PERSONAL ASSETS TRUST PLC

SEPTEMBER 2004 **QUARTERLY REPORT No. 34**

THE INCOME CONUNDRUM

It's taken me more than sixteen years to write this Quarterly. The origins of it are to be found in the attached article, *A Canny Way to Squander a Bit*, published in early 1988 in the magazine *Investment Trusts* (as indispensable to trust investors today as it was then).[1] My suggestion was that investors should use part of the total return from a high-quality share portfolio as a source of cash income, rather than buying unsuitable securities just to get a high yield.

While the investment environment then could hardly have been more different (the article covers the period from the trough to the peak of the 1980s bull market), the problem has got ever more urgent over two decades of falling inflation: how can you get enough income from your capital to enable you to live comfortably, if the yields available are so low?

CAPITAL RICH, INCOME POOR?

Squeezing out even a half-decent income from your capital is perhaps today's greatest investment challenge. Let's take first the position of the Personal Assets investor. Personal Assets became self-managed in 1990. Its dividend growth since then may surprise those who think of it as just a capital growth fund. While our net asset value per share (NAV) now stands at over three and a half times its April 1990 level, our annual dividend has also more than trebled, from £1 per share to a current rate of £3.20. So, true to the adage that capital performance over the longer term mirrors dividend performance, our capital and dividend growth records have not been far apart: NAV up by 268%, dividend up by 220%. Our 220% growth in dividend compares with a dividend increase of 72% on the FTSE All-Share over the same period and a rise of 50% in the RPI, so the rate of increase has been both sizeable in itself and far ahead of the obvious benchmarks.

Dividend growth on this scale is a powerful thing. My wife and I, for example, bought a sizeable proportion of our Personal Assets holding in the summer of 1990 at an average price of around £44. These shares, which yielded only 2.3% when we bought them, now yield nearly 7.3% on their book cost. Furthermore, during the time we've held them we've received dividends amounting to £32.47½ per share, or nearly 75% of what we originally paid for them.

That's after 14 years, however — or, for those having to finance children's education, from nursery school to university entrance. And I can't pretend that Personal Assets has ever been, or will ever become, an "income stock". At our current dividend rate of £3.20 the shares yield just 1.5% compared to 2.2% on the FTSE Actuaries Investment Companies Index and 3.2% on our benchmark, the FTSE All Share.

To set this in context, even if you were fortunate enough to have £1 million invested in Personal Assets it would bring you in only around £15,000 a year. Even a family of church mice would be hard pressed to live well on that.

As all of us know only too well, however, this problem is not peculiar to holders of Personal Assets. Let's stick with £1 million, which was once upon a time the financial world's icon of success. Even now, the word "millionaire" can give readers of the tabloids a mild *frisson*. But *(bearing in mind that for the 2002-2003 tax year the average gross annual pay of full-time employees in Britain was £25,170)*, what would £1 million earn for you? £15,000 a year from Personal Assets won't get you very far, but £22,000 from the FTSE Actuaries Investment Companies Index or £32,000 from the FTSE All Share won't get you much further.[2] And given that an average couple working full time could expect from official figures gross earnings of over £50,000, obviously the £48,000 you'd get from War Loan (the most familiar irredeemable gilt) would hardly, *er*, I was about to say, put you into the millionaire spending class.

'*WHO WANTS TO BE A MILLIONAIRE*?'

Well, lots of people did in 1956, when Frank Sinatra and Celeste Holm sang about it in *High Society*; but the income figures I've just quoted will show that in 2004 anyone who (to quote the song), *"has an itch to be filthy rich"* would need a lot more than that — as would the sultry Eartha Kitt of my boyhood, who wanted just *"an old-fashioned millionaire"*.

This seems hard luck for today's investors, given that during much of the last three decades you could get a double-figure yield from £1 million just by putting the money on deposit, and thus have a six-figure income to spend. Of course, these returns were an illusion. £100,000 a year from £1 million invested looks

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[1] Available from Investment Trusts Subscription Dept, FREEPOST SEA 5489, Sittingbourne, ME9 8BR, or see website: www.investment-trusts-magazine.co.uk.

[2] The figures are even more depressing for higher-rate taxpayers, a category we assume includes most of the readers of this Quarterly. After higher rate tax (levied on dividends in a very complicated way following Mr Brown's 'reforms') £1 million in the FTSE All-Share would give a yearly cash income of just £24,000 compared to £16,500 from the Investment Companies Index and £11,250 from Personal Assets.

nice; but if the £1 million depreciates by, say, 12% a year thanks to inflation, your return will be negative. You've received £100,000 (and paid lots of tax on it, too), but your £1 million will have been eroded by even more than this in real terms, to £880,000. If it's a fixed-coupon investment you'll still get your £100,000 next year — but it'll be worth only £88,000, and (if inflation stays at 12%) only £77,000 the year after that. But perception is reality, so they say. You somehow *feel* poorer if you can only get 2% or 3% on your money, and although your capital is no longer being eaten away by inflation it doesn't stop you worrying about getting enough income to live on.

"I CAN'T AFFORD TO HOLD PAT"

Yes, potential investors have actually said this to us. One of them, indeed, was a well known, highly respected figure in the City who had just retired after heading a major investment bank. To fulfil his retirement plans he needed an income of 4% from his capital, and although he was attracted to Personal Assets he understandably found the gap between our dividend yield of 1.5% and his 4% requirement too wide to bridge. He isn't alone in this. We've often heard such pleas from investors: *"Protection of capital is nice, and so is capital growth, but we need a certain yearly cash sum to live on — and that's not negotiable."*

Many investors such as charities, shareholders in family investment companies or people with sizeable investment portfolios need a high yield from their investments *in the form of cash to spend.* This leads investors who don't think in total return terms to pay too much for high-yielding shares in the market, making them overvalued. What does this mean for overall returns? Ian maintains that each additional 1% per annum in dividend yield will over the long term cost around 3% per annum in capital growth, so investing for high yield inevitably lowers long-term total return.

Let me therefore turn to the tale of Mr McCanny and Mr McSquander and see what can be learned from it. Here we see two eternal human types. Each of them has something to teach the other about how to handle money, but (in my opinion, anyway) neither has got it entirely right.

MR MCCANNY'S MISTAKE

What was Mr McCanny doing wrong? He had a sizeable amount of capital invested in very low-yielding securities, so he wasn't getting the benefit of his past thrift and present prosperity. IFAs trying to sell financial products often say: *"You should try to make your money work a bit harder."* This didn't apply to Mr McCanny. His money was working quite hard enough. He just wasn't enjoying much of the fruits of its labour!

I know lots of people like Mr McCanny — so careful all his life with his money, thinking always of tomorrow and never of today. But who *can* foresee the future? All the McCannys' thriftily saved capital might have been swallowed up in nursing-home fees, rather than going to their grandchildren as they had hoped. In my view, the McCannys should have had a lot more fun while they were able to — golfing holidays in Barbados for him, and shopping trips to Edinburgh for Mrs McCanny (though I suspect Jenner's would have been more in her line than Harvey Nick's).

MR MCSQUANDER'S MISTAKE

Funnily enough, while I see Mr McCanny as an Elder of the Kirk and Mr McSquander as seldom attending (it clashes with his Sunday morning golf), Mr McSquander's behaviour is truer to the letter of the Gospels than is Mr McCanny's.[3] But the reason I secretly admire Mr McSquander is that by temperament I'm more of a Mr McCanny and so envy those who can just live for the present. Yet Mr McSquander was still taking a needless risk, even for someone who *did* live for the present. He was picking investments (let's assume he chose War Loan) just to get a high nominal income from them. I'm all in favour of him spending as he goes, but what if he were to outlive the purchasing power of his fixed income?

Well, he might be gaga by then, says the realist in me, while the cynic in me chips in with the thought that even if he *were* still fit and *compos mentis*, the state would bail him out. Nonetheless, to outlive his income isn't a fate I'd wish to see visited on the genial Mr McSquander.

THE NEED FOR BALANCE

Perhaps if we take the best of each man's approach, Mr McCanny and Mr McSquander can together point us to a way of drawing a higher rate of cash income from a holding in Personal Assets than the 1.5% or so available from the dividend without being too risky or profligate. The real total return from a holding in Personal Assets since October 1990 on an NAV basis has been an annual 11% or so. Accepting that such a rate of return will be unrepeatable in future, would not even half that rate of return still justify our investor who needed a 4% annual cash income in drawing it from Personal Assets with a clear conscience?

Of course it would. Returns from equities come in the form of dividend yields and capital growth, the combination of the two being the total return. Let's go back to those shares that my wife and I bought for £44 and are now worth around £209. On each of them there's therefore a capital gain of £165. If we sold 100 shares annually at that price we would realise £20,900, of which £16,500 would be capital gain — almost exactly our £16,400 CGT allowances for the year, which are untaxed.

£16,400 tax-free to higher rate taxpayers is worth the same as £27,300 of salary, so it's a very efficient way of getting a cash income from your assets.

Yes, but isn't it spending capital? To quote Mr McCanny, "*Spend CAPITAL? It would be about as bad as refusing haggis on Burns Night or putting lemonade in whisky — simply not done."*

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[3] E.g. Matthew 6.34 *("Take therefore no thought for the morrow: for the morrow shall take thought for the things of itself")*, to say nothing of the lilies of the field, the fowls of the air and that very un-Scottish character, the Prodigal Son.

But it *is* done! It's always been done. Even Mr McCanny would have spent capital without realising it if he'd had money in a building society during the late '80s and spent the interest.

In times of high inflation we all got used to spending our capital painlessly. It was painless because the capital we spent looked like interest.

Now inflation no longer serves as a veil for our financial modesty, we perhaps have to learn to do consciously what we did unconsciously for so long — always with the *proviso* that we understand exactly what we're doing.

SO HOW DID IT WORK OUT?

First, however, let's look at how it all worked out for Mr McCanny and Mr McSquander — not just to where the article leaves them in 1987, but to where they might be today, in 2004. After all, none of what I'm writing here would be very convincing if it turned out that Mr McCanny, had he taken my advice about drawing some of his total return as a cash income, had come badly unstuck!

Let's take Mr McSquander first. With his investment in War Loan, his capital would have grown 2.6 times between 1982-2004 (a real increase of 17% after inflation). Assume Mr McCanny also ended up with 2.6 times his starting capital, keeping him level with Mr McSquander. This would have let him withdraw 5.6% of his capital annually, with the result that after just five years he would have had twice Mr McSquander's income to spend and would between 1982 and 2004 have drawn income after tax of £88,000 compared to Mr McSquander's sum of £59,000. And this is — literally — only the half of it. For reasons I can't remember but were compelling at the time (!), ***I made Mr McCanny start off with only half the capital of Mr McSquander!*** So, while it's not been a bad outcome for Mr McSquander, it's still game, set and match to Mr McCanny nonetheless.

MAKING YOUR MONEY LAST

Following on the story of Mr McCanny and Mr McSquander, this Quarterly's contention is that it would be logical for most investors seeking a high cash yield to achieve it by realising regularly a small percentage of their investment in high quality shares, rather than by investing only for yield. Investing for quality rather than immediate yield will in the long term make your money go a good deal further, as well as being considerably more tax-efficient.

In practice, however, this is both expensive and difficult for individual investors. Also, while diversified investment trusts with conventional capital structures would otherwise be ideal for such individuals, they tend to sell at a fluctuating and sometimes high discount to NAV. Selling shares at a volatile discount to realise a regular cash sum risks an unpalatable loss of value for shareholders. So an efficient income plan that involved selling shares on a regular basis could be offered only by an investment trust committed to ensuring that there was ***no*** ongoing discount on its shares.

THE CASH INCOME PLAN

Personal Assets is such a trust, as is Collective Assets; and we mean to offer shareholders a convenient and cost-free way to realise quarterly cash amounts from their investment through a *Cash Income Plan* (CIP). The CIP will offer:

- ***Investment efficiency***. The cash income will come from realising a percentage of the *total return* from a holding in Personal Assets or Collective Assets. This total return should be higher in quality, and therefore more sustainable, than that available from high-yielding equities.
- ***Ease of use.*** Using the CIP will be as straightforward as using our existing Investment Plans. Arranging to get your quarterly cash sum will be as simple as getting your dividends reinvested.
- ***Cost efficiency.*** Like our other Investment Plans, the CIP will be zero-charge.
- ***Tax efficiency.*** Most investors would pay no tax on their realised cash sums. Up to £16,400 for a couple paying tax at the higher rate, ***each £1 of realised capital gain is worth £1.33 in dividends and £1.67 of deposit interest***. (To keep it simple for tax purposes the CIP, like our other Investment Plans, will re-invest all dividends, so the cash return paid to shareholders will just be the amounts realised by selling shares.)

Since the CIP will be one of our Investment Plans, those holding shares on the main register who want to use this facility will need to transfer them free of charge into a Plan. The Plan Manager will then be instructed to pay the desired quarterly cash sum by selling at the end of each quarter one or other of the following:

- a ***specified percentage*** of the value of a holding; *OR,*
- enough shares to achieve a ***specified cash sum***; *OR,*
- a ***specified number of shares***.

Two key points of the CIP are that it will offer a range of choices *and* that the Plan literature will include illustrations of these. The illustrations might be based on yields, showing how a CIP would work if an investor wanted a yield equivalent to, say, 4% or 7% *(or even 10%)*. In each case, the implications of drawing such a return from a CIP will be spelt out *(for instance, over the long term a 4% withdrawal rate should leave one's capital intact in real terms, whereas this would be more risky at 7% and unlikely in the extreme at 10%).*

Application for a CIP will be by a simple form, on a single page if possible, although the insistence of the regulators that everything attempting to be simple and easy to understand should be drowned in a treacle-well of information may prevent this.[4]

Who knows what difficulties we may yet encounter in implementing something as innovative as a CIP? But we hope to be able to offer this Plan before the start of the next tax year.

ROBIN ANGUS

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[4] A former Master of my Cambridge college wrote a biography of that great churchman and martyr, Archbishop Laud, of which it was said, *"It contains everything about Laud except what is important."* Could this have been an inspiration for the Financial Services Authority?

A canny way to squander a bit

Robin Angus explains how to get the best total return on investment

Mr McCanny has had a portfolio of investment trusts for five years now, and he's done rather well from them. The £20,000 he originally invested when he retired, back in the summer of 1982, has grown to nearly £80,000 — much in line with the investment trust average, but still better than UK equities as a whole. So he's quite pleased with himself.

Yet in some respects he's inclined to envy his old colleague, Mr McSquander, who retired at the same time. Mr McSquander started off in the summer of 1982 with £40,000 — twice as much as Mr McCanny. He put the lot into gilts, and in capital terms it's hardly grown at all — only to £46,000 or so. But he's getting 10 per cent on his gilts, and so has nearly £5,000 a year (pre-tax) to add to his pension. Poor Mr McCanny's only getting around 2.2 per cent on his trusts, and so he only has a beggarly £1,700 or so a year on top of his pension. When he last saw Mr McSquander, that prosperous-looking gentleman was about to leave for a fortnight's golfing in Barbados — while Mr McCanny was booked up for his usual week in Rothesay. No wonder Mr McCanny felt a bit fed up.

But what can he do about it? Switch his money into gilts? Too short-sighted. Not much hope of capital growth, or even of capital protection — and that wouldn't please Mr McCanny. Put it into high-yielding unit trusts? Again, reduced prospects of capital growth — and that's not Mr McCanny's style at all. So it looks as if golfing in Barbados is not for him, despite the fact that he's got nearly twice Mr McSquander's capital.

But wait a minute. There's another solution. Mr McCanny could always sell a few shares every year — say, £2,500 worth. That would be well within the £6,600 CGT allowance, so it would be tax-free. It would therefore give him a disposable income as big as Mr McSquander's.

But I'm sure you can imagine Mr McCanny's likely reaction to such a suggestion. Spend CAPITAL? It would be about as bad as refusing haggis on Burns Night or putting lemonade in whisky — simply not done. No, income is income and capital is capital, and that's all there is to it!

SPECTRUM

Piping good fortune: Taking a Scottish example

Well, that's not all there is to it. There's a different way of looking at returns from investment, and it's now generally used by professional investors and by the investment trusts themselves. It's called total return, and it could be the solution to Mr McCanny's problem.

The idea behind total return is very straightforward. An investment trust is run by its Board and managers in order to make a profit for its shareholders. This profit comes in two ways — as dividends, and as capital growth. The dividends are paid to the shareholders direct. The capital growth is added to the net asset value of each share, and so becomes reflected in the share price in the market. It isn't paid directly to the shareholder as income. But it's profit just the same.

As a very simple example, you could buy an investment trust share for 100p and find that, after a year, you'd received 3p in dividends and the share price was 120p. This would give you a total profit — a 'total return' — of 23p on your 100p investment, or 23 per cent. If you held, say, 1,000 of these shares, you could spend the £30 you'd received in dividends, sell 60 shares at 120p each to give you another £72, and so end up having spent £102 (equal to a yield of 10.2 per cent on a gilt) while still having 940 shares worth £1,128 — a 12.8 per cent appreciation. You'd have enjoyed a handsome income, and still kept your capital safe and growing.

What's more, you'd have been drawing the profits the trust would have earned for you in a more tax-efficient form. You pay tax on dividends, so £1,000 earned for you by the managers is worth only £730 after basic rate tax. Any £1,000 earned through asset growth is worth the full £1,000 to you, as long as you keep within the £6,600 annual CGT limit.

If our friend Mr McCanny thought in total return terms, he would see that he has earned total profits on his capital at a much higher rate than Mr McSquander has, despite the much higher income Mr McSquander's been getting. He would therefore have been fully justified in selling his £2,500 worth of shares every year, to keep his income in line with Mr McSquander's. Not only would he have been saving tax (Mr McCanny likes doing that!) but he would still have been protecting his capital and making it grow. And if anybody can understand that there is definitely more than one way of making a profit, it should be Mr McCanny!

Two final thoughts. First, trust managers work very hard to produce total return for their shareholders. And of course it's quite legitimate to say that a profit is a profit and can therefore be spent, whether it comes as dividends or as an increase in share price. But psychologically it's still difficult to accept. In America, some companies have an interesting custom of having frequent small stock dividends — say, one new share for every ten held. Mr McCanny may find it hard to say 'the price of my shares is up 10 per cent, so I can sell 90 out of my 1,000 and still keep my capital intact.' He might find it easier to say 'my company sent me a bonus of 100 free shares — I can sell them, and I'll still have my original 1,000 shares intact'. The same effect — but psychologically better, and more user-friendly.

> 'He would still have been protecting his capital and making it grow'

And, second, the price of shares can go down, as well as up. So Mr McCanny might well find that one year he's not just received a low dividend income but also seen the price of his holdings fall. He's still justified in selling some shares to keep his income up. But to set his mind at rest he should look not at the one-year performance of his holding but at the five- or ten-year performance. He can think of the profits he hasn't 'cashed in' for past years, as being a kind of income reserve. And unless we see another 1974 (which looks unlikely) he should find that he's still comfortably ahead of his shortsighted friend McSquander.

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PERSONAL ASSETS TRUST INVESTMENT PLANS

While the shares of Personal Assets Trust are listed on the London Stock Exchange and so can be bought and sold in the normal way, investors can also buy shares ***free of all commissions and charges*** through the Company's ***Investment Plan***.

Investments in the Company's shares can also be made free of all commissions and charges through the Company's ***ISA*** or through ***PEP and ISA transfers***.

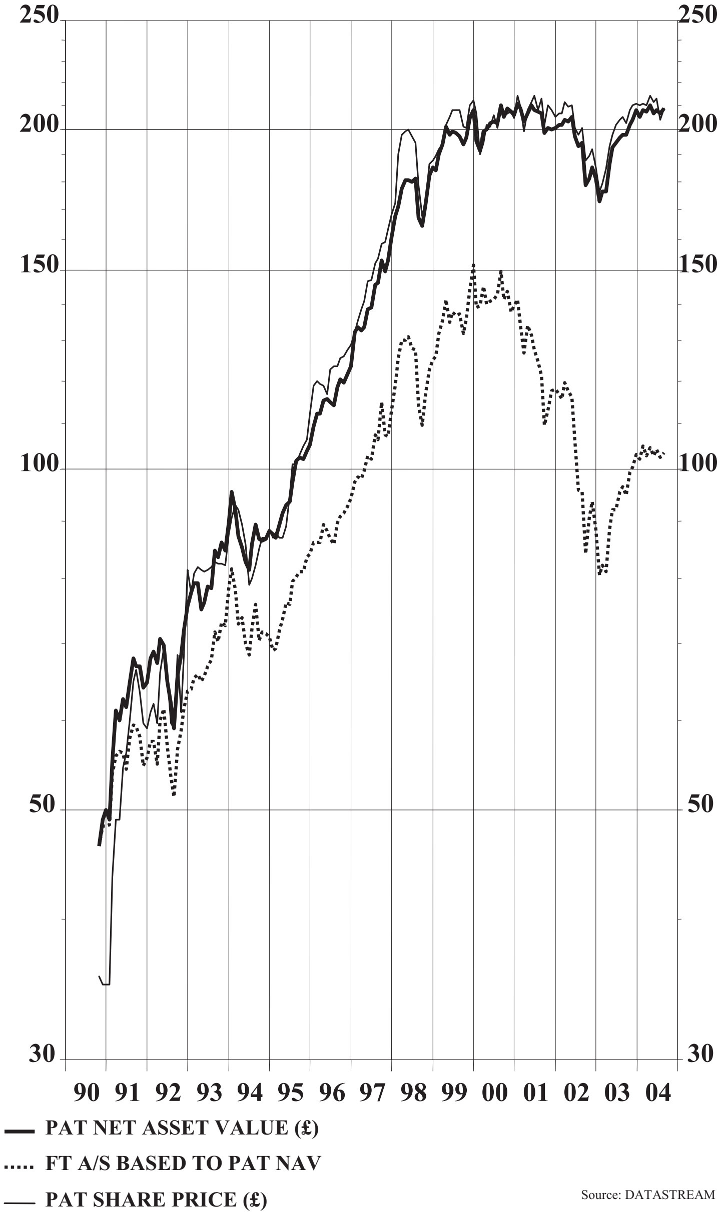
Full details of how to invest in the shares of Personal Assets can be obtained from:

Steven Budge
Personal Assets Trust PLC
10 St Colme Street
Edinburgh EH3 6AA

Tel: 0131–225 9995
E-mail: steven.budge@hemscott.net

PORTFOLIO (000's)	**31-Aug-04**
Royal Bank of Scotland	£7,812
BP	£7,194
HBOS	£5,946
Shell Transport & Trading	£5,312
Barclays Bank	£5,042
GlaxoSmithKline	£4,185
Scottish & Newcastle	£3,249
BT Group	£2,196
Rentokil Initial	£1,503
British Assets Trust	£1,444
Top Ten Equities	**£43,883**
Other Equity Exposure	**£46,393**
Effective Liquidity	**£44,918**
Shareholders' Funds	**£135,194**

PERSONAL ASSETS TRUST PERFORMANCE



% Changes from	31-Oct-90	31-Aug-99	31-Aug-01	31-Aug-03	31-Aug-04
Period	13Y 10M	5 Years	3 Years	1 Year	Values
Share Price	488.0%	0.4%	-2.0%	1.7%	£208.75
NAV per Share	349.1%	5.6%	0.8%	5.1%	£208.55
FTSE All-Share Index	123.1%	-24.7%	-14.5%	7.2%	2,214.19
NAV rel to FTSE All-Share	101.4%	40.2%	17.9%	-1.9%	