PERSONAL ASSETS TRUST PLC

FEBRUARY 2006 QUARTERLY REPORT No. 40

INCREASING OUR LIQUIDITY

Following discussion at our January Board Meeting we have increased our liquidity from 33% to 40%. This we did by selling some FTSE 100 Futures. Our holdings of equities remain intact, the exposure to our two favoured sectors, Banks and Oils, being little changed at 16.5% and 18.2% of shareholders' funds respectively, compared to the FTSE All-Share's weightings of 17.1% and 17.6%.

This Quarterly sets out the *rationale* for our increasing bearishness, in an analysis of where the gigantic sums of money have come from that have kept US Treasury bond yields unrealistically low for so long and a consideration of what must happen when this tide of money turns. First, however, as Ian often says when giving presentations, let me backtrack a little.

BULLS ROUND THE TABLE

Just after New Year I took part in an investment 'Round Table' run by *The Scotsman*. The general view of markets was, in W S Gilbert's words, *'Modified rapture.'*

'After a year in which worldwide stock markets forged ahead . . . most of our seven investment lights were cautiously optimistic for 2006.'

'In terms of equity markets . . . it's hard to see a catalyst in the short run that's going to push markets lower.'

'Earnings have improved alongside share prices — and often at a faster rate. If you couple that with the fact the market is well below its world highs, it's quite encouraging. I would have my money in equities.'

'Everyone is cautiously optimistic and talking about 7-10% [growth in price terms] *for world markets this year . . . I'm not worried about inflation. So, I'd start at 7-10% and hope that we'll do better than that.'*

One participant, however, sighed:

'I don't see anything I want to buy. UK [equity ratings] *are not far from what they were in 1987* [just before the Crash]. *UK long gilts are yielding a shade under 4%; if I can get 4.5% in cash, why should I put it in a long gilt at 3.9%? . . . I'm keeping in cash and guarding the gold under the bed.'*

No prizes for guessing who said that. Indeed, my initial market view surprised them a bit, because it was a snatch of Latin verse: Virgil's celebrated passage from the *Æneid* about the Tiber foaming with much blood . . .[1]

I DON'T *WANT* TO BE BEARISH!

Some of you may think I'm a perpetual bear. Not so. In my time I've been a raging bull, snorting and pawing the ground with the best of them. Recently I found this, from January 1991, when the FTSE 100 stood at around 2050:

'The world is in a hell of a mess. We have never written a piece of trust research against so depressing a global background . . . [But] *this will be a cheerful Review with a clear message: START BUYING.'*

Why was I so bullish? Well, after drawing attention to a long list of woes, including some colourful comments about how Sterling had been forced into the ERM like a fat lady into her corsets, within a band which could only be described as the triumph of hope over experience, I pointed out that UK shares, then yielding over 5%, were cheaper than at any time since 1983. I did, however, make allowance for human nature.

'Many people will accept these arguments, at least in general terms. But, of course, it is still too early to buy, isn't it? . . . And if the market goes to a yield of 6%, it won't stop there. It will probably go higher.'

The market pendulum usually swings too far. It pointed towards excessive bearishness then, and I was a bull. It has swung too far in the other direction now, which only accentuates my bearishness.

OUR LOW-RETURN WORLD

What *is* there that's worth buying? Equity markets other than the UK and the US I'm not competent to comment on. We aim to serve the needs of Sterling-based equity investors, including gearing and liquidity decisions. Our fundamental objective is to protect shareholders' funds in the short term and to outperform the UK equity market over the long term. Shareholders who do want a stake in specialised investment areas in the UK or overseas should look for it elsewhere, over and above their holdings in Personal Assets.

After that *caveat*, let's begin with equities. A latter-day Dante would call equities the 'First Circle' in today's Hell of asset valuations; yes, they look expensive enough, but things will get far, far worse when we come on to fixed interest. The FTSE All-Share sells on a P/E ratio of 14.1 times ('14.1x') and yields 2.9%. (Our preferred sectors, Oil & Gas Producers and Banks, sell on P/Es of 12.6x and 12.8x respectively and yield 2.7% and 4.0%.) Historically, this *is* a demanding rating. Nor are we tempted by US equities: the Dow Jones sells at 18.8x and yields 1.7%. Indeed, our exposure to US equities is now minimal, at 2.5% of shareholders' funds.[2]

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[1] The Sybil's prophecy of *'bella, horrida bella, 'Et Thybrim multo spumantem sanguine cerno.'* P Vergilii Maronis *Æneidos,* Liber VI 86-7.

[2] I agree with Russell Napier, the author of the recently-published *Anatomy of the Bear: Lessons from Wall Street's Four Great Bottoms* (CLSA Book, £21.99) that what has been happening since 2003 is just a protracted bounce in a major bear market. Although as regards its title I can't help remembering Boswell's celebrated remark about Dr Johnson's conversation that *'the word "bottom" thus introduced, was so ludicrous when contrasted with his gravity, that most of us could not forbear tittering and laughing'*, I heartily recommend this indispensable book to anyone interested in what has happened in markets in the past and may be happening now.

Current fixed interest yields frighten me. US ten-year Treasury notes yield 4.5% — a low real return in itself ('headline' US inflation is 4.0%) *and* identical to the Fed rate of 4.5%, so there is *no* extra reward for tying your money up for ten years. Such a flat 'yield curve' has traditionally heralded a recession. *(Greenspan says it's different this time — but then he would, wouldn't he?)*

In the UK, the 50-year conventional gilt sells at a gross redemption yield of 3.8% *vs* 4.5% on one-month Treasury Bills. To invest for 50 years at 3.8% with the long-dated gilt's capital risk when you could get ¾% *more* in T-Bills, risk-free, seems barely sane. Yet index-linked gilt pricing is even more surreal, thanks to panic among pension funds. To quote Philip Coggan and Joanna Chung in the *Financial Times* for 19th January 2006:

'Pension deficits of FTSE 350 companies have increased by £20 billion this month . . . The problem . . . is that their liabilities are calculated using a discount rate based on bond yields. As real yields fall, liabilities increase. The result has been a vicious cycle in which pension funds buy index-linked gilts to match liabilities, forcing real yields lower and causing pension funds to buy more gilts . . . '

The UK 50-year index-linked gilt (1¼% IL Treasury 2055) currently yields 0.5%.[3] *This is scary.* It's much worse than just accepting a minuscule real return over 50 years. Holding a 50-year indexed gilt doesn't mean that if I invest £100 today its real purchasing power is protected until 2055. It means that on one particular day in 2055 my heirs get back a sum which, if you can ***trust*** the RPI *(I don't, and I'll explain why in a Quarterly soon)*, will have the same purchasing power as my £100 in 2005. What if in the next few years the real rate of return ('RRR') required by the market on IL gilts rises from 0.5% to even just 2%, as in the USA now? My stock will fall by over 40%. And if the RRR rises to 4% (as in the UK 1981-97), it will fall by some 70%. That's Armageddon — an investment bloodbath.

DANGER FOR AMERICA

Before we ask ***why*** returns on financial instruments worldwide are so low, note these words from *The Economist* for 14th January 2006:

'Mr Greenspan is leaving behind the biggest economic imbalances in American history . . . The economy has shown amazing resilience in the face of the bursting in 2000-01 of the biggest stockmarket bubble in history, of terrorist attacks and of a tripling of oil prices. Mr Greenspan's admirers attribute this to the Fed's enhanced credibility under his charge . . . But the main reason why America's growth has remained strong in recent years has been a massive monetary stimulus. The Fed held real interest rates negative for several years, and even today real rates remain low . . . Cheap money has not spilled into traditional inflation, but into rising asset prices instead — first equities and now housing . . . By borrowing against capital gains on their homes, households have been able to consume more than they earn . . . Part of America's current prosperity is based on borrowing from the future.'

Savings in the US have collapsed. In the *Financial Times* for 3rd February 2006 Martin Feldstein, President of the US National Bureau of Economic Research, pointed out that household saving fell from 2.5% of after-tax income in the third quarter of 2003 to *minus* 1.8% two years later, producing a rise in consumer spending equal to 3% of GDP. In Quarterly N°. 39 I alluded to the Austrian economist Ludwig von Mises, Friedrich von Hayek's mentor. *The Economist* editorial quoted von Mises tellingly:

'It may sometimes be expedient for a man to heat the stove with his furniture. But he should not delude himself into believing that he has discovered a wonderful new method for heating his premises.'[4]

WHY ARE RETURNS SO LOW?

The overpricing of financial and real assets worldwide stems from the transmission of the extraordinarily low RRR on US Treasury bonds across markets and asset classes everywhere. There is no mystery as to why this happened. It results from Greenspan's action, when faced by an incipient recession in 2001, in cutting the Fed rate from 6.5% to 1% by June 2003. The 'carry trade' opportunity of borrowing short at 1%+ and investing long at 4%+ created a substantial speculative demand at the long end of the Treasury market, driving down yields and spilling into other types of financial assets like high-risk fixed interest US securities ('junk bonds') and emerging market debt and equity, reducing risk premiums and hence yields.[5]

Nor is there much of a mystery as to why equity markets have continued on their merry way since turning in March 2003. Recent major corporate earnings growth in both the UK and the US comes from two sources.

- **Increased revenues.** Massive shifts in US and UK government budgets from surpluses to deficits have combined with enormous increases in consumer borrowing to inject huge amounts of purchasing power into both economies.
- **Limited cost increases.** There has been little, if any, wage cost pressure, thanks to the restraining effect of global competition. Earnings, meanwhile, have also been boosted by the considerable reduction in corporate borrowing costs thanks to low interest rates.

THE YIELD CURVE CONUNDRUM

So the recent strength of equity markets and the low RRR on all asset classes worldwide during the time of a 1% Fed rate are not hard to explain. The real ***conundrum***, as postulated by Greenspan, is why the rise in the Fed rate from 1% in June 2004 to 4.5% today has so far failed to increase yields

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[3] Compare the average real return on cash of 1% per annum over the last 105 years, according to Barclays Capital. One cause of this bizarre pricing is the issue's smallness (under £2 billion at par — little use to pension funds when their aggregate deficits have risen by ten times this in a month. Why Gordon Brown is not refinancing huge amounts of government debt at these low rates is a mystery. Perhaps he is a bigger fool even than I had imagined him to be.

[4] My own comparison, in Quarterly N°. 36, was with the scene in Will Hay's *Oh! Mr Porter!* in which the locomotive runs out of coal and the driver and fireman keep tearing off bits of the train's bodywork and ramming them into the furnace to keep the engine going ever faster.

[5] The 'carry trade' is not new. The Roman historian Suetonius records that the Emperor Augustus, 2,000 years ago, *'notavit aliquos quod pecunias levioribus usuris mutuati graviore fœnore collocassent'* (censured those who borrowed at a low rate of interest to lend it out at a higher rate). C Suetonii Tranquilli, *Vita Divi Augusti,* 39.

on long US Treasuries. Many solutions have been put forward:

- Buying of long-dated Treasury securities by foreign central banks has continued to boost US bond prices and lower long-term yields. This has been much touted as an explanation, but the numbers are unconvincing.[6] Asian foreign exchange reserves total some $2.4 trillion, of which 70%, only $1.6 trillion, is held in US dollars (the bulk of it at the short end of the market). China's trade surplus tripled in 2005, but only to $0.1 trillion. As regards petrodollars, it is estimated[7] that between the end of 2001 and the first half of 2005 the members of OPEC generated $1.0 trillion in revenue from oil exports. 88% of this has gone on imports, leaving something in excess of $0.1 trillion to be added to OPEC's international deposits.
- As profits have surged, companies have become net 'savers' on a major scale, partly thanks to the need to make up shortfalls in company pension plans, and borrowing for capital spending has been correspondingly weak.[8]
- There has been increased demand from pension funds for long-dated fixed interest securities, to match their liabilities.
- The cost-cutting forces of globalisation have kept inflation expectations in check and so have lowered the inflation risk premium on fixed interest securities.
- The Fed's increases in short rates have reduced the prospects for future economic growth, and so held down long-term rates.

THE MYTHICAL 'SAVINGS GLUT'

There is something in all these attempted explanations for the continuing conundrum of low US long bond yields. Neither individually nor in aggregate, however, are they enough to give us our answer. Something bigger is needed, and the 'unified theory' grabbing everyone's imagination[9] is that advanced by Ben Bernanke, Greenspan's successor as Chairman of the Fed, that the low RRR on financial securities has been caused by a ***'global savings glut'***. This, I believe, may one day prove to have been as embarrassing a statement as Harold Wilson's on the 1967 devaluation of the pound from $2.80 to $2.40. This, he told us, would enable Britain to sell more goods abroad and create more jobs at home; but *'it does not mean, of course, that the pound here in Britain, in your pocket or purse, or in your bank, has been devalued'*. Bernanke appears to share both Harold Wilson's commitment to growth and jobs at any cost, and his disdain for the view that one of the foremost duties of government is to safeguard the value of the country's currency (but then, so did Greenspan). I discussed the alleged 'savings glut' in Quarterly N$^{o.}$ 36, noting that savings rates in the advanced economies had been not rising but declining. As Greenspan himself testified to Congress on 15 February 2005:

'The sizable gains in consumer spending of recent years have been accompanied by a drop in the personal saving rate to an average of only 1% over 2004, a very low figure relative to the nearly 7% averaged over the previous three decades.'[10]

For the world as a whole the estimated total level of gross savings has risen, but only from 23% at the end of the 1990s to 24.5% in 2004. Such a small increase in savings (1.5% of world GDP of $59 trillion is only $0.9 trillion) could not possibly by itself have generated a fall in the level of real interest rates as substantial as that implied by the seismic shift in the level of yields on long bonds. An increase in global savings may have aided the reduction in returns available from financial securities worldwide, but it comes nowhere near to explaining it.[11]

LET'S CUT TO THE CHASE

There is another possible explanation, this time one alluded to by none other than Alan Greenspan himself. In his *Monetary Policy Report to the Congress* on 16th February 2005, he wrote:

'Thirty-year fixed-rate mortgage rates have dropped to a level only a little higher than the record lows touched in 2003 and, as a consequence, the estimated average duration of outstanding mortgage-backed securities [MBSs] *has shortened appreciably over recent months. Attempts by mortgage investors to offset this decline in duration by purchasing longer-term securities may be yet another contributor to the recent downward pressure on longer-term yields.'*

THE US HOUSING MARKET

So we have something new to factor into the equation: the US mortgage market. And the first point to note is — it's enormous.

Outstanding US home mortgages total approximately $8.5 trillion. This is a huge sum, almost twice the size of the entire US Treasury market of $4.3 trillion.

New mortgages are created by the 'thrifts', savings & loans (S&Ls), insurance companies, banks and other financial intermediaries, and are financed by them in the first instance through short-term borrowings. In normal times around one third of new mortgages are retained by the originators and two thirds are securitised into MBSs through government agencies, Fannie Mae, Freddie Mac or Ginnie Mae,[12] or by substantial banking entities. These guarantee the payment of interest and principal,

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[6] To quote the economist Dr Kurt Richebächer, of whom the former Fed Chairman Paul Volcker said, *'Sometimes I think that the job of central bankers is to prove Kurt Richebächer wrong'*:

'Many see a main reason in the large bond purchases of Asian central banks . . . Without question, the US bond purchases by Asian central banks help to keep US longer-term bond yields down. Yet they are grossly insufficient to accommodate the credit deluge flooding the US economy and its asset markets at these low rates.' Dr Kurt Richebächer, *The Daily Reckoning*, 17th January 2006.
http://www.dailyreckoning.com/Issues/2006/DRUS011706.html

[7] *Financial Times*, 16th January 2006.

[8] According to *The Economist* of 7th July 2005, **'The corporate savings glut',** *'The total increase in companies' net saving in the past four years* [in the main developed countries] *has been more than $1 trillion.'* This, however, averages only some $0.25 trillion per annum.

[9] Including that of Mervyn King, the Governor of the Bank of England, who, in an important speech in January 2006, highlighted this as one of two possible explanations. (The other explanation was, guess what, 'excess liquidity'!)

[10] As noted earlier, by 2005 things had worsened and savings were running at a *negative* rate.

[11] As Irwin Stelzer (Sunday Telegraph, 6th November 2005) commented, *'Studies by the International Monetary Fund concluded, without saying so, that Bernanke is wrong, and that global savings "are near historic lows". No glut, merely a fall in savings in industrial countries, partly offset by a rise in emerging markets.'*

[12] Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac) and the Government National Mortgage Association (Ginnie Mae).

effectively producing an instrument with the credit-worthiness of the ten-year Treasury bond.

The MBS market, some $5.6 trillion, dwarfs the US dollar holdings of foreign central banks.

US homeowners are entitled to repay their mortgages at any time without capital penalty. The standard 30-year US mortgage is normally priced at a 1.5-2% interest rate premium to the yield on the ten-year Treasury note. This covers the servicing costs of the mortgage originators and rewards Fannie Mae (say) for guaranteeing the payment of interest and principal on the underlying mortgages (a total of around 50 basis points), together with meeting the implicit cost of providing a 'put' at par to the mortgagor.

An MBS based on standard 30-year mortgages has an expected duration of around ten years: the principal amount of a 30-year repayment mortgage would, other things being equal, be outstanding for an average 15 years, but experience shows that early repayments (home moves, refinancings, deaths of homeowners, etc), typically lower a mortgage's average duration by around five years.

As mortgage costs fell from 8% in 2000 to under 6%, the probability that borrowers would refinance and repay their old mortgages increased. *(In fact, not to have done so would have been nothing less than financial lunacy!)* Moreover, at a time of rapid house price rises fuelled by the easy availability of cheap money, refinancing homeowners took on new mortgages for larger amounts than the loans that they paid off, thus realising as spending money some of the accumulated equity in their homes.

Such a tidal wave of refinancings, at a much earlier date than would normally have been expected, inevitably shortened the duration of MBS instruments and presented investors in them with a problem. To keep the duration of their portfolios steady as interest rates fell, MBS investors found themselves having either to buy longer-dated Treasury bonds or to enter into interest rate contracts with a similar effect, so pushing long bond rates lower still.

THE $11 TRILLION QUESTION

This is where it gets really interesting. As in a detective story in which Professor Moriarty taunts Holmes and Watson with a cryptic clue to the solution, Greenspan in September 2005 published a research paper (only the second during his tenure at the Fed): *'Estimates of Home Mortgage Originations, Repayment, and Debt'*.[13]

No-one could have written it but Greenspan. From 1997, when the Department of Housing and Urban Development discontinued its quarterly gross mortgage flow system, there had been no systematic attempt to disaggregate the net change in outstanding home mortgage debt into its constituent gross flows. However, using the resources and researchers available to him at the Fed, Greenspan achieved this in his paper, with astonishing results. The enormous level of refinancing of mortgages it reveals, offers (in our view) the first plausible explanation of how the RRR on financial securities worldwide could have been driven below 2% — just as it chillingly suggests what could happen once things start going into reverse.

Here are the figures. To get them in proportion, remember the earlier ones: an approximate $0.25 trillion per annum increase in corporate savings; the estimated $0.1 trillion increase in OPEC's reserves since 2001; and China's 2005 trade surplus of $0.1 trillion.

- During the 1990s, repayments of US mortgages averaged around **$0.7 trillion** annually.
- Repayments more than doubled to **$1.7 trillion** in 2001.
- They were just under **$2.2 trillion** in 2002.
- In 2003, repayments reached an astounding **$3.4 trillion**.
- Repayments have continued at an annual rate of around **$2 trillion** for 2004 and 2005.
- Mortgage repayments between 2001 and 2005 thus totalled **$11.3 trillion**.

(This, remember, is almost equal to a full year's US GDP.)

Here, at last, we have the ***'unified theory'*** we have been looking for: the weight of money from unprecedentedly huge and bunched-together early mortgage repayments, dwarfing those Asian central bank holdings, net corporate savings, Chinese trade surpluses and recycled petrodollars, and pressing on the long end of the US Treasuries market for five years, driving yields down remorselessly. And Greenspan is well placed to explain it, because he caused it, deluging the economy with unlimited free money, like Petronius's Trimalchio on his self-designed monument:

'in tribunali sedentem prætextatum . . . et nummos in publico de sacculo effundentem'[14]

What is remarkable is that despite all the 'Greenspan watchers', neither his comments in his Monetary Policy Report to Congress in February 2005 nor the publication of his paper in September 2005 seem to have attracted any attention at all. Yet Greenspan knows exactly what is happening. His blatantly obvious attempts to talk the US housing market down (despite his previous denials that there was any 'bubble') show his awareness that rising house prices and ever-increasing sums in new mortgages will eventually flood through the mortgage originators into MBSs, which, because of the supply of new mortgages that can no longer be financed by their originators through the 'carry trade', will no longer need bolstering up by large quantities of long Treasuries or their derivatives. This switch in funding will put substantial upward pressure on the ten-year Treasury yield.

WHY BOND BUYING CONTINUED

Before we examine what is likely to happen when the tide turns, however, it is worth asking why it carried on running so strongly for so long in the direction it did. Why did investors in MBSs keep on buying long-dated Treasury bonds, so driving down yields,

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[13] http://www.federalreserve.gov/pubs/feds/2005/200541/200541pap.pdf

[14] *'sitting in official robes on his official seat,, pouring out money in abundance from a bag'.* Petronii Arbitri *Satyricon*, LXXI. (Greenspan is otherwise very unlike the preposterous Trimalchio, a sort of combination of Billy Bunter, Michael Barrymore and Gordon Brown.)

rather than take the obvious course of investing in the new mortgages being created in the refinancing of old ones? The answer lies in ***liquidity*** and ***availability***.

- **Liquidity**. Although the MBS market is much larger than the Treasury market, it is fragmented into many thousands of separate instruments and so is far less liquid. Only the Treasury market (or derivatives based on it) lets MBS investors lengthen (or shorten) the duration of their MBS holdings quickly and efficiently.
- **Availability**. In normal times around a third of new mortgages are retained by the originators and two-thirds are securitised into MBSs. However, thanks to the effectively risk-free 'carry trade' of borrowing short at very low rates and lending long at over 6%, originators have been tending to retain a much higher proportion of new mortgages issued: first, to replace their own disappearing mortgage holdings; and, secondly (given the huge increase in profitability on mortgage lending), to expand the size of their mortgage books.[15] So, although the demand may have been there, the supply was not. Nothing was left for the investors in MBSs, therefore, but to turn to the long end of the US Treasury bond market.

For those with long memories, 2000 to 2006 has seen a complete inversion of the S&L crisis of the 1980s, when extraordinarily high short interest rates crucified those whose business it was to borrow short and lend long. This time, when the situation was reversed and borrowing short to lend long was a licence to print money, it is obvious why mortgage originators have kept the benefits to themselves as long as possible.

Bad Moon Rising

I see the bad moon arising;
I see trouble on the way.

To quote Creedence Clearwater Revival does 'date' me as a child of the 1960s; but it seems to fit.

[15] The share prices of the 'thrifts' have effectively quadrupled from the beginning of 2000 (a period over which the general market has fallen). However, the rise in the Fed rate from 1% in June 2004 to 4.5% currently (with further rises to come) has dramatically reduced the profitability of this 'carry trade' of late.

I hear hurricanes a-blowin'.
I know the end is comin' soon.
I fear rivers overflowin'.
I hear the voice of wreckage and ruin.

Into Reverse Gear!

If ***liquidity*** and ***availability*** were what drove prices up and yields down at the long end of the US Treasury market during the five-year orgy of mortgage refinancing we saw between 2001 and 2005, the dominant features of the reversal of the trend now mortgage refinancing has ended (there is no longer anything for house-buyers to gain by it) are most likely to be ***duration*** and ***premium***.

- **Duration.** Mortgage refinancing having ended, the duration of MBSs will start to lengthen. This will lead to short sales of long-dated Treasuries, driving up yields as inexorably as the earlier shortening of the duration of MBSs caused yields to fall. A rising yield on long Treasuries will equally inexorably raise the rate of return that will be demanded by investors from other asset classes across the world. Meanwhile, rising short-term interest rates and continuing US house price rises (higher prices imply both more and larger mortgages) will create balance-sheet pressures which will force mortgage originators once again to start selling on their mortgages (currently financed by ever more expensive short-term borrowings) to e.g. Fannie Mae or Freddie Mac. The resulting greater availability of new MBSs after the recent shortage will add to the upward pressure on ten-year Treasury yields (unless Bernanke panics and lowers the Fed rate). While substantial levels of mortgage refinancing cause an immediate reduction in the duration of MBSs, the absence of such refinancing will lengthen their duration only gradually, however.
- **Premium.** Having explained the impact of 'duration', I now have to introduce the concept of 'premium'. By this I mean the amount by which the yield on MBSs exceeds the yield on ten-year Treasuries — that is, the additional yield, or 'premium', required by investors to cover the risk of borrowers repaying early. By itself, the upward pressure on long-term rates due to lengthening of duration will not take effect overnight. ***What will both confirm and accelerate the trend will be a striking change in the relative attractiveness of MBSs and ten-year Treasuries.*** When interest rates were falling, it made sense to be long of Treasuries and short of MBSs. Falling interest rates lead to refinancing of mortgages, which reduces significantly the value of MBSs compared to ten-year Treasuries. When rates are rising, however, the effect is reversed. Since both ten-year Treasuries and MBSs are effectively guaranteed by the US government (if no early repayment of mortgages were to occur you would expect MBS to yield little more than ten-year Treasuries), it makes sense to go long of the higher-yielding security and short of the lower-yielding one. While the mortgages that underlie MBSs are now at little risk of early repayment, MBSs are still yielding 1.3% more than ten-year Treasuries. This seems a major pricing anomaly which hedge funds, in particular, may well exploit.

The combination of these two factors, duration and premium, will bring about the inevitable result: a higher required rate of return on financial assets, starting with US Treasury bonds. And higher rates of return on financial assets necessarily imply falling asset prices.

If we factor rising inflation into the equation (and we believe inflation will continue to rise), the inevitable resulting demand by investors for even higher returns to compensate for the increasing inflation risk could in our view cause a self-sustaining financial tsunami of falling asset prices — equities, property, index-linked securities and conventional fixed interest alike — that would sweep away all in front of it. In such a situation, the fully invested equity investors at the Round Table I referred to at the beginning of the Quarterly would be better described not as the modest bulls they think themselves to be, but as Morecambe Bay cockle-pickers with their backs to a rising tide.

Robin Angus/Ian Rushbrook

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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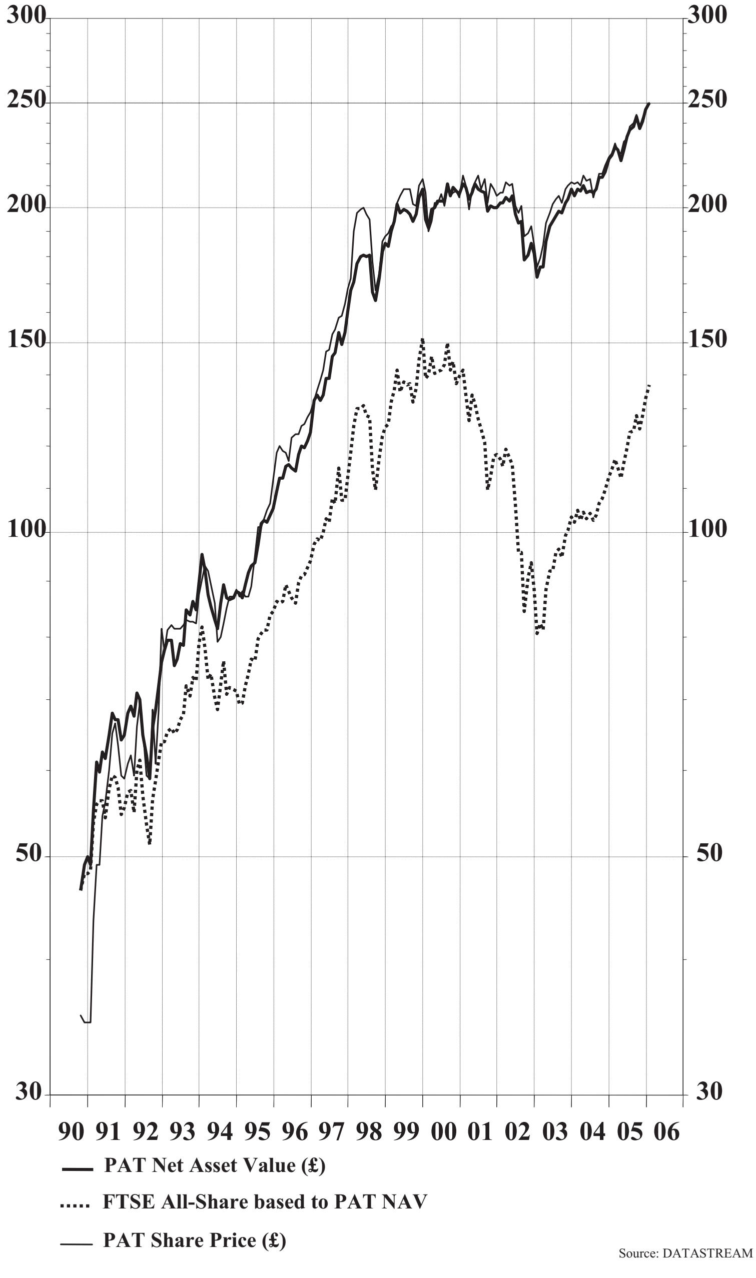
PORTFOLIO (000's)	**31-Jan-06**
BP	£15,413
Royal Dutch Shell 'B'	£14,486
RBS Group	£10,283
HBOS	£9,732
GlaxoSmithKline	£7,185
Barclays Bank	£6,731
BT Group	£5,336
Scottish & Newcastle	£4,100
Scottish Investment Trust	£2,460
British Assets Trust	£2,010
Top Ten Equities	**£77,736**
Other Equity Exposure	**£32,996**
Effective Liquidity	**£72,570**
Shareholders' Funds	**£183,302**

Personal Assets Trust Performance



% Changes From	31-Oct-90	31-Jan-01	31-Jan-03	31-Jan-05	31-Jan-06
Period	15 Years	5 Years	3 Years	1 Year	Values
SHARE PRICE	604.9%	16.7%	42.0%	11.5%	£250.25
NAV PER SHARE	440.2%	19.0%	45.3%	12.1%	£250.83
FTSE ALL-SHARE	195.0%	-3.3%	70.0%	20.0%	2,928.56
NAV REL TO FTSE A/S	83.1%	23.2%	-14.6%	-6.5%	