PERSONAL ASSETS TRUST PLC

MAY 2005 QUARTERLY REPORT No. 37

A BLAST FROM THE PAST[1]

Live long enough, and your words will come back to haunt you. My friend and former student John Newlands, a naval officer turned stockbroker and investment trust historian, has just launched a private subscription newsletter called *Investment Trust Scrutineer*[2] in which he reprints (under the heading "*Blast from the Past*") an article I wrote in 1986, when the Berlin Wall still stood and Michael Heseltine had just stormed out of the Cabinet over Westland. Originally published in *Investment Trusts* magazine[3], its title was *Living Happily with the Discount*. I can't imagine choosing such a title now. So what did I find to say in favour of the discount in 1986?

"For several years [I wrote] *the discount has been spoken of as if it were a heartless imposture. . . But consider. People who own investment trusts which sell at a discount almost certainly bought them at a discount, too — and probably a higher one, at that. So the discount is much more likely to have benefited them than to have harmed them . . .*

"Certainly it is possible for a trust's share price to go from a premium to a discount. This can especially be the case with new issues. But that's why investment trusts are potentially both riskier and more rewarding to investors than unit trusts.[4] *With an investment trust there are two ways to make money — through movements in assets and through movements in the discount . . . You can make money on swings in the discount not just once, but time and time again. So why get rid of the source of opportunity?"*

LIVING WITH THE DISCOUNT

Glowing stuff — and mostly true, in its own way. In 1986 I was an analyst at a large investment bank, writing for the investing institutions. Many of these, depending on their tax status, could switch into and out of trust shares to exploit discount anomalies without paying Capital Gains Tax (CGT).

Even from the private investor's point of view, however, there was good sense in what I wrote. Discounts at that time had been trending downwards for several years:

"In mid-1976, the average trust discount was around 36% . . . But an average discount of 30% has not been seen since 1981, and we seem now [1986] *to be in an environment in which the average discount ranges between the low and middle 20s."*

So it really ***was*** the case that many holders of trusts selling at discounts in 1986 had bought them on considerably higher discounts during the previous decade and so had enjoyed some extra "discount gearing" from the trusts' share prices on top of their net asset value (NAV) performance.

"Yes, but no, but . . . ", as Vicky Pollard says in *Little Britain*. In 1986 you'd no choice but to hunt around for positives about the discount, ***because there seemed no way of getting rid of it*** — except through aggressive corporate activity that could leave private investors with big CGT bills if the roll-over paper on offer was unsuitable and they felt obliged to take cash (if it was an option) or sell the new paper they received.

At that time, for instance, we had "rights issue bids", whereby an industrial company bid for a trust using its own shares. Since this was often because its own shareholders were likely to snub a conventional rights issue, the shares they offered might not prove the soundest of long-term investments — e.g. the bids in 1984 and 1986 for Bishopsgate and Philip Hill by BPCC, later Maxwell Communications Corporation. There could be policy changes, too, as when in 1982 holders of CLRP Investment Trust (an offshoot of City of London Real Property Co. Ltd) found themselves owning an Australian specialist, TR Australia — maybe not everyone's idea of a balanced, low risk investment. In short, the discount in those days sometimes got eliminated at too high a price.

THE STOCK SELECTION ASPECT

There was also a tendency at that time, when looking at investment trusts, to see the discount as being all that mattered. I deplored this:

"The discount is largely irrelevant to the selection of investment trusts as long-term investments. The real motor driving investment trust prices is not movement in the discount but movement in underlying assets."

I still think there's a lot of sense in that, but I do have to admit that it's rather like my wife saying she likes my characterful appearance, whereas I know that in reality she'd prefer me to look like Brad Pitt. In life, you play the hand you're dealt. I must stress again that the reason I so greatly under-

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[1] Given the coverage they receive in the Annual Report, you will be relieved to hear that Alan Greenspan and Gordon Brown are getting a rest in this Quarterly. However, I can't resist quoting in a footnote the perfect song for Gordon Brown to sing when he takes over from Tony Blair:

The last man nearly ruined this place,
He didn't know what to do with it;
If you think this country's bad off now —
Just wait till I get through with it!
The country's taxes must be fixed,
And I know what to do with it;
If you think you're paying too much now —
Just wait till I get through with it!

The Marx Brothers, *Duck Soup* (1933)

[2] Available from Newlands Fund Research, 15 Gordon Road, Edinburgh, EH12 6NB, or see website: www.newlandsfr.co.uk/scrutineer/index.html

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

[4] I'm writing about 1986 here, of course. An investment trust like Personal Assets which has no discount risk is NOT riskier than a unit trust. Indeed, were the *"no discount risk"* model to be adopted by investment trusts in general it could lead to their supplanting unit trusts as the collective investment of choice in the retail market.

stated the negative aspects of the discount was sheer pragmatism: why waste time and energy complaining about it, when getting rid of it seemed as inconceivable as getting rid of exchange controls or overweening trade union power in the decades before Mrs Thatcher?

A HAPPY ANNIVERSARY

Nevertheless, things ***can*** change; and this year marks an important anniversary for Personal Assets. As you can see if you look at the chart on the back page with a very large magnifying-glass, ***we have not sold at other than a nominal discount since the spring of 1995.***

Not everyone grasps this. It may surprise you to know our views on the discount are cited in *The Impact of Corporate Governance on Closed-end Funds*[5], by Gordon Gemmill, Professor of Finance at the Warwick Business School, Warwick University, and Dylan C Thomas, Professor of Accounting & Finance at the Cass Business School, City University. The paper uses a large sample of UK-listed funds to see if corporate governance has an impact on two performance indicators: management fees and *(my special concern here)* discounts. Gemmill & Thomas state of Personal Assets:

*"In their annual reports, directors often discuss the discount and imply that they have some influence over it. For example: **'The Board's policy is to ensure that the shares of Personal Assets (unlike those of most other investment trusts) do not sell at other than a nominal discount to net asset value.'**"* (Personal Assets Investment *[sic]* Trust, Annual Report for year ended June *[sic]* 2003)

ACADEMIC RECIPE FOR SUCCESS

The authors hold interesting views about discounts and how Boards can have influence over them:

"We know from other work (e.g. Gemmill and Thomas, 2002) [namely, themselves] *that the premium/discount depends in the long term both on the expense-ratio and on the openness of the fund to arbitrage, while in the short-term it depends on flows of retail money into the relevant sector (i.e. on investor sentiment) . . .*

"Directors could reduce the discount if they were able periodically to shift the style of the fund to that which was currently in fashion . . .

"Discounts are larger for funds in which the manager (or any blockholder) has a significant stake, suggesting that investors dislike funds which have entrenched management."

According to this, Personal Assets seems to be missing a lot of tricks. Ian and I should sell our shares, because investors don't like *"entrenched management"* (some call it *"committed management"*) and don't like it if managers have a *"significant stake"* in the trust. Next we should search for a sector which has positive investor sentiment, and shift into it. What's hot these days? People loved technology stocks in 1999-2000. Would that have been a good idea? I suppose it might, for as long as the bubble lasted; and the memory of all those paper gains would have kept us warm as we huddled inside our cardboard boxes in Queer Street once the bubble had burst. So I looked around for the best-performing market in 2005 and noticed Egypt, up by over 50%; but as I dreamt of Scriptural spice for Personal Assets as a *"flesh-pots of Egypt"* trust (Exodus 16.3) Ian spotted the Al Quds Index of the 10 leading shares on the Palestinian Stock Exchange, up by over 150%. Truly a *"land flowing with milk and honey"* (Exodus 3.8) — but for how long, one wonders . . .

A BIZARRE CONCLUSION

Judging by their paper, Gemmill & Thomas seem to have as their ideal a small, bloodthirsty Board of outside directors with no financial commitment to the trust, but who will terrify the manager into continually changing its investment policy — this being the surest way (they seem to think) of getting rid of the discount.

In summary (they write):

"[Our] *results provide only limited support for the claim by directors that they can influence the premium* [or] *discount . . . "*

Let us pause there for a moment. The *"claim"* by directors, indeed! It isn't a claim. It's an observable fact. To be fair, Gemmill & Thomas put their trust sample through more permutations than are available on Peter Snow's Swingometer. It just didn't seem to occur to them to look at the record and see that the directors of Personal Assets actually did what they said they would! I think Boswell's *Life of Johnson* is relevant here:

"We stood talking for some time together of Bishop Berkeley's ingenious sophistry to prove the non-existence of matter, and that every thing in the universe is merely ideal. I observed, that though we are satisfied his doctrine is not true, it is impossible to refute it. I never shall forget the alacrity with which Johnson answered, striking his foot with mighty force against a large stone, till he rebounded from it — 'I refute it THUS.'"

Again to be fair to them, I expect Gemmill & Thomas would argue that although their paper was published earlier this year, its analysis covers only January 1995 to December 1998.[6] Such a time-lag between the date of gathering the data and the date of publication of the research is typical of academics; but in this case it means that the paper, however interesting it may be as a chapter of investment trust history, has been overtaken by events. This is because the environment for the control of trust discounts has been transformed since December 1998, the paper's cut-off date, by the ability obtained by investment trusts since then to buy in their own shares.

DISCOUNT FREEDOM DAY

The date to note is 8 November 1999: Discount Freedom Day. Before 8 November 1999 investment companies had been permitted to buy in their own shares for cancellation, but only by using revenue reserves. This, however, was never popular. Revenue reserves are usually tiny in relation to a trust's share capital but, given the preference of private investors for income, they are invaluable for smoothing dividends. Later, the custom grew up of resorting to the Courts to have certain reserves reclassified as distributable, so they could be used to buy back shares. We ourselves did this in April 1999. On Discount Freedom Day,

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[5] European Financial Management Symposium 2005. For the paper, see:
www.efmaefm.org/efmsympo2005/accepted_papers/Gordon_Gemmill_paper.pdf

[6] Note, however, that this didn't stop them from quoting Personal Assets' 2003 Report & Accounts, even though these were published well outside their timescale!

however, an amendment to the rules relating to investment companies as set out in the Companies Act 1985 became effective, permitting an investment company to distribute its capital profits *(assuming it had any!)* by way of redemption or purchase of its own shares in accordance with section 160 or section 162 of the Companies Act 1985 *without losing investment company status*.

In my opinion, this was the best thing to happen to the investment trust sector since 1979/80, when exchange controls were abandoned and CGT within trusts' portfolios abolished in the first year of Mrs Thatcher's rule.

So far, however, the new powers have not (in my view) been fully exploited. Most trusts which have taken buy-back powers have used them only to buy in shares at as big a discount as possible, to increase the NAV per share. This is laudable enough, but misses the main point. The new powers do not just allow trusts to make enhancements to their NAV by buying back shares at a discount. ***They make it possible to abolish the discount itself, and to ensure that the trust thereafter sells consistently at around NAV.***

Gemmill & Thomas might respond by pointing out that, as well as Personal Assets, their sample included 192 other trusts, none of which had done away with its discount or had even claimed it could do so. ***Yet what Personal Assets has done, any trust could do*** — any trust, that is, the Board of which was prepared for it to shrink in size before it started to grow. It takes only the will of the Board; and (to paraphrase Mark 9.43) it must surely be better to enter into life smaller in size than to stay the same size and be cast into the hell of corporate activity, where the eagerness of the arbitrageurs is never quenched!

DISCOUNTS ARE VOLUNTARY

John Bunyan's *The Pilgrim's Progress* recounts the sorry fate of the Man in the Iron Cage:

"[The Interpreter] *took* [Christian] *by the hand . . . and led him into a very dark room, where there sat a man in an iron cage. Now the man, to look on, seemed very sad; he sat with his eyes looking down to the ground, his hands folded together, and he sighed as if he would break his heart. Then said Christian, What means this? . . .*

"MAN: I am now a man of despair, and am shut up in it, as in this iron cage. I cannot get out; . . . I cannot!"

There is no reason why the man cannot escape if he chooses. His cage is merely the cage of his own despair. He is convinced, however, that he is a prisoner; and in this he is like the Boards of most investment trusts today, who believe they can do nothing about the discount while ignoring the clear evidence that it is in their power to get rid of it. I therefore cannot say it too strongly: in the investment trust sector of today, ***discounts are voluntary.***

So why do other Boards not act? There are various reasons. For instance, The Independent Investment Trust argued in its most recent Annual Report that it was unwilling to issue shares because an increased size might begin to impair its dealing flexibility, but was disinclined to buy in shares because a shrinking asset base would be likely to lead to a rising expense ratio. Neither of these arguments apply to Personal Assets; but, even if they did, we believe they would be hugely outweighed by the advantage to shareholders of our having no discount.

The main reason for the failure of Boards to eliminate discounts is probably, however, *agency risk*.[7] Put simply, this is the risk that the managers *(as agents of the Board)* would not encourage the Board to adopt a policy *(the elimination of the discount)* that would disadvantage the managers themselves *(by reducing, even if only in the short term, the size of the funds under their management)*; and I have to admit that managers are unlikely to emulate the SNP and Liberals in 1979, who, by voting to bring down the Government, evoked from the now departed Lord Callaghan the celebrated taunt,

"It's the first time that turkeys have been known to vote for an early Christmas."

"BUT I *LIKE* THE DISCOUNT!"

This heartfelt statement is, however, something I do still quite often hear from some trust directors and shareholders. Their arguments are that selling at a discount is no big deal if you've bought at a discount in the first place, while buying trust shares means you buy a stream of dividends at a discount — a higher quality income stream than you'd get if you invested in the stock market directly.

Both these things are true. Yet our shareholders have shown us that they ***do*** want to be sure they can realise NAV for their holdings at any time. Our record proves it.

- From 1992/93 it became possible to invest the full PEP entitlement in a qualifying investment trust PEP. Our zero-charge plans immediately let shareholders take the fullest advantage of this.
- Our 1993 share consolidation enabled a lot of very small shareholders to come out of Personal Assets free of any charges.
- Thanks to the resulting increased demand and lack of selling pressure, by our 30 April 1995 year end the discount was already on the point of vanishing.
- Our growth since then mirrors shareholders' confidence in the Board's "no discount" policy. We today have nearly four and a half times as many shares outstanding (677,185 vs 152,187). In 1995, 31,510 (20.7% of the total) were held in our investment plans. Now there are 303,002 (44.5%), nearly ten times as many — up in value from £3 million to £70 million.

When the Board began managing Personal Assets in 1990, the discount was around 30%, or £1.5 million of shareholder value. A 30% discount today would mean the loss of £45 million of shareholder value — except, of course, that we know that if Personal Assets were at any risk at all of going to a discount the trust would be nowhere near the size it is . . .

ROBIN ANGUS

[7] "[Agency risk] *involves the contract between an investor and a financial service provider whereby the provider, who is the investor's agent, may not fulfil his or her obligations. Agency risk may result either from self-interested or opportunistic behaviour by an agent or from the inability of an agent to serve all customers or clients (the principals) equally well."* J R Boatright, *Conflict of Interest in Financial Services: A Contractual Risk Management Analysis*, Loyola University, Chicago, 2004

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***.

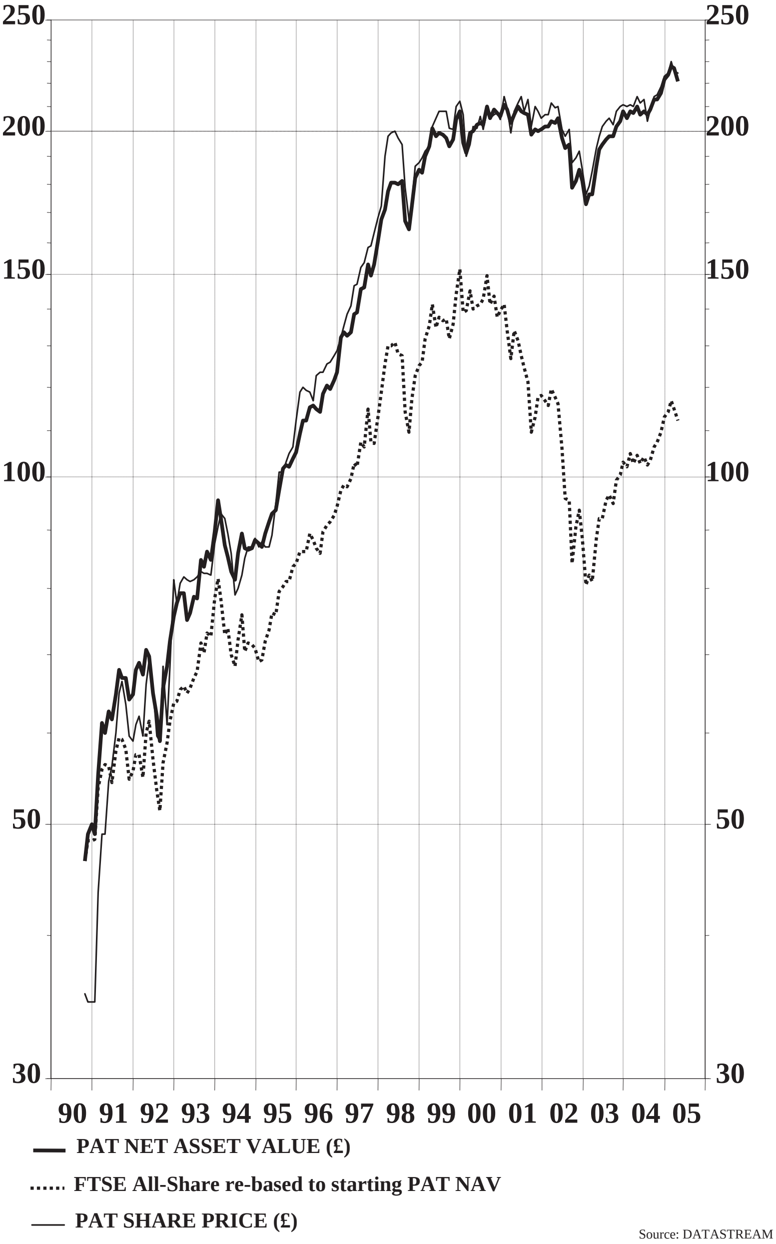
Full details of how to invest in the shares of Personal Assets can be obtained from:

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)	30-Apr-05
BP	£9,398
Royal Bank of Scotland	£9,302
HBOS	£7,609
Shell Transport & Trading	£7,371
Barclays Bank	£6,014
GlaxoSmithKline	£4,854
Scottish & Newcastle	£3,717
BT Group	£2,397
British Assets Trust	£1,598
Rentokil Initial	£1,563
Top Ten Equities	**£53,823**
Other Equity Exposure	**£44,004**
Effective Liquidity	**£52,007**
Shareholders' Funds	**£149,834**

PERSONAL ASSETS TRUST PERFORMANCE



% Changes From	31-Oct-90	30-Apr-00	30-Apr-02	30-Apr-04	30-Apr-05
Period	14 Yrs 6m	5 Years	3 Years	1 Year	Values
SHARE PRICE	533.1%	11.3%	7.3%	4.8%	£224.75
NAV PER SHARE	376.5%	10.7%	8.8%	5.3%	£221.26
FTSE ALL-SHARE	141.5%	-20.1%	-4.6%	7.1%	2,397.05
NAV REL TO FTSE A/S	97.3%	38.7%	14.0%	-1.7%	