PERSONAL ASSETS TRUST PLC

SEPTEMBER 2005 QUARTERLY REPORT No. 38

WELCOMING NEW HOLDERS

This is the first Quarterly to be published following the merger between Personal Assets and Collective Assets, so my first and very pleasant task is to welcome our new shareholders and to wish them a long and happy association with us. Collective Assets shareholders have been receiving the Personal Assets Quarterlies for some time, so they will know what to expect from them. Those who want back numbers of the Personal Assets Quarterlies, however, can get them by contacting Steven Budge by letter to the address on the back, by e-mail to Steven.Budge@fandc.com or by telephone on 0131-225 9995.

ANNUAL GENERAL MEETING

Personal Assets' Annual General Meeting (AGM) took place on 14 July. As usual, it overran the time allotted (even though we allowed an extra half-hour this year) and the number of shareholders attending was also greater. One particularly interesting question we were asked (about continuity of management, or, *"the succession"*) is worth discussing in some detail later in this Quarterly. Most of the questions from shareholders, however, concerned our view of markets, so I shall begin by recapitulating our stance as described by Ian at the AGM *(it hasn't changed since then!)* and go on to answer a couple of related queries about equity valuations raised recently by a shareholder in a letter to Ian.

OUR INVESTMENT VIEW

Our investment view continues to be dominated by the remarkably low level of real rates of return available on financial securities of every kind. Since, however, market players' hunger for returns is undiminished (bonuses depend on them), active investors like US investment banks and hedge funds have gambled by taking on much higher levels of risk than before, borrowing more and more dollars to exploit ever-shrinking margin spreads on ever-falling yields, in a desperate attempt to earn the same quantum of return as previously.

The result has been a drastic collapse in yields. While the yield on 30 year US Treasuries has fallen from 5% to 4.5% over the last 2½ years (despite 11 rises from 1% to 3.75% in the Fed Rate), the redemption yield on high yield US corporate bonds has *halved* from 14% to 7% and the spread on emerging market bond yields over US Treasuries is down from over 10% to under 4%.

Worrying enough in itself, the low real return on US Treasuries and UK Gilts coupled to the demise of the risk premium on high risk financial securities has also had the perilous effect of making equities look much more attractive than in absolute terms they actually are. *'Expensive'* isn't as bad as *'extremely expensive'*, but it doesn't mean *'cheap'*; and the UK equity market currently sells on a dividend yield of 3.1% compared to 3.0% on 30 September 1987 (less than three weeks before the 1987 Crash). Although they didn't calculate a P/E on the All-Share in those days, the P/E on the FTSE 500 Share was 18.8x. This compares to today's 15.7x P/E on the FTSE Actuaries Non-Financials.

Although UK equity earnings and dividends have been strong during 2005, the economic background is gloomy. Since 2001 the USA and the UK have moved from a 3% annual budget surplus to a 3% annual deficit (even *before* Hurricane Katrina in the US), injecting an annual 1½% of GDP into the economy as new money. This, given a typical 2x multiplier, should have produced an *extra* 3% of annual GDP growth; but *total* GDP growth has been only 3% annually over that period in the UK and the US, so there has been no real GDP growth at all.

It is obvious that financial securities' present overstretched valuations cannot continue indefinitely. However, it is ***not*** obvious when it will come to an end. The UK and US governments can continue to increase borrowings (in the UK to fund ever more public spending and in the USA to fund even more tax cuts) while Greenspan continues to hold the Fed Funds Rate below a neutral level in order to ensure ever more liquidity in the system. Quoting Alan Greenspan against himself has been a feature of recent Quarterlies, but I'll do it again. At a symposium in Jackson Hole, Wyoming, on 27 August 2005, he remarked:

"History has not dealt kindly with the aftermath of protracted periods of low risk premiums."[1]

That is exactly the sort of period we've been living through. When financial markets take their revenge for Greenspan's follies, it will not be a pretty sight.

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[1] Paul Krugman's words in the New York Times for 31 August 2005 are too good to miss:

"Most of what Alan Greenspan said at last week's conference in his honor made very good sense. But his words of wisdom come too late. He's like a man who suggests leaving the barn door ajar, and then — after the horse is gone — delivers a lecture on the importance of keeping your animals properly locked up. Regular readers know that I have never forgiven the Federal Reserve chairman for his role in creating today's budget deficit . . . Now, it seems, he's playing a similar game with regard to the housing bubble. At the conference, Mr. Greenspan didn't say in plain English that house prices are way out of line. But he never says things in plain English. What he did say . . . was that *"this vast increase in the market value of asset claims is in part the indirect result of investors accepting lower compensation for risk. Such an increase in market value is too often viewed by market participants as structural and permanent."* . . . I believe that translates as 'Beware the bursting bubble.'"

WE STILL LIKE BANKS AND OILS

Within the UK equity market, our preferred sectors continue to be oils and banks. While the attractions of the major oils are obvious, investors do seem to have missed how attractive the banking sector is. In general, demand for banking services grows at around twice the rate of GDP, which puts banks in a growth category. At this point the question of bad debts is always raised. Today, however, banks can insure against bad debts by securitising and selling on portions of their debt portfolios (at ever rising prices, as risk premiums have fallen!). Historically, banks always sold at a P/E ratio discount to the market because their capital was continually eroded by high inflation. In today's low inflation, banks should in our view enjoy a higher rating than the general market.

To summarise, at 31 August 2005 shareholders' funds were invested 14% in oils and 20% in banks. 31% was in other equity exposure and liquidity amounted to 35%.

THE 1997 TAX CREDIT THEFT

Is there something we have overlooked? One shareholder thinks so, and wrote to Ian with a question it earlier took the *Financial Times* and the Institute of Actuaries quite some time to resolve.

"You place great emphasis on dividend yield, with which I agree, but in 2003 you were comparing dividend yields with historic averages and coming to the conclusion that the market was highly valued . . . You appear not to have taken into account the fact that the historic averages included dividends which were declared as gross amounts, whereas since 1998 dividends are declared in net terms. This makes a big difference to conclusions concerning market value."

In fact, it makes no difference at all. The removal of the ACT tax credit in 1997 was not some fiscal technicality that left the underlying value of equities unaltered. Instead, it was a breathtaking imposition that reduced the yield from equities to the largest investors in the UK equity market[2] by 20%.

In plain words, it was a straightforward theft by Gordon Brown of 20% of the value of the stock market — a typical act of smug perfidy on the part of a Chancellor of the Exchequer who already shames two of his most famous predecessors by combining the sanctimony of Mr Gladstone with the duplicity of Mr Lloyd George.

The comparability of dividend yields before and after the removal of the ACT tax credit is of fundamental importance to the valuation of equities. While it is true that for basic and higher rate taxpayers the changes made no difference to their after-tax dividend returns, this is a red herring. Tax-paying private individuals, before *and* after 1997, bought equities for their after-tax returns rather than on published gross yields which they could not receive and so were not of relevance to them. Gordon Brown's tax theft from gross funds (were I an Englishman and not a Scot I would be tempted to call it the *'Browngeld'* by analogy with the Danegeld, another tax levied by a foreign invader) so crippled equity market values that it is essential to include the ACT tax credit in the dividend yield prior to 1997, to maintain comparability with current stated yields. Before 1997, gross dividends were net to gross investors (in other words, the stated gross dividend was what they actually received). Today, all they receive is the actual stated (net) dividend — a simple confiscation of value.

THE INFLATION CONUNDRUM

The same shareholder continued:

"The second factor which does not seem to have been taken into account is the inflation rate which corresponded with the historic dividend averages. I believe that the average inflation rate would have been over 5%. I believe that inflation rate has a major impact on stock values."

We're not arguing with that. In fact we would go even further, because we believe inflation to be the dominant factor in determining the comparative valuation of equities against other financial asset classes. In summary, as rising inflation reduces earnings in the short term and hence increases the price earnings ratio, investors sell equities; conversely, falling inflation increases earnings, generating buying demand.

The conundrum or paradox of how equity markets behave in response to changing rates of inflation (which in turn creates opportunity to add value to equity investment) is that ***changes in inflation shouldn't affect the value of equities at all***. Whereas rising inflation depresses fixed interest values, this should have no long-term effect on the values of equities. Equities, as an asset class, offer not only protection to investors against inflation over time but also the expectation of a real rate of return equal to the dividend yield plus around 2% from GDP growth. Hence, at times of high inflation (and hence high interest rates) equities should have a low Equity Risk Premium and *vice versa* in a period of low inflation such as currently exists.

Over the last 30 years, we have experienced an exact inversion of this logic, creating an unrepeatable 25 year bull market and propelling the market to valuation levels that (even after the 2000-03 correction) are ominously high. I discussed the reasons for this in Quarterly N° 35, which I think the shareholder in question must have overlooked because it should have left its readers in no doubt as to how important we regard the inflation rate as being.

THE QUESTION OF SUCCESSION

Much of my time at university as a student of history was spent studying wars about the succession to the thrones of various kingdoms or empires — the Wars of the Spanish Succession, for instance, or the Austrian Succession, or the Bavarian Succession — and in Scotland the rival merits of the Jacobite *vs* the Hanoverian Succession are still *(by some of us, at least)* hotly debated. I didn't expect, however, to find that a growing amount of my working time would be taken up in answering questions about the Personal Assets Succession!

Ian Rushbrook was 65 this year and still works full-time as Managing Director of Personal Assets. Does he want to retire? No. Like

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[2] The pension funds and insurance companies, which are effectively gross funds and which at the end of 1997 held, in total, 46% by value of the UK equity market.

me (I don't intend to retire either), he loves what he does and will continue doing it as long as he is able.[3] Investment management is Ian's passion and all-consuming interest. He works seven days a week at it, taking three weeks' holiday a year. It is his job in the sense that acting is an actor's job, making music is a musician's job and praying is a monk's job — and how often do really first-class actors or musicians retire (to say nothing of monks)?

BUT IF IAN WEREN'T THERE?

Sometimes people who ask me about *'the succession'* seem to have the idea that if Ian were to die or become incapacitated Personal Assets would grind to a halt straight away. But this isn't so. Perhaps it would be too much to compare Personal Assets, as Plutarch tells us that the envoy of Pyrrhus compared Rome, to a hydra that was impossible to overcome because for every head that was cut off, two others grew in its place. However, I work full time for Personal Assets in the office here in St Colme Street. So does Steven Budge, who assists Ian with dealing, share analysis and shareholder liaison. Gordon Hay Smith, our Company Secretary, and Steven Davidson, our Accountant, also devote a large part of their time to the trust's affairs.

The Chairman is in the office at least once a week. The other directors are also frequently either in the office or otherwise in contact, and can be reached at any time if need be. In the short term, therefore, Steven Budge and I would have no difficulty in seeing to the day-to-day running of Personal Assets, under the active supervision of the Chairman and the rest of the Board and with the assistance of the Company Secretary and Accountant.

There is more to it than that, however. I must also emphasise that the investment strategy Personal Assets is presently pursuing ***is not Ian's alone, but is that of the entire Board***. As we say in the Annual Report, *"The Board takes all major decisions collectively."* The Board is therefore equipped to implement these decisions on a day-to-day basis through Steven, myself and the Secretariat.

HIRING A DEPUTY FOR IAN?

Yes, but why (some shareholders ask) haven't we done what would seem the obvious thing and hired a deputy to Ian, a Managing Director-in-waiting, who could take over the succession immediately when the time came?

My reply would be, come to the office and see! Any young, enthusiastic fund manager appointed as Ian's deputy would jump from the roof in despair after a month. Most fund managers live for action, and for buying and selling shares; and at Personal Assets, which is run as a prudent individual's own portfolio, there would be very little for an ambitious young *(or old, for that matter!)* investment manager to *do*. As you will know from the Annual Report & Accounts, we seldom buy or sell shares. Ian and I work in an idiosyncratic way — reading, thinking, and then spending long hours with the Chairman and the other directors exploring ideas and concepts that are actually highly relevant to long-term investment decisions but would sound to a young, eager fund manager like a lot of pointless philosophical waffle.

In life, of course, one should never say never. An ideal successor to Ian might suddenly appear in our lives at any time. Were the chemistry right and the logistics manageable, I'm sure Ian and the rest of the Board would respond. It seems unlikely, however; and for the reasons I've just given it would be a waste of time to advertise such a post, because the job would only be a sort of virtual one, waiting to be activated at some indeterminate time in the future.

LOOKING TO THE LONG TERM

In summary, confronted with Ian's demise, the Board could choose from among four courses of action, any one of which, depending on circumstances, might be the most attractive at the time:

1. The Board could carry on running Personal Assets as before, Steven and myself continuing to work as full-time employees.
2. We could recruit a new individual Managing Director, if a suitable one happened to be available at the time and known to us.
3. We could form an alliance with another independently managed investment trust.
4. We could hire an investment trust management group to manage the trust's portfolio on lines laid down by the Board.

NO DISCOUNT WORRIES

Some shareholders, however, have asked me, in tones of some concern, about what might happen to the Personal Assets share price in the short term if Ian were out of action. Would it suffer an immediate sharp fall, as a discount to net asset value emerged in response to selling by worried shareholders and/or pre-emptive marking down by worried market makers? And would there then be a period of sustained weakness as a result of a persistent discount?

The answer to both questions is an emphatic no. The directors will never allow this to happen. The Board has taken the decision that the shares of Personal Assets will not sell at a discount to net asset value. Therefore the Board would buy in for cancellation any necessary quantity of shares (however large) in order to ensure that a discount would not appear — and, if it were required, would keep on doing so indefinitely. Hence, in the inconceivable event that after Ian's death his executors and trustees (I constitute 50% of them) took it into their heads to sell all his shares in Personal Assets, even this would not affect the market price of Personal Assets' shares in any way. The Board would simply buy in all Ian's shares for cancellation. Personal Assets is a discount-free zone. It will remain so in all foreseeable circumstances.

ROBIN ANGUS

[3] This, I may say, is in his genes; Ian's father, Frank Rushbrook CBE, the former Firemaster of Edinburgh and the Lothians, is now 91 and still travels the world as a leading international consultant on ship fires. The Board has sometimes spoken of asking Ian's father to take over the running of Personal Assets should Ian in some way become incapacitated.

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***.

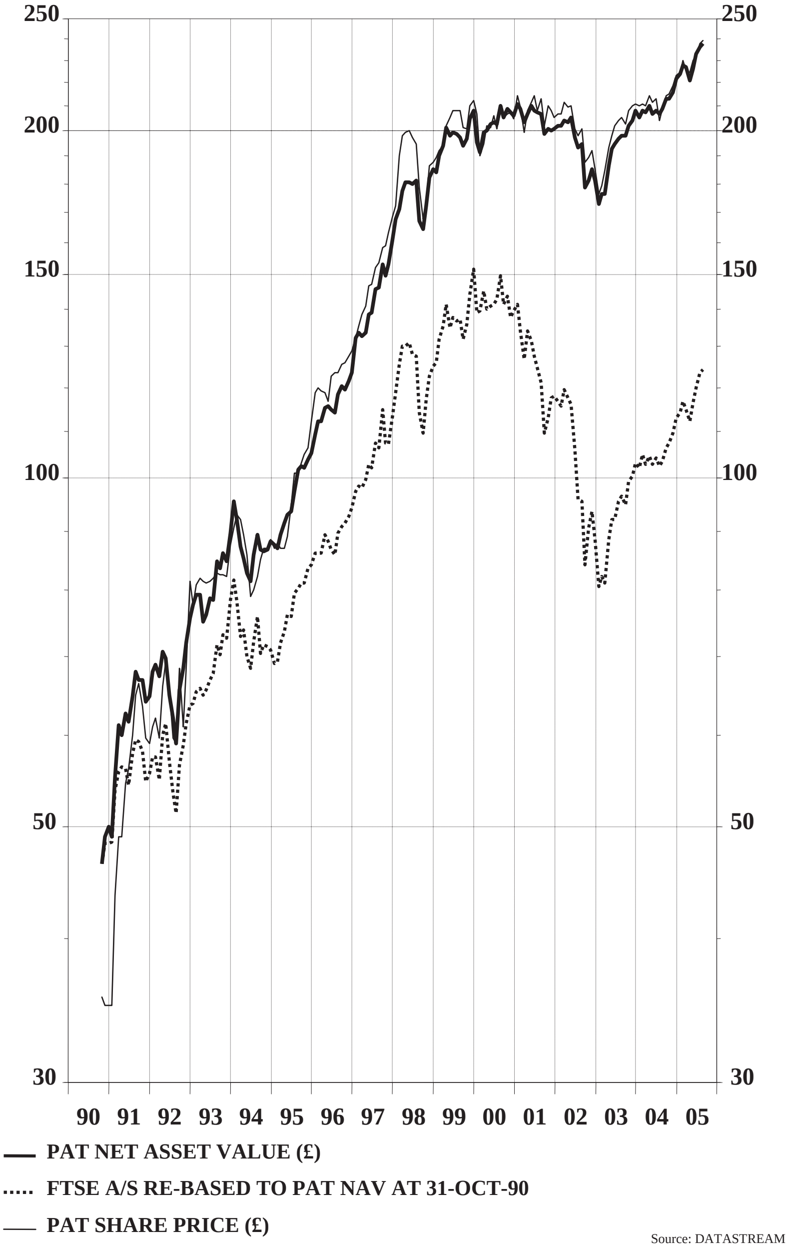
Full details of how to invest in the shares of Personal Assets can be obtained from:

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

Tel: 0131–225 9995
E-mail: steven.budge@fandc.com

PORTFOLIO (000's)	**31-Aug-05**
BP	£14,410
Royal Dutch Shell	£13,543
RBS Group	£9,580
HBOS	£8,564
GlaxoSmithKline	£6,695
Barclays Bank	£6,194
BT Group	£5,603
Scottish & Newcastle	£3,766
Scottish Investment Trust	£2,107
Foreign & Colonial I/T	£2,005
Top Ten Equities	**£72,467**
Other Equity Exposure	**£40,822**
Effective Liquidity	**£59,276**
Shareholders' Funds	**£172,565**

PERSONAL ASSETS TRUST PERFORMANCE



% Changes From	31-Oct-90	31-Aug-00	31-Aug-02	31-Aug-04	31-Aug-05
Period	14 Yrs 10m	5 Years	3 Years	1 Year	Values
SHARE PRICE	575.4%	15.3%	19.3%	14.9%	£239.75
NAV PER SHARE	413.0%	13.3%	22.5%	14.2%	£238.21
FTSE ALL-SHARE	167.9%	-17.1%	30.0%	20.1%	2,659.21
NAV REL TO FTSE A/S	91.5%	36.7%	-5.8%	-4.9%	