PERSONAL ASSETS TRUST PLC

NOVEMBER 2005 QUARTERLY REPORT No. 39

A CHANGED INTERIM REPORT

You may be surprised to receive, along with this Quarterly, not the modest four page Interim Report of yesteryear but one twice the size, supplemented with a bewildering profusion of Notes to the Accounts. This new format was not the Board's idea. It is the result of the UK's recent adoption of International Financial Reporting Standards (IFRS).

Much as it goes against the grain for me to welcome innovations, IFRS are in some ways an improvement on what we had before. For instance, while the IFRS requirement to value holdings at bid prices rather than at mid-market prices has little impact on us because we are reluctant to hold illiquid stocks anyway, it will give a truer and fairer view of the net assets attributable to the shareholders of trusts which hold lots of unmarketable stocks with wide bid-offer spreads — stocks which would be very difficult to sell at anything like the middle price *(or even the bid price)*.

A more neutral change is that because this is the first time we have produced an Interim Report on an IFRS basis, we have to list fully all our accounting polices. While this may be convenient to readers, none of our accounting policies (except inasmuch as affected by IFRS) will be news to you, since they have all been published previously in our Annual Reports.

Another IFRS change, to do with accounting for transaction costs, is not, in my view, an improvement. Previously, the transaction costs of a new purchase were included in the book value of the holding. IFRS now require us to account for these costs separately. While the change has no effect on the aggregate value of the portfolio, it does complicate reporting.

Lastly, accounting for dividends has changed. Previously, a declared dividend would be accrued in the accounts pending payment to shareholders. Bizarrely, this is not now permitted, which can make financial statements misleading. It was for this reason that we paid the First Interim dividend a month earlier than usual, and this will apply to all dividends from now on, including the Second Interim of at least £1.80 per share in respect of the year to 30 April 2006, which will be paid at the end of April next year and not, as previously, in late May.

IN PRAISE OF *'HUTBER'S LAW'*

Having described these specific reporting changes, I want to comment briefly on the wider question of 'improvement'. One of the greatest advances in business wisdom during my lifetime must surely be *Hutber's Law*, which owes its name to Patrick Hutber, the late and much lamented City Editor of the *Sunday Telegraph*:

'Improvement means deterioration.'

Hutber's Law applies to virtually everything I can think of, from 'chip-and-PIN' cards, the railways and the educational system to the introduction of decimal currency, the abandonment of Imperial units of measurement and the near-destruction of the House of Lords. In my youth, I used to think Shakespeare's Dick the Butcher in *Henry VI Part 2* had got it right:

'The first thing we do, let's kill
all the lawyers.'

Today, having read of a church in Suffolk forced to pay £1,315.66 to get four lightbulbs changed because it must now use scaffolding instead of a good old-fashioned ladder, I suspect that a 21st century Dick the Butcher might say:

'The first thing we do, let's abolish
the Health & Safety Executive.'

In the words attributed to one of our greatest Prime Ministers, the 3rd Marquess of Salisbury[1]:

'All change is for the worse, so let us have as little change as possible.'

Whatever Messrs. Cameron and Davis may say, the best political manifesto ever produced in Britain was, I maintain, that issued in 1715 on behalf of the Church Party (as the Tories then called themselves) by Francis Atterbury, Bishop of Rochester. It had just 60 words and consisted entirely of a list of negatives:

'No new war, no new taxes; no attempt against the Church; no repeal of the conditions upon which the crown was settled upon the King; no foreigners in employment; no standing army; no Long Parliament; no restraint of the liberty of the press; no insulting the memory of the Queen. TOTAL: No alteration of the Constitution in Church and State.'[2]

I cannot help wondering if a fresh Tory cry of *'No new war, no new taxes'* might not have succeeded in overthrowing Mr Blair at the last election. Who knows? It may overthrow Mr Brown next time.

HUTBER AND HEDONICS

Hutber's Law might be said to have a bearing even on our present fears about the US economy, because 'improvements' to goods

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[1] This excellent man shared my scepticism about 'experts' of all kinds, and about Parliament too:

'No lesson seems to be so deeply inculcated by the experience of life as that you should never trust experts. If you believe the doctors, nothing is wholesome; if you believe the theologians, nothing is innocent; if you believe the military, nothing is safe.'

'Can it be maintained that a person of any education can learn anything worth knowing from a penny paper? It may be said that people may learn what is said in Parliament. Well, will that contribute to their education?'

[2] *'The King'* was George I and *'the Queen'* was Queen Anne, much loved by Church Tories, who had died the previous year. *'No foreigners in employment'* was a swipe at George I, who had filled lots of government posts with Germans.

and services are currently being used as a pretext to disguise a deterioration in the rate of inflation. This is through the bringing into play of the pseudo-science of *'hedonics'*, defined by Professor Anthony Müller of the Ludwig von Mises Institute[3] as follows:

'The term 'hedonics' is derived from ancient Greek and basically means 'pleasure doctrine'. It is also the doctrine which the Bureau of Labor Statistics (BLS) applies when calculating the price indices and for the computation of the real gross domestic product and of productivity. The idea behind hedonic price index calculation is to incorporate quality changes into prices. This way, a product may be on the market at a higher price, but when the product qualities have augmented more than the price in the eyes of the BLS, it will calculate that the price of this product has actually fallen.'

This curious and flawed doctrine, that something is cheaper even if it costs you more because it gives you 'extras' you might well not have chosen to pay for if you had had the choice, is not of academic interest only. It has worrying implications for the US economy and for financial markets. As Professor Müller points out (note the words I have emboldened):

'Applying the hedonic technique to a host of goods and services means that even when prices were generally rising, but product improvement are deemed to be larger than the price increases, the calculated inflation rate will fall. With a lower inflation rate, the transformation of nominal gross domestic product (GDP) into real GDP will render a higher result. Likewise, given a constant labor input, productivity will increase.

'Hedonics opens the door to producing magical results: a lower inflation rate with generally rising prices, a higher growth rate though the economy may be weaker, and a higher productivity number, although productivity would have been declining without the hedonic imputations . . .

'It is quite obvious that hedonic imputations open the way to all kinds of manipulation. Given the implicit pressure that governments and central banks want to hear low inflation rates to be reported, due delivery would suggest to search mainly for quality improvements, and to calculate these even when [of] *a dubious nature.'*

In other words, you can't trust the figures. They are being cooked by the authorities. Yet Americans, on the strength of them, are spending freely — and are failing to save.

Comparing Annual Reports

There would be enough in Hutber's Law and 'hedonics' for several Quarterlies, and I shall return to 'hedonics' later; but now I revert to investment trust reporting and, in particular, to changes in Personal Assets' own Annual Report over the years. Despite welcoming a couple of the changes brought in by IFRS, I feel confident in saying that where there have been genuine improvements in our Reports the Board has been mainly responsible, whereas any deterioration has been due to the mushrooming in recent years of corporate governance legislation and other reporting requirements.

'Investment trust Annual Reports are like ice-skating,' Hamish Buchan used to say. *'You've got the compulsories, and you've got the voluntaries.'* By this, he meant that some parts of an Annual Report were there because they had to be, while others were there at the trust's choosing. While my chief complaint in this Quarterly is the extent to which the *'compulsories'* have grown and multiplied, it is undeniable that, over the years, the *'voluntaries'* in most trusts' Annual Reports have also increased in size and number.

Trust reports have got more and more like gift catalogues, printed on heavy paper and full of illustrations of investee companies' products and smiling portraits of young fund managers in crisp white shirts or multi-coloured blouses. We have none of that here, although I have often tried *(and always failed)* to get rid of those rather unappealing photographs of the Board from the Annual Report. We don't think a glossy photograph of an oil refinery will help you understand why we hold BP, or one of a group of youthful, white-coated researchers carefully chosen for the approved balance of gender and ethnic origin will tell you much about GlaxoSmithKline. *(What's more, glossy photographs cost money.)*

The expansion of the *'compulsories'*, however, affects Personal Assets regardless of the Board's own wishes and has over the years dictated many changes in our way of reporting to you. I have here in front of me the Annual Report of Personal Assets for the year to 30 April 1991 — nine months after Ian's appointment as Investment Director, and the first Annual Report to be produced under Dick Anderson's Chairmanship. It was a good report, telling you everything you might reasonably want to know about Personal Assets and its doings, and it takes me back to a happier world, before Cadbury, Greenbury, Hampel and Higgs[4] arrived to pester us. As the poet Lucan so vividly put it:

Numquam tanto se volture cælum
Induit aut plures presserunt aëra pinnæ.[5]

Today's air is indeed thick with the vultures of corporate governance. The spirit of Sir Humphrey Appleby lives on in them, as does the hectoring socialism chillingly described by Douglas Jay:

'In the case of nutrition and health, just as in the case of education, the gentleman in Whitehall really does know what is better for people than the people know themselves.'[6]

Underlying such patronising pomposity, too, is an unpleasant hint of envy *and* of disdain for capitalism itself. The apostles of corporate governance are always metaphorically holding their noses — in George Orwell's words, *'like Dr Bowdler walking through Gomorrah'*. How much better it would be for the common good if they could find something more productive to do with their time!

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[3] This describes itself as *'the research and educational center of classical liberalism, libertarian political theory, and the Austrian School of economics'* — worthy causes all, in the opinion of the Personal Assets Board. The reference is:

Anthony Müller, *The Illusions of Hedonics*, The Ludwig von Mises Institute, July 2005.

http://www.mises.org/story/1873

[4] This sounds rather like the beginning of a children's rhyme. I therefore suggest:

Cadbury, Greenbury, Hampel and Higgs
Were pompous, impertinent puritan prigs;
They choke us with rules, and on liberty trample,
We're hog-tied by Higgs —
and we're hampered by Hampel!

[5] *"Never did the sky clothe itself with such a host of vultures, or more wings beat the air."* M Annæi Lucani *De Bello Civili*, Book VII, 834-5.

[6] Douglas Jay, *The Socialist Case*, Faber & Faber 1937, revised and reissued in 1947.

SUBLIME VS RIDICULOUS

Comparing our 1991 Annual Report with that for the year ended 30 April 2005, the first thing to notice is a big difference in size: the 1991 Report runs to only 24 pages, compared to 38 in 2005. Trees die that corporate governance may flourish. (Our Report is still concise as these things go. Foreign & Colonial's Annual Report for the year ended 31 December 2004 has 124 pages.)

A greater size, alas! means slower reporting. It was with some pride that the Chairman wrote in 1991:

'Timely information is of particular interest to private investors and you will see that we are publishing this Annual Report much earlier than is usual for an investment trust. In future years we would hope to improve on this still further.'

Some hope. The authorities keep giving us more to do, so it takes ever more time both for us to compile the figures and for the auditors to audit them. In 1991 the Balance Sheet was signed on 17 May; in 2005 it was not signed until 23 May. There were five Notes to the Accounts in 1991 on just over two pages, compared to 20 on nine pages in 2005. The third page of Notes to the Accounts in 1991 also contained the Report of the Auditors, telling you everything you needed to know in six crisp lines. (We mischievously reproduced this in our 2003 Annual Report.) However, the cumbersome 2005 *Directors' Responsibility Statement and Independent Auditors' Report* (the very *name* is longer!), which weighs in at 973 words compared to 1991's 73, is full of new information you never suspected, like:

'The Directors are responsible for preparing the Annual Report, including the financial statements which are required to be prepared in accordance with applicable United Kingdom law and accounting standards.'

Well, what do you know?! I bet you thought the Annual Report was prepared by Heart of Midlothian Football Club in accordance with the laws of Outer Mongolia. I'm glad that's been cleared up.

DIVIDENDS ARE IMPORTANT

The 1991 Annual Report was a manifesto for the 'new' Personal Assets, and it is as well that today's information overload was not there to obscure the message. Its 24 pages contained much that was to be important for the future.

Dividends are significant to private investors, and the Chairman set out our new dividend policy.

'Historically Personal Assets has placed little evidence on dividend policy. However, the Board has decided that such an approach gives insufficient weight to the importance of dividends to the private investors for whom Personal Assets is run.'

This we have followed ever since, with a hiccup in 1994-95, when dividend growth slowed down to a crawl. After receiving some less than delighted comments from shareholders, we delivered a 10% increase in 1996 and also pledged to increase the new higher dividend at least in line with inflation in the years ahead. We have fulfilled this pledge. The dividend for the year to 30 April 2005 was £3.40, an increase of 55% over the £2.20 we paid for the year to 30 April 1996, compared to inflation over the same period of 26%.

AIMING FOR FLEXIBILITY

Dick Anderson next described our new investment policy.

'As a small investment trust [which we were, then, our market capitalisation being only £7 million], *Personal Assets previously focused on investment in smaller companies. We have decided, however, that Personal Assets' size should be viewed not as implying that we must invest in companies with lower market capitalisations, but rather as giving us the opportunity to be more flexible than our larger competitors within the investment trust industry. The emphasis of the portfolio will accordingly be shifted over time towards companies with larger market capitalisations, giving us the ability to carry out asset management without incurring the "small company penalty" of high transaction costs.'*

This we have stuck to ever since, and although large stocks have not notably outperformed small stocks over the period — since 30 April 1991 the FTSE 100 is up 122%, virtually the same as the FTSE Small Cap's 121% — Personal Assets' net asset value has risen by 305% over that time.

From the Chairman's description of our new investment policy, it would have seemed natural to turn to the Investment Director's Report. However, there wasn't one. (The first Investment Director's Report appeared in 1992.) Under the bold heading *'Our specialisation will be our shareholders'* there instead appeared a five-page *Review of Purposes and Policies* analogous to today's *The Board's Polices for Personal Assets*.

Here we wrote (my emboldening):

'The Board [intends to make] *Personal Assets a genuinely diversified trust for wealthy individuals. Wealthy people, contrary to general belief, are usually risk-averse with their family investment portfolios. They will tend in any case to hold other risk investments — property and land, works of art and other high value tangibles, or shareholdings in other companies on which their wealth was, or is, based.* ***In general, therefore, their objective from their share portfolios will be to achieve a good compound rate of return at an acceptable risk level, rather than high returns at a significant risk level.****'*

This still holds good, in our view; and it is complemented by what a shareholder wrote to Ian in 1992:

'Certainly I would hope Personal Assets would be managed in such a way that it is an appropriate investment for a substantial percentage of the wealth of a private investor. You referred to "a diversified equity portfolio". I suspect, however, that very many private investors would simply wish to make an investment suitable for retention in the long term, which they could forget about. I believe they would prefer, therefore, that the managers should have the flexibility to switch out of equities if at any point it was the view of the managers that fixed interest investment had become preferable . . . Tax considerations are such that a move out of the equity market is better taken by the managers than by the shareholder disposing of his shares in the company.'

'BACK TO THE FUTURE'

These comments tie in with one of the most interesting features of our 1991 Annual Report — the page headed *'Back to the Future'*, being Maynard Keynes' prospectus statement for the launch of The Independent Investment Company Limited in 1924. We reproduced it in 'The Blue Bible', our volume of collected Quarterlies published in 2002; but, since shareholders who have joined us more recently may never have seen it, I am reproducing it again as page five of this Quarterly. Dick Anderson wrote in 1991 that it was a model summary of the principles of running an investment company and would help shareholders to understand the Board's approach to the running of Personal Assets. It was indeed, as might be expected of a company the Board of which consisted of John Maynard Keynes himself, his stockbroking friend Oswald Falk, and the formidable Thomas Johnstone Carlyle Gifford, whose name lives on today in Baillie, Gifford & Co. (I joined Baillie, Gifford as a trainee two years after his death, but his spirit still brooded over the office.)

Ironically, however, Keynes' fine statement was a manifesto for what didn't happen. As Ian wrote the following year (1992):

'Unfortunately for the shareholders of Keynes' company, these claims proved to be unfounded and the trust produced a very disappointing performance record. Keynes, twenty years later, was to admit that he had not seen a single successful instance of credit-cycle investing, buying shares in slumps and disposing of them in booms, or what is called today, "market timing".'

LOOKING TO CATCH THE TIDES

In his quest to benefit from Keynes's insight and to make Keynes's dream a reality, Ian has for over a decade used an equity valuation model, refined on various occasions in the light of experience, to help make 'macro' investment decisions. As he wrote in the 1996 Annual Report:

'For many years I have wanted to create an explicit valuation framework for UK equities, fixed interest and index-liked gilts, so that I could make investment judgements among them at any given time.'

Two problems, however, hinder any such attempts to profit from investment 'cycles', or, as I prefer to call them, 'tides'. One is, as Harold Macmillan said, *'Events, dear boy, events'* — or, rather, the failure to anticipate and react to them properly. To illustrate this I turn to our 1996 Annual Report, in which Ian, after referring to our valuation model, wrote (my emboldening):

'By the time our Annual Report is published next year, we shall have had the General Election and it is likely that the British electorate will make a grave mistake and vote for a dose of socialism . . . A socialist victory would have consequences far beyond what that nice Mr Blair is prepared to tell us (or possibly even knows). One certainty is that a Labour government will spend more than a Conservative government . . . Sooner or later, the political risks of a Labour Government are going to be priced in the market. ***In anticipation, we have ignored the equity model presented (it suggests that equities are appropriately valued at present but is unable to take account of what investors may think in the future) and increased our liquidity to 16%.****'*

The other problem is when the figures change in such a way that they can no longer be trusted. I mentioned a worrying example of this earlier: 'hedonics', which is making US economic data, and the conclusions that can be drawn from them, less trustworthy. Another prime example was the calculation of yields on the FT indices following the removal of the ACT tax credit, a problem which (as I wrote in Quarterly N[o.] 38) took the *Financial Times* and the Institute of Actuaries quite some time to resolve. During the waiting period, equity valuation models relying (like ours) on yield statistics were gravely hampered.

ALL TIME HIGHS

In the 1996 Annual Report Ian also wrote:

'In the short term, individual share prices are no more than corks bobbing in the water. What I am interested in is the longer-term price performance of just one stock, Personal Assets.'

This is the ultimate test of any investment approach which seeks to catch investment 'tides' for the cumulative benefit of shareholders. Although the UK market has recovered strongly from its March 2003 low, it is still some 20% below its all-time high in 2000; but, ***even despite our recent underperformance***, the shares of Personal Assets reached ***their*** all-time high of £245 only recently — on 3 October 2005, to be exact.

This happy occurrence drove me to look at the long-term performance of the trusts in our AITC sector, Global Growth. In the table below are shown the ten AITC Global Growth trusts which are most comparable to Personal Assets, are over £150m in size, and have at least a ten-year record in their present form.[7]

With the exception of Monks, all these trusts reached their all-time high in 2000 and still show a loss compared to five years ago.

The percentage figure shown in the table is each trust's ***loss*** in share price terms since its 2000 high, and the figure in £ sterling is the sum a shareholder would have had at 31 October 2005 after investing £100 in the shares on 31 October 1995 and reinvesting all dividends thereafter ('Price Total Return', or 'PTR').

The findings more than justify our policy of trying to catch 'tides' instead of investing with a shorter-term outlook. ***Despite the market recovery, none of the ten trusts except Monks has yet climbed back to where it was five years ago***, the arithmetic average shortfall for the nine trusts shown (excluding Monks) being 24%.

Personal Assets, however, despite our liquidity during the market recovery, has since 2000 made a worthwhile price gain ***in absolute terms***: our 2000 share price high was £212¼, whereas our share price now, at £238, is 12% higher than that and our PTR since 1995 is the best of the trusts surveyed.

TRUST	% OFF HIGH IN 2000	PTR
Brunner	-46%	£178
Electric & Gen	-45%	£193
Witan	-29%	£194
Scottish Inv	-22%	£200
Foreign & Col	-21%	£185
Scottish Mortgage	-19%	£206
Alliance	-14%	£199
Second Alliance	-13%	£202
Bankers	-5%	£198
Monks	+2%	£233
Personal Assets	**+12%**	**£267**

ROBIN ANGUS

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[7] I have left out *British Empire Securities*, which (although a superb performer) has a very different investment policy, *Law Debenture*, which owns a trusteeship business in addition to holding an investment portfolio, and *Martin Currie Portfolio*, (formerly *Scottish Eastern*), which underwent significant structural changes.

THE INDEPENDENT INVESTMENT COMPANY
EXTRACT FROM PROSPECTUS

THIS Company has been formed with the objects specified in its Memorandum of Association, and in particular to carry on the usual business of an Investment Company, aiming at obtaining a higher return on the capital employed than is open with safety to the individual investor, and also having special regard to certain principles of investment which are now well recognised but have as yet been acted on in only a limited measure. It is now known that fluctuations in the relative values of long-dated and short-dated fixed interest securities and also of fixed interest securities generally and of ordinary shares are all affected by a periodic credit cycle. Changes in the short period rate of interest affect the value of long-dated securities to a greater degree than should strictly be the case, with the result that considerable profits can be made by changing from one class to another at the appropriate phases of the credit cycle. Similar periodic changes also take place in the relative values of money on the one hand and of goods and real property on the other, which are reflected in the relative values of bonds and of shares, representing as these do respectively money claims and property, so that here also the same principle of changing from one class to another at appropriate times can be applied.

The result of accumulated experience on these matters is to make it clear that the course of events is sufficiently regular to enable those who are in close and constant touch with the financial situation in certain instances to anticipate impending changes in the course of the credit cycle.

Whilst the Directors will carry on the business of the Company on the stable lines recognised by sound Investment Companies, they intend in addition to avail themselves of the above principle by moving from one category of investment to another whenever the general situation indicates such a change to be advisable. This does not imply any intention to adventure the funds of the Company upon investments which would not be considered suitable for a prudently managed Investment Company. Indeed the policy of moving from time to time from one category of investment to another will require that the funds of the Company should in the main be employed in investments which are readily marketable, and which are among the leaders of their class. It will be the object of the Directors to create an organisation which will enable the ordinary investor who is unable or does not desire to pay constant attention to his individual holdings to obtain all the advantages of close supervision of his investments.

The power of the Directors to borrow money on Debentures or Debenture Stock, or in any other way, is limited to the subscribed Capital of the Company for the time being. In addition, the Directors have power to borrow up to twenty per cent. of the subscribed Capital, but only for temporary purposes. In order to facilitate prompt investment, should such be deemed advisable, the Directors may also obtain advances from their Bankers or others in anticipation of the receipt of Call and Debenture money.

No contracts have been entered into. No promotion money has been or will be paid, and no underwriting contract has been or will be entered into, in connection with the present Issue.

The whole preliminary expenses, apart from the Capital stamp duty of one per cent., but including the fees of the Solicitors and the cost of printing and issuing this Prospectus, and of printing, stamping and issuing the allotment letters, are estimated not to exceed £750, and will be paid by the Company.

MAYNARD KEYNES

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***.

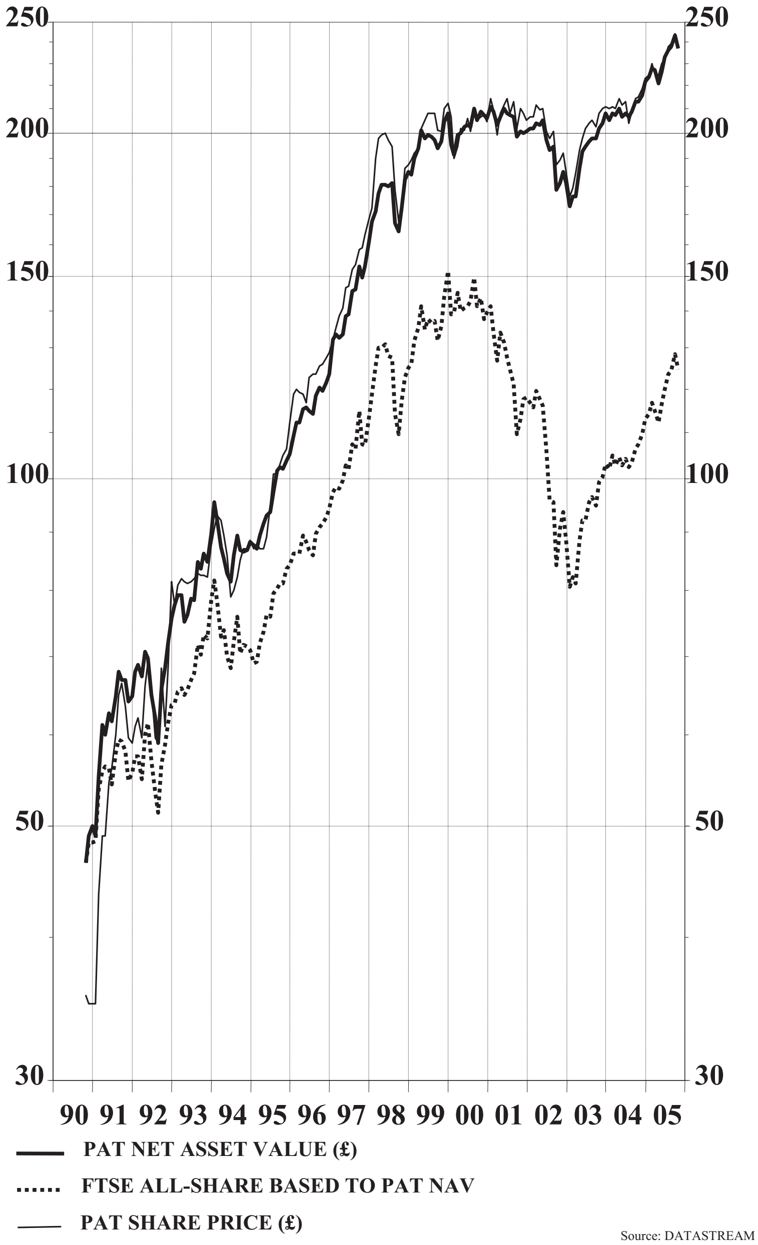
Full details of how to invest in the shares of Personal Assets can be obtained from:

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-Oct-05
BP	£14,216
Royal Dutch Shell 'B'	£13,255
Royal Bank of Scotland	£9,237
HBOS	£8,215
GlaxoSmithKline	£7,345
Barclays Bank	£6,261
BT Group	£5,531
Scottish & Newcastle	£3,825
Scottish Investment Trust	£2,146
Foreign & Colonial IT	£2,048
Top Ten Equities	**£72,079**
Other Equity Exposure	**£38,965**
Effective Liquidity	**£61,731**
Shareholders' Funds	**£172,775**

PERSONAL ASSETS TRUST PERFORMANCE



% Changes From	31-Oct-90	31-Oct-00	31-Oct-02	31-Oct-04	31-Oct-05
Period	15 Years	5 Years	3 Years	1 Year	Values
SHARE PRICE	570.4%	15.3%	25.6%	10.4%	£238.00
NAV PER SHARE	409.1%	13.2%	30.5%	10.8%	£236.41
FTSE ALL-SHARE	168.4%	-13.4%	37.4%	16.0%	2,664.40
NAV REL TO FTSE A/S	89.7%	30.7%	-5.1%	-4.5%	