PERSONAL ASSETS TRUST PLC

NOVEMBER 2004 QUARTERLY REPORT No. 35

YES, STILL BEARISH . . .

"Ian didn't say anything about his view of equities in the last Quarterly," a shareholder wrote to me recently (maintaining as he did so the touching fiction that it's Ian who actually writes these things). *"So where does Personal Assets stand now on the stock market and on liquidity?"*

Well, there was one good reason for not elaborating on our view of equities in the last Quarterly — it hadn't changed since the time of the previous Quarterly, or of several Quarterlies before that! Nor has it changed now. Ian and I are profoundly uneasy about the outlook for world markets; and it is probably time to spell out in more detail why this should be.

There are some serious problems facing would-be investors today, and I shall have more to say about these in a moment:

- Equity valuations that leave nothing to hope for and a good deal to fear;
- An over-extended and vulnerable US Dollar;
- No real economic growth in either the UK or the US;
- Huge current account deficits in both those countries, causing their economies to be eaten away from within by excessive, debt-driven consumption.

To begin with, however, I want to rebut a common misconception. One of the occupational hazards of working for an investment trust is that I am constantly being asked for a view of the market by everyone from taxi-drivers to members of the clergy. (The only person who never asks me about the market is my wife, which may be what has kept us together all these years.) Often such inquiries prove to be merely preliminaries to the speaker's own confident assertion that the bear market ended in 2003 and we are now in the sunny uplands of bull territory.

Would that it were so!

Ian and I believe we are not yet in a bull market; and where better to begin than with the prime architect of our present woes, Mr Greenspan? When he at last presents his accounts to Plutus, the god of wealth, he will have many fiscal follies to answer for. Some of you may remember a silly speech to the 1992 Conservative Party Conference by Mr Michael Heseltine, then the President of the Board of Trade, in which he promised to *"intervene before breakfast, before lunch, before tea and before dinner. And I'll get up the next morning and I'll start all over again."* Mr Greenspan, more even than Mr Heseltine, has become the Great Interventionist.

Clearly he has a pathological dread of bear markets. His stockbroker father was bankrupted in the 1929 Crash, which led to his parents' divorce; and on Monday 19 October 1987, just two months after becoming chairman of the Federal Reserve, he faced the biggest one-day fall (20%) in the history of the US stockmarket. Fearing on a number of occasions between 1997 and 2001 that the market was about to catch cold, he pumped liquidity into the system again and again, to the extent that the market got roaring drunk — a notable instance of the cure's being worse than the disease.

I have grown fond of saying that since 9/11 the US's greatest enemy has been not Osama bin Laden but Mr Greenspan. He it was (I emphasise) who, more than anyone, put us in the predicament we are in today. Before I describe how this happened, however, let's take a look at where equities currently stand.

WHERE ARE WE NOW?

Equity markets are at present significantly overvalued and, thus, unattractive to investors. This, of course, you've often heard me say before; but this time I support my assertion by a visual aid. It's an updated version of a graph Ian used at the AGM to help explain to shareholders why we were still so bearish; and those who saw it said they found it useful. There is even more room for concern in the overall picture than the graph indicates, as will become clear later; but it's nonetheless the best starting-point I know.

The graph shows the total real rate of return[1] from equities, the inflation rate (smoothed by expressing it as a two-year rolling average) and the dividend yield on the UK equity market over the last 40 years. It uses the dividend yield on the market as its valuation criterion because this, in our view, is a much better proxy for equity value than the price earnings ratio. Dividends reflect management's view of a company's long-term earnings power, but earnings are all too easily massaged and are in any case volatile in changing economic cycles.

(Indeed, a dividend yield on an equity share is in itself a real rate of return, since it is something a company should be able to afford to pay while leaving both the capital value and the earning power of the business intact.)

Furthermore, it is a startling fact (it certainly startled Ian and me when we investigated it a few

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[1] The real rate of return is the return adjusted for inflation. For instance, if in a given year the stock market rose by 10% in capital terms and yielded 4% but inflation was 5%, the total real rate of return for that year would be 8.8% — 4% from the dividend and 4.8% (110% divided by 1.05) from capital appreciation.

years ago) that dividends have over nearly a century provided around two-thirds of the total return from equities.

Two straight horizontal lines on the graph show, respectively, a 3% and a 5% yield. Ian and I both believe that there is an approximate "right" yield for equities. He, the office bull *(yes, really!)* says it is around 4%. I, the office bear, say it is around 5%.[2] However, Ian is cleverer than I am and so is likelier to be right.

The shaded bars on the graph represent the four major market falls over the 40 years. You will notice that each decline began when the dividend yield approached 3% or went on to fall below it. You will also notice a strong inverse correlation between the inflation rate and the real rate of total return on equities. This inverse correlation is central to our argument.

Over the decade 1965 to 1975 the inflation rate increased by some 2 percentage points annually, from 2% to 22%. This was what caused the collapse of the equity market in 1974. Over the 20 years from 1975 to 1995, however, the inflation rate *fell* by around 1 percentage point per annum and equity markets experienced amazing real rates of return. This is counter-intuitive. In theory, equities offer protection against *rising* inflation but should not benefit from *falling* inflation. The explanation of why things turned out differently lies in how companies price their goods and services and in how investors value equities (short-term earnings changes extrapolated to infinity and accorded appropriate price-earnings ratios).

Companies, not surprisingly, tend to use the current level of inflation as their best expectation of future inflation. So if a company has a 10% profit margin based on the current inflation rate, an *unexpected* rise in inflation of 2 percentage points will cut its profits by around 20%. When this occurs year after year, corporate profits are seriously eroded — as we saw vividly between 1965 and 1975. After 1975, this process reversed itself. The equally unexpected average annual 1 percentage point *fall* in inflation pushed profits *up* by around 10% per annum. Ian's calculations using this pricing model show that *over 50% of the real rate of return from equities over the period can be explained just by falling inflation.*

However, to analysts and investors it looked as if corporate profits were growing dramatically because management was getting better by the year, producing ever higher returns on capital — which meant equities should be much more highly valued. Not so. ***Now inflation has stopped falling, there is no more extra profit to be accrued from this source.***

WHERE WILL THIS LEAD US?

Current levels of corporate profits have been inflated over the last *two* years by huge deficit spending in the US and the UK over the last *four* years (of which, more later) coupled with the reduction in the Fed Funds rate from 6.25% in 2000 to 1% by 2003. These factors have inflated corporate profits *without* the countervailing cost pressures one might have expected in a genuinely growing economy; and, as usual, investors have interpreted short-term earnings changes as long-term trends. So it is against a background of *no* fundamental corporate profits growth and *no* real improvement in the management of companies that we see a UK market now very highly valued on a yield basis (close to its valuation before the four major market falls on the graph). ***The graph shows just how vulnerable the market is.***

HOW DID WE GET HERE?

How did it happen? For the best account of how we got where we are today I turn to an explanation of an earlier market *débâcle* by a brilliant commentator who (after playing as a clarinettist in a swing band) studied economics and in 1966 published in the magazine *The Objectivist* an essay entitled *Gold and Economic Freedom*, later reprinted in Ayn Rand's *Capitalism: The Unknown Ideal*. The essay is one of the best I have ever read on any subject, warning of the mischief governments engage in when freed from the constraints of the gold standard. Illuminating it are aphorisms blending the wit of Oscar Wilde and the prejudices of Ian Rushbrook:

- *"Deficit spending is simply a scheme for the confiscation of wealth."*
- *"The welfare state is nothing more than a mechanism by which governments confiscate the wealth of the productive members of a society to support a wide variety of welfare schemes."*
- *"The financial policy of the welfare state requires that there be no way for the owners of wealth to protect themselves."*

Good knockabout stuff, and not what you'd expect, for instance, to hear in our new, caring, sharing Scottish Parliament.[3]

THE FED'S IRRESPONSIBILITY

In his essay, the author sets out vividly the sheer havoc and distress that can be caused by well-meant interventions in the normal workings of the market. If strong remedies are often described as being cruel to be kind, the Fed as portrayed here was being kind to be cruel — as "kind" as giving sweets to diabetic children to cheer them up, or pouring alcoholics a few stiff drinks when they've had a shock.

"*Prior to World War I, the banking system . . . was based on gold and even though governments intervened occasionally, banking was more free than controlled. Periodically, as a result of overly rapid credit expansion, banks became loaned up to the limit of their gold reserves, interest rates rose sharply, new credit was cut off, and the economy went into a*

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[2] This is not new. In my NatWest Securities *Investment Trust Review of 1988* I wrote, *"Everybody . . . knows that equities should yield 5%. This is one of the great universal truths, like the existence of God — although it is equally difficult to prove and, at present, equally out of fashion."* Anyone who possesses my old anthology *Hæc Olim: Exploring the World of Investment Trusts 1981-1991* will find the relevant section on pp. 199-219.

[3] If there were a Marconi Prize for the destruction of value, our local MSPs would be strong challengers, having shamed even the worst split capital trust managers by turning £431 million over five years into no more than a tenth-rate Spanish office block for 129 "Numpties". *(This is Gordon Brown's alleged nomenclature, not mine!)*

sharp, but short-lived recession… The readjustment periods were short and the economies quickly re-established a sound basis to resume expansion.

"But . . . if shortage of bank reserves was causing a business decline (argued economic interventionists) why not find a way of supplying increased reserves to the banks so they never need be short? If banks can continue to loan money indefinitely (it was claimed) there need never be any slumps in business. And so the Federal Reserve System was organised in 1913…

"[In 1927 the Fed tried to help the UK, which was losing gold because the Bank of England] *refused to allow interest rates to rise when market forces dictated (it was politically unpalatable)* . . . [If] *the Federal Reserve pumped excessive paper reserves into American banks, interest rates in the United States would fall to a level comparable with those in Great Britain; this would act to stop Britain's gold loss and avoid the political embarrassment of having to raise interest rates.* [The Fed] *succeeded; it stopped the gold loss, but it nearly destroyed the economies of the world, in the process. The excess credit which the Fed pumped into the economy spilled over into the stock market, triggering a fantastic speculative boom . . . by 1929 the speculative imbalances had become so overwhelming that . . . the* [US] *economy collapsed."*

This account is astonishing in its similarity to the situation today. Pumping credit into the system in order to lower interest rates in defiance of the market when trouble and political embarrassment were looming, so causing a *"fantastic speculative boom"*, is exactly what our friend Mr Greenspan increasingly did during the late 1990s, and then with a vengeance after 9/11.

If only he had read the essay I have just quoted, from what errors might it not have saved him and the world!

Well, Mr Greenspan did more than just read it.

***<u>HE WROTE IT</u>*.**

His subsequent conduct must be the biggest *volte-face* since Hitler stopped painting watercolours. How (to quote Dr Steven LaTulippe[4]) can this be *"the same guy who has been wall-papering the world with dollars to sustain our titanic budget deficit"*?

Maybe the clue is Mr Greenspan's horror of bear markets referred to earlier, coupled to the keen appreciation he showed in 1966 of the power of the Federal Reserve. It must be very difficult to sit back and let events take their course (as he advocated in his 1966 article) when, uniquely in the world, you yourself have the power to alter that course.

Look at the chronology. In December 1996, Mr Greenspan criticised the "irrational exuberance" of markets. Quite right. But what happened then? A series of annual crises, which turned the former arch-libertarian into the Great Interventionist. 1997 saw a major Asian currency crash, followed in 1998 by the Russian bond default and the collapse of Long Term Capital Management (LTCM). By 1999 the thinking of the world's central banks was dominated by paranoia about Y2K (remember it?), succeeded in 2000 by the Dot.com bubble's long-postponed collapse and in 2001 by the attack on the Twin Towers.

Mr Greenspan intervened every time. The market never got the chance to clear itself. We never suffered the necessary pain. One day we shall realise that it would have been better if we had done.

THE AILING DOLLAR

Unfortunately, Mr Greenspan calls the tune for the world's most powerful economy; so the damage he causes cannot be confined to the USA. Just look at what has happened to the USA's finances. In the late 1990s, both the USA and the UK had large budget surpluses. But these surpluses have now been dramatically reversed by both Governments. Thanks to Mr Greenspan's amazing interest rate policy, letting you borrow at 1% and reinvest right away at 4% *("Pssst! Wanna get $1.04 for $1.01 as often as you like? Roll up! Roll up!"),* and his desperation to avoid recession we have seen debt-propelled consumption and financial asset investment at astonishing levels. Over the last four years both the US and the UK have shifted from a 3% annual budget surplus to a 3% annual deficit, thus hosing an annual 1½% of GDP into the economy in the form of new money.

Just of itself this should have produced, given a typical two times multiplier, an extra 3% annual GDP growth. But what has GDP growth actually been running at over that period in the UK and the US? Yes, around 3% — which means *there has been no real intrinsic GDP growth at all.* We have been eating the seedcorn. We have been borrowing to consume. And the day of reckoning can't be postponed indefinitely.

From the US point of view, a lot will eventually have to be paid back to the Chinese, the Japanese and other Far Eastern creditors. *"Just keep buying our goods and we'll hang on to your IOUs — you know, the green ones with 'In God We Trust' on them."*

That is the unspoken agreement between the Far East and the USA. It's a scary interdependence I don't like to examine too closely in case it gives me nightmares. In the later 1960s, US profligacy and a resulting Dollar glut led to the breakdown of Bretton Woods in 1971, in effect forcing the USA off the gold standard. Now there is no gold standard for the USA to be forced off *(I smile, having a few gold sovereigns that I cherish),* and I can see only two outcomes, which are likely to occur in some kind of combination: a massive fall in the Dollar, of which far too many now exist (Paul Volcker, Mr Greenspan's fondly-remembered predecessor,

[4] I was first put on the trail of Mr Greenspan's essay by Dr LaTulippe's article *Is Alan Greenspan a Malignant Alien Life Form*, on the US libertarian website http://www.lewrockwell.com. While Mr Greenspan may or may not be *"a cunningly disguised extraterrestrial who has been sent here by hostile aliens to wreck our economy"*, as Dr LaTulippe claims (the article is in fact dated 1st April 2004), Mr Greenspan's 1966 essay is nevertheless 100% genuine and can be found both on the internet and in Ayn Rand's book, *Capitalism: The Unknown Ideal*.

said recently there was a 75% chance of a major currency crisis in the US within five years); or a significant recession in the US economy as the consumer's vastly increased indebtedness bites. It will not be pleasant.[5]

WHAT DOES THE FUTURE HOLD?

This is all very macro stuff. US budget deficits? Bretton Woods? It's starting to read like the kind of investment trust Chairman's Statement I most detest, when the Chairman writes as if he (it's always a 'he', in these cases) is the Chairman of the IMF and the Chairman of the OECD and the leader of the Conservative Party all rolled into one. However, it does have a direct impact on the investment outlook. The real rate of return on UK gilts of under 2% is historically extremely low (from 1981 to 1997, UK index linked gilts yielded 4%). The effective halving of the return was caused by the emergence in the late 1990s in the UK (and US) of the budget surpluses I mentioned earlier. These have now been dramatically reversed, which would normally have been expected to drive up the real rate of return.

Instead, Mr Greenspan's interest rate policy has suspended reality and driven all asset prices into bubble territory.

But plenty of pins are on hand to prick the bubble. It is hard to see how an eventual rise in the required real rate of return on financial instruments can be avoided; and a rise of only 1% would cause a fall in equity markets of over 30%.

Don't just take my word for it, however — and don't just take the evidence of Ian's graph, either. Pay heed instead to my old Wood Mackenzie colleague Martin Barnes, formerly Managing Editor of *The Bank Credit Analyst* and now of BCA Research in Montreal. A recent study of his was covered extensively in *The Economist* for 19th August 2004, in an article headed informatively, if not exactly succinctly, "*The return on equities over the next decade is likely to be much lower than most investors expect.*" The study concludes that (despite surveys suggesting US investors still expect average annual returns from equities of at least 10% over the next decade, which, some argue, look conservative compared with the annual return of 13% that stocks delivered during the 45 years to 1995, before the bubble inflated), the average return over the next ten years is likely to be, at best, only half what we enjoyed over the past half century.

This forecast is based on two assumptions, both very reasonable. The first is that, because of lower inflation, company profits are unlikely to rise by more than 5% a year over the next decade, a bit slower than the average of 7% a year over the past 50 years. In the long run, profits tend to grow in line with GDP, and America's nominal GDP is thought likely to grow by around 5% a year over the next decade (3% real growth, 2% inflation).[6] Although profits growth has outpaced GDP over the past couple of years *(dramatically so, for which, as I have noted, there were special reasons)*, this is unlikely to continue because pre-tax profit margins are nearly at their highest in 35 years. And since firms now operate in a world of greater competition, profit margins are, if anything, more likely to fall than rise.

Martin's second assumption is that there is little scope for a sustained rise in the valuation of shares. The S&P 500 is currently trading at around 18 times historic operating profits. That is far below its ratio of almost 30 at the peak of the bubble, but still higher than its 50-year average of 15. Martin's "optimistic" scenario assumes that the p/e ratio stays flat over the next decade as a whole and the S&P 500 rises in line with profit growth of 5% a year. Adding in dividends, this would give a nominal average annual return of 6.7%. That implies an average real return of only 4.7%, compared with almost 10% in the half century to 2000. However, history suggests there is a risk that the p/e ratio could fall over the next decade. If the p/e ratio reverted to its historic average of 15, the annual nominal return would be a mere 4.7% and the annual real return only 2.7%. *(Should the reversion occur over five years, the real return would fall to 0.8%.)*

Investors have become used to much higher returns than this, because their expectations are still conditioned by the 18% average annual return of the bull market from 1982 to 2000. But those two decades of falling inflation and falling interest rates provided an exceptional boost to equities. The present era of low and stable inflation may be conducive to economic growth, but it is unlikely to be good for financial markets.

SO WHERE DOES THIS LEAVE US?

Personal Assets' aim is to protect and increase the value of shareholders' funds over the long term. Protection comes first. That was why we began to build liquidity in 1996-97, when it became apparent that Mr Brown meant to confiscate 20% of the value of the UK market from pensioners and others by abolishing the tax credit on dividends and Mr Greenspan made his famous pronouncement about "irrational exuberance" in financial markets. The FTSE All-Share is still 27% below its end-1999 peak. Thanks largely to our being prepared to go significantly liquid when necessary (over 60% in June 2002) our NAV is up 5% over the same period.

The protection of shareholders' funds remains our top priority, and we are currently 32% liquid. We are not inclined to reduce our liquidity below this level at present and it is possible that we will decide to increase it. We do maintain, however, a full market exposure to banks and oils. The current surge in the oil price speaks for itself, while banks — ideally suited to a low inflation environment and standing to gain much from technology — continue to produce excellent results.

ROBIN ANGUS

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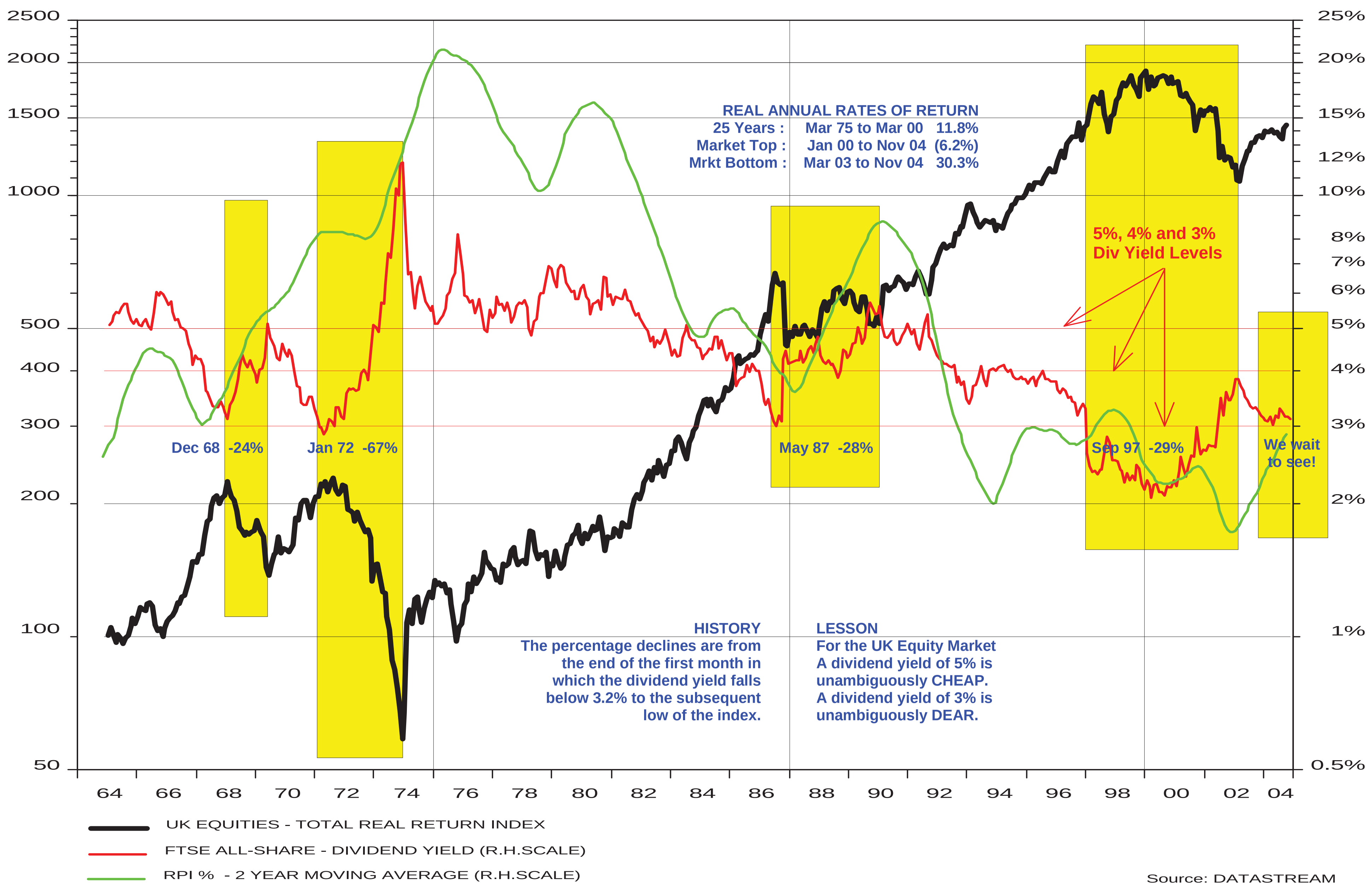
[5] I am reminded of a cartoon I saw many years ago of a nurse about to pull a very large sticking plaster off a patient's very hairy chest. *"How do you want this?"* she was asking him sweetly. *"Lots of little 'oohs', or one huge scream?"*

[6] I would call this rather optimistic, but never mind. There is plenty of time for ups as well as downs over a decade.

UK DIVIDEND YIELDS AND EQUITY MARKET VALUATION

30 Nov 2004



Source: DATASTREAM

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:

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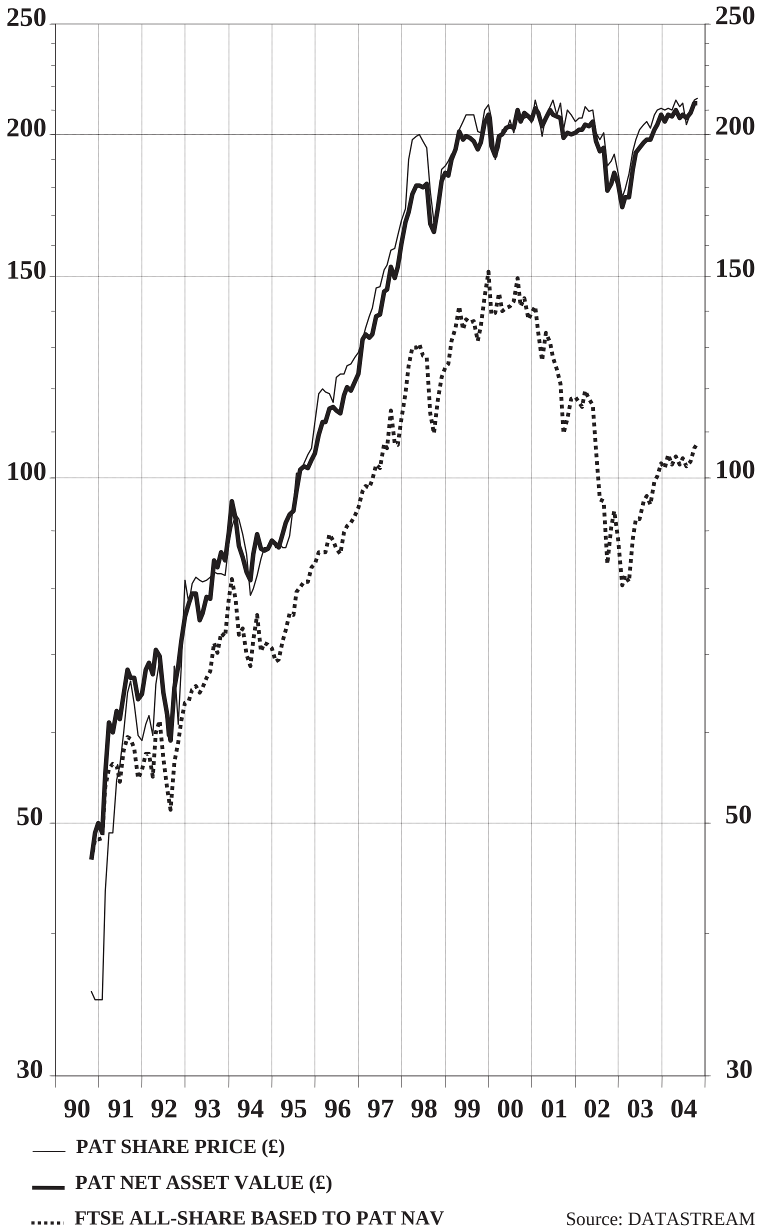
Edinburgh EH3 6AA

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

PORTFOLIO (000's)	31-Oct-04
Royal Bank of Scotland	£8,197
BP	£7,702
HBOS	£6,383
Shell Transport & Trading	£5,617
Barclays Bank	£5,214
GlaxoSmithKline	£4,244
Scottish & Newcastle	£3,307
BT Group	£2,229
Rentokil Initial	£1,550
British Assets Trust	£1,541
Top Ten Equities	**£45,984**
Other Equity Exposure	**£46,805**
Effective Liquidity	**£46,039**
Shareholders' Funds	**£138,828**

Personal Assets Trust Performance



% Changes From	31-Oct-90	31-Oct-99	31-Oct-01	31-Oct-03	31-Oct-04
Period	14 Years	5 Years	3 Years	1 Year	Values
SHARE PRICE	507.0%	7.5%	2.4%	3.6%	£215.50
NAV PER SHARE	359.6%	8.4%	6.4%	5.5%	£213.41
FTSE ALL-SHARE	131.5%	-20.9%	-4.8%	8.1%	2,297.66
NAV REL TO FTSE A/S	98.6%	37.0%	11.8%	-2.4%	