PERSONAL ASSETS TRUST PLC

SEPTEMBER 2017 QUARTERLY REPORT Nº. 85

A STARTLING QUESTION

'Yours is more of a passive investment style, isn't it?' an amateur investor remarked to me recently. Once I'd recovered from the shock of being bowled such an utterly unexpected googly, I felt relief that my interrogator wasn't a Personal Assets shareholder. Had he been, I'd have been forced to accept that after nearly a quarter of a century of writing these Quarterlies to explain to shareholders what we were trying to do on their behalf I had pretty conclusively failed.

As is often the case with such unexpected statements, however, it made me stop and think. When I use a word (as Humpty Dumpty said to Alice) it means just what I choose it to mean — neither more nor less. I know exactly what I'm saying, so I assume that my hearers do too. But even highly intelligent people can misunderstand what we say much more easily than we suppose if they don't know the specialised meanings of words used in a professional context. What my interrogator meant was that Personal Assets didn't change its portfolio investments as much as most other funds and was hence a *'passive'* investor, as opposed to one which was *'active'* in the sense of having a high portfolio turnover.

WHAT IS PASSIVE INVESTING

But if *'passive investing'* doesn't mean *'not making many changes to your portfolio'*, what does it mean? In brief, it's a thought-provoking and increasingly fashionable method of investing that does away with the requirement to make decisions about sector and stock weightings, and about which individual stocks to buy or sell. Instead, a passive investment fund typically tracks a recognised market index (hence 'index funds' or 'tracker funds') with the aim of reproducing that index's performance.

Personal Assets is not a passive investor and has no intention of becoming one. However, looking at the pros and cons of passive investing sheds light on the aims and workings of the investment management industry, and this is the first of two Quarterlies in which I intend to consider that very subject. Quarterly Nº. 85 looks at why and for what purposes we invest, and Quarterly Nº. 86 in December of this year will not only look at what Personal Assets offers to various types of shareholder but will also identify those types of shareholder for whom Personal Assets would not be a suitable investment.

PASSIVE INVESTING — THE PROS

What are the advantages and disadvantages of passive investing as an investment technique? Beginning with the advantages, an index fund should, in theory, secure for its investors slightly better than average performance at a below average cost. Performance should be above average because an average fund will of necessity underperform the index which measures it, thanks to dealing, management and other costs. Costs should be below average because the fees for passive fund management should be lower than for active management. But dealing costs may still be high because of the many micro adjustments that keep having to be made to reflect changes in the composition of the index or cash inflows to and outflows from the fund.

Furthermore, a passive fund is easy for investors to follow because (assuming it is efficiently run and has a low tracking error) one need only look at the index to find out how one's investment has performed. And if the fund tracks a major single country index such as the FTSE All-Share Index (the "All-Share") or the S&P 500 one not only enjoys the same degree of diversification that the index itself possesses but also benefits from the psychological advantage that one can't blame oneself for having made investment choices at sector or stock level which differ from those made by investors in general and which turn out badly.

PASSIVE INVESTING — THE CONS

Given the cost advantage in particular, why doesn't every investor choose to buy a passive fund? First and foremost, while it can't be denied that most active investors will underperform the market in which they invest (by definition, the aggregate of funds investing in a given market will always underperform that market because the funds incur costs which the market itself does not), it *is* possible for an active investor to beat the market over the long term, although it would almost certainly be impossible to do so in each individual year.

We have proved this for ourselves. Between 30 April 1990 and 30 April 2017 Personal Assets' net asset value per share grew at 7.5% per annum whereas the All-Share grew by only an annual 5.1%. (We also beat the All-Share in total return terms over the same period.)

There are many other snags to passive investing. These include:

- A passive investor must always buy the stocks required for accurate index tracking even when it's obvious that those stocks are dangerously expensive, while an active investor is free to avoid them. A passive fund buys and sells because of company size, but market capitalisation is no guide to quality.
- Passive investment isn't a low risk strategy. It's as risky as the stock market as a whole, which is to say that it can be very risky indeed. Yes, it eliminates (or should eliminate) stock-specific risk, but it doesn't eliminate the risk of holding equities rather than cash.

- Lastly, while saving on costs is undoubtedly a good thing it isn't the be-all and end-all. Some investment commentators are in my view penny wise but pound foolish, worrying more about keeping fees as low as possible than about successful investment management.

IT'S NOT A METHOD FOR ME

While I can understand the attractions and uses of passive investing, it's not for me. My temperament and my training combine to make me reject it. Just about the worst thing I can imagine would be to be in charge of a passive fund and watch disasters occur without being able to avoid them. It would be like driving a car with no brakes and no steering wheel. And trying to buy or sell when everyone else was trying to do the same must be like being stuck in a motorway lane which has slowed to a crawl.

As with Brexit (according to Mrs May), so with investment — it's better to have no deal than a bad deal. You can live without positive returns as long as you keep your capital intact, but negative returns can cripple you. Never forget how hard it is to recoup stock market losses. If an investment or an index falls by half (50%), it has to double (i.e. go up by 100%) to get back to where it started. That's a lot to ask, and sadly sometimes causes investors to shoulder increasing risk in an attempt to recover lost capital.

But there's a deeper reason for rejecting passive investment. Investing is not chiefly about matching an index. It's about fulfilling objectives. People invest for all sorts of reasons, and I think I'm a typical Personal Assets investor in that my objective is not to track an index but to keep the capital I've built up over my working life secure for my wife and myself and for the generations to come, except insofar as I need some of it to live off comfortably, support my favourite causes and make the most of life.

FAMOUS LAST WORDS

Sometimes people are defined by (indeed, damned by) a single quotable quote. For instance, there was the economist Irving Fisher, who wrote nine days before the Crash of 1929 that stocks had *'reached what looks like a permanently high plateau'*. Then there was Prime Minister Harold Wilson, who said of the 1967 devaluation that *'it does not mean that the pound here in Britain, in your pocket or purse or in your bank, has been devalued'*.

Similarly, Charles "Chuck" Prince, Chairman and CEO of Citigroup at the time of the financial crisis, will be remembered for his comment in July 2007 that *'as long as the music is playing, you've got to get up and dance. We're still dancing.'*

That statement is the antithesis of everything I believe in. It smacks of fatalism — that we are not masters of our financial fate, but helpless pawns at the mercy of the financial elements. But we have financial free will. We can get out while the going is good, if we think the risk/reward ratio of investing in equities has become unfavourable. In bad times we may be able to do no more than minimise the damage, but we're still not helpless. Even in the great German inflation of 1923 we could have abandoned paper money and stocked up on real goods, as in the urban legend of the robber who grabbed a basket of currency notes from someone leaving the bank, threw away the notes and kept the basket.

Beware also of thinking it's too late to act. Shareholders may remember how following a profits warning we sold our holding in Tesco for £9.2 million in March and April 2012 at prices between 318p and 334p per share compared to its January 2012 high of 411p. Selling after a drop of over 20% took courage but was the right thing to do. By 2016 the shares had reached a low of 139p and as I write they stand at 186p. Had we held on to our holding it would now be worth only £5.3 million.

SOME GREAT INVESTMENT LIES

Chuck Prince's remark about dancing while the music is playing will, in my view, go down in history as one of the great lies of the investment world. Perhaps 'lies' is too strong a word here, implying as it does an intent to deceive, but there are some great investment misconceptions and here I list ten of them. Some you'll have seen mentioned in past Quarterlies, but all of them bear repetition.

1. The point of investing is to beat an index.

If you spent all your time reading investment company reports you might be forgiven for thinking that the point of investing was to beat an index. Nearly every investment fund has a benchmark or comparator (even Personal Assets, although we'd be happy not to) and funds' own reports often focus on performance relative to their benchmark.

But to quote Bobby White, formerly Chairman of Personal Assets, *'Good relative performance does not necessarily buy the groceries.'* If a fund sets out to preserve the value of capital and then, if possible, to make it grow, an investor would have every excuse for being as sick as the proverbial parrot if the All-Share fell by 30% and the fund's net asset value fell by only 25%. It should have been able to protect its shareholders' funds better than that even from the investment equivalent of Hurricane Irma.

The all-important criterion for judging the performance of an investment fund is whether it does what it says on the tin. Read the writing on the tin first, and if it accords with what you're aiming to do, then that's a reason for buying it. Thereafter, judge it on the extent to which it keeps its promises.

Even good performance in the absolute (as opposed to against a benchmark) doesn't excuse everything. If I entrusted some of my *'sacred savings'* to an investment adviser who promised to invest it conservatively but instead put it on a horse which romped home at 50-1 in the 3.30 at Chepstow, I might buy him a case of champagne to celebrate but I'd still give him the sack as my financial adviser, because he hadn't done what he had promised. Never forget that a result by itself tells us nothing about how it was achieved. It might have been through careful, steady investment or wild, reckless plunges. As well as knowing where we are we also must understand how we got there.

2. The point of investing is to beat your competitors.

The second of my great investment lies is closely related to the first. The competitive spirit is in all of us, and we easily fall into the language of sport (indeed, I've just done so). My toes still curl when I remember how, nearly 30 years ago, I hypothesised in an investment trust annual about a 'Management Olympics' for investment managers. So forget all those metaphors about races. If an investment fund does what it says on the tin, that's what matters. If it delivers more than it promises, then that's fine — but not if the fund, in attempting to over-deliver, takes more risks than it said it would.

3. The point of investing is to make your money grow as much as possible.

No, it isn't. Risk comes into it too. Every investor has a different degree of tolerance of risk, and a level of risk which one investor would be happy to accept would be much too great for another.

To investors who value stability and try to reduce worry to a minimum, Personal Assets offers low price volatility. Every year in our Report & Accounts we show a chart of share price performance against share price volatility *(see page 10 in the 2017 Report)*. This shows investors not only how our share price has performed, but also how smooth a ride it has been. We may not be among the trusts which travel the farthest, but we do (we believe) offer a less bumpy ride.

4. Total return is the only fair way of measuring performance.

Total return is one valid way of measuring performance, but it's less useful to private investors than to institutional investors. Private investors are not homogeneous. They have very different aims, tolerances of risk and tax positions. Therefore the total return I get from a particular investment may be different from the total return you receive from exactly the same investment, or I would receive if I held the investment in an ISA.

Let's say I hold the investment in an ISA because I want to accumulate capital by reinvesting dividends free of tax. Total return in those circumstances is a useful measure. But suppose that I hold an investment because I want to live off the income from it without touching the capital. Total return is of no interest to me then. What I want to know is how big, safe and fast-growing the stream of dividends is. Total return would be the universally best measure of performance only if all investors held their investments for exactly the same reasons. But they don't.

5. Past performance is no guide to the future.

To adapt the old chestnut, there are three great lies in life: the cheque is in the post; I'm from the Government and I'm here to help you; and past performance is no guide to the future. A moment's thought shows you how silly the last statement is. Were it true, we could abolish examinations, references and almost every other means of distinguishing between the options open to us.

Past performance is not a perfect guide to the future, but it's the only one we've got and it can give us useful information. Do we want to invest in small companies? Then we go for proven small company managers. Do we want yield? Then we go for income managers with good track records. And so on.

6. The unforgivable risk for an equity investor is to be out of the market.

While there are circumstances in which this is true (fund managers who promise to be fully invested in equities at all times have a fiduciary duty to keep that promise), equity fund managers not compelled to be 100% in equities at all times can and should use their discretion. This is what they are paid for, and they shouldn't hide behind a non-existent policy restriction.

7. To hold cash is an admission of failure.

Our industry hates holding cash, especially now that it's all but impossible to earn any interest on it. It's regarded as a failure of imagination and a waste of fees. But at times it's right to hold cash, for without it we couldn't do what we hope eventually to be able to do — buy bargains when at last these appear. We hold cash not only to reduce risk but also to ensure that it'll be there when we need it.

8. Never be forced to pay Capital Gains Tax ("CGT").

A major advantage of investment trust status is that investment trusts are exempt from CGT on gains realised within their portfolios. This is more tax-efficient than if a private investor managed the same portfolio in the same way. (Gains realised on the disposal of investment trust shares are of course subject to CGT at the normal rate.)

While CGT may not be as grim a levy as it was between 1988 and 2008, when a higher rate taxpayer was liable to pay it at the rate of 40%, even paying it at the current rate of 20% for higher rate taxpayers still goes against the grain. Sometimes, however, it's better to pay it and sacrifice a portion of your capital gain in order to secure the rest. Purely tax-driven investment decisions are best avoided.

9. Gold, being sterile, is not a proper investment.

Ian Rushbrook would never hold gold, for this very reason. And he wasn't alone. Lots of able investment managers I have known held the same view, even if a few of them may have accumulated Krugerrands on the sly. Yes, gold is sterile. It pays no dividends but costs money to keep safe, and — in short — it's easy to see why it's been called a *'barbarous relic'*.

But we don't see it that way. Gold can do a job for us, and as long as it does we're prepared to hold it.

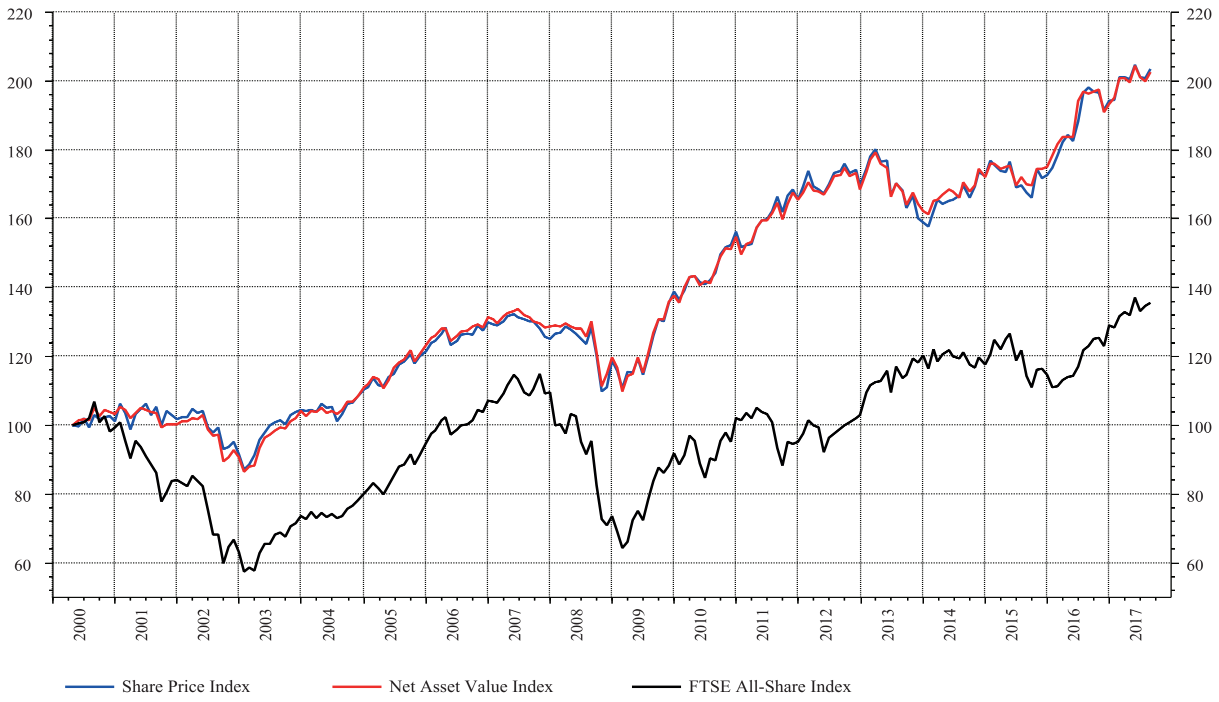
10. Capital is capital, and income is income, and never the twain shall meet.

Is this a great investment misconception? You'd think that someone who regularly questions the usefulness of the total return approach to measuring investment performance would deplore any blurring of the lines between capital and income.

Far from it. Sometimes it makes good sense. As a recent example, we began temporarily 'borrowing' from capital to maintain the level of our dividend. Our reason for so doing is that it's more conservative to realise a small portion of high quality investment profit than to switch into lower quality, higher-yielding stocks. Counter-intuitive though it may be, sometimes being prepared to dip into capital for living expenses rather than reduce portfolio quality can be what true total return investing means.

ROBIN ANGUS

Personal Assets Trust Performance



	Value	Percentage Changes				
	31 Aug 2017	**1 Year**	**3 Years**	**5 Years**	**10 Years**	**30 Apr 2000**
Share Price	£411.10	2.8	19.9	17.1	56.3	103.5
NAV per Share	£405.07	3.2	18.8	17.3	54.4	102.7
FTSE All-Share Index ("Index")	4,072.98	10.2	11.9	37.0	24.9	35.7
NAV relative to Index		(6.4)	6.2	(14.4)	23.6	49.4

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 2017 £'000	Shareholders' funds %
Philip Morris	USA	Tobacco	36,167	4.3
British American Tobacco	UK	Tobacco	31,398	3.7
Microsoft	USA	Software	31,059	3.7
Nestlé	Switzerland	Food Producer	31,035	3.7
Coca-Cola	USA	Beverages	28,524	3.4
Sage Group	UK	Technology	18,698	2.2
Altria	USA	Tobacco	18,631	2.2
Berkshire Hathaway	USA	Insurance	17,873	2.1
Unilever	UK	Food Producer	17,571	2.1
Colgate Palmolive	USA	Personal Products	15,677	1.9
			246,633	**29.3**

Portfolio Analysis

	Valuation 31 Aug 2017 £'000	Shareholders' funds %
Equities	359,171	42.7
US TIPS	185,929	22.1
US T-Bills	13,125	1.6
UK T-Bills	129,780	15.4
UK Index-Linked Gilts	31,892	3.8
Gold Bullion	81,279	9.7
Cash and Cash equivalents	40,003	4.7
Shareholders' funds	**841,179**	**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