.1
British American Tobacco	UK	Tobacco	37,786	4.9
Nestlé	Switzerland	Food Producer	28,192	3.6
Microsoft	USA	Software	27,747	3.6
Coca-Cola	USA	Beverages	27,447	3.5
Altria	USA	Tobacco	22,993	3.0
Berkshire Hathaway	USA	Insurance	17,670	2.3
Sage Group	UK	Technology	17,442	2.3
Colgate Palmolive	USA	Personal Products	16,683	2.2
Imperial Oil	Canada	Oil & Gas	16,128	2.1
			251,879	**32.6**

Portfolio Analysis

	Valuation 28 Feb 2017 £'000	Shareholders' funds %
Equities	361,803	46.9
US TIPS	150,325	19.5
UK T-Bills	114,974	14.9
UK Index-Linked Gilts	31,473	4.0
Gold Bullion	81,250	10.5
Cash and Cash equivalents	32,234	4.2
Shareholders' funds	**772,059**	**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