PERSONAL ASSETS TRUST PLC

SEPTEMBER 2006 QUARTERLY REPORT No. 42

OUR 2006 AGM

You can't please everyone. A shareholder recently wrote to me:

'I was disappointed to read the Quarterly Report N$^{o.}$ 41. I have no quibble with the facts it contains, nor the key sentiment. However, I do think it "goes on a bit", and in doing so is in danger of detracting from the reputation which PAT has justly earned. I want to be sure that the chap who is looking after a chunk of my money has his feet on the ground . . . but if he carries on writing six pages when two would do, then I might begin to conclude that he is beginning to levitate a bit, which would not be a good sign.'

Well, Quarterly N$^{o.}$ 41 certainly wasn't a synopsis for a busy man! So that shareholder (and probably the rest, too) will be relieved that this one has reverted to the usual size. It revisits some of the questions raised at the AGM and asks whether our views on the market have changed. *(They haven't.)* As background I've enclosed a copy of Ian's AGM speech, which preceded (and provoked) the question and answer session at the meeting.

MARKETS SINCE THE AGM

At 30 April 2006 the FTSE 100 stood at 6,023.1. It reached its 2006 peak of 6,105.6 on 9 May, but then fell as low as 5,506.8 on 14 June. By 18 July, the day before our AGM, it had recovered to 5,681.7, down 5.7% from its 30 April level. It is now 5,822.3 (22 September) — up 2.5% since the AGM, but down 3.3% since our year end. In the US, the S&P Composite fell by 5.6% between 30 April and 18 July, recovering by 22 September to stand 0.3% higher than its 30 April level.

Here is how Personal Assets' net asset value performance compares with that of our benchmark, the FTSE All-Share (FTA/S) since the year end, all figures being based to 100 as at 30 April 2006.

	FTA/S	PAT	
		Price	NAV
30 April	100	100	100
14 June	91	94	95
18 July	94	96	97
22 Sept	97	97	99

This shows our relative price and NAV stability during quite a turbulent spell in the markets, albeit one that petered out into nothing more than a minor perturbation.

SHAREHOLDERS' QUESTIONS

What follows is a summary of the main questions asked by shareholders at the AGM. The questions are in bold italic and our answers are in ordinary plain text.

I hear what you're saying about markets, Greenspan, etc, in your presentation — but you've been saying it for a very long time!

Yes, I know — and I expect it's as frustrating and tiresome for you as it is for us. But it doesn't necessarily mean we're wrong. It just means that what we fear hasn't yet happened. We're used to this, as are any investment managers who take a view different from that of the broad consensus. For instance, we were mocked a few years ago because we doubted the so-called 'new paradigm' in the US economy and then believed the rise in dot.com stocks was a 'bubble' (which, of course, it subsequently proved to be). I also can't resist pointing out that, while it should have been obvious to any thinking person from 1917 onwards that Communism was going to come badly unstuck, this didn't become evident to the doubters until 1989!

What now? I was amused to read the recent leaked comments of the Hungarian Prime Minister, Ferenc Gyurcsány *[crazy name, crazy guy!!!!!]* to the effect that he had to thank *'divine providence, the abundance of cash in the world economy and hundreds of tricks'* for keeping the Hungarian economy afloat. This has not only been true of Hungary. We believe that our fears of an *inverted* 'Goldilocks scenario' such as was outlined in Ian's speech (rising interest rates, rising inflation and declining economic growth) are well founded. But while we are fairly convinced of *what* will happen we have no means of knowing *when* it will happen. We just protect our capital in the meantime, believing there's more risk in the market at the moment than potential reward.

Equities have benefited from the 'Greenspan Effect', but over the last twelve years bonds and property have benefited even more. So will they suffer more when the implosion comes?

They may, and this would have implications for all financial markets. In particular, the equity and bond markets closely influence each other and will continue to do so. What affects one will inevitably, over time, affect the other. But Personal Assets is primarily an equity investor and we do not invest in property, although we hold, and have profited from, property specialist trusts. We hold bonds now and have often held them in the past. However, while we have not debarred ourselves from holding long-dated bonds, we typically hold bonds as an alternative to cash and so the ones we hold today are short-dated and would not be subject to major movements in capital value if the bond market fell severely.

There's one obvious conservative investment you haven't touched on so far. What about gold?

Readers of these Quarterlies may have noticed that I'm by temperament a 'gold bug'. Ian, while recognising that gold can be an excellent store of value over the long term (centuries or millennia rather than decades), points out that it produces no income, which becomes more of a disincentive the higher interest rates rise; and costs money to store and to insure. It also suffers from major swings in price and in real terms is still far from its 1980 peak of $800/oz. In short, gold is not a conservative investment but a very risky one, and we don't see it as a natural holding for Personal Assets.

Why not take your bearish stance to its logical conclusion? Why are you only 40% liquid, not 50%, 60% or even 100%?

Investing in equities is about looking for potential reward and balancing against this the risk required to gain it. Markets invariably offer, at any time, some risk and some potential reward. This will fit somewhere on the overall risk and reward spectrum, which runs from high reward/very little risk (at the end of 1974, for instance, when prices were so depressed that there was not much risk in investing) to high risk/very little reward (in early 2000, for example). At present, we believe that our 40% liquidity strikes an appropriate risk/reward balance.

However, there are circumstances in which it might be logical for us to be 100% liquid. This doesn't need 100% certainty of a market fall (the worst that can happen to a fund that is 100% liquid is that its NAV rises only by the return on its fixed interest investments less its costs of management). No-one ever went bust from too much liquidity, whereas fixed gearing of 40% from 1972 would have bankrupted a fund by December 1974.

Could you comment on the structure of your equity portfolio?

It has changed very little since the year end. We have 57.8% of our shareholders' funds in equities. 55.5% is in the UK and 2.3% in the US. Our three largest sector holdings are Banks, Oils and Investment Companies (including our holding in F&C Management, acquired when we merged with Collective Assets last year).

Banking services and energy supplies are essential ingredients of any sophisticated economy and both sectors can be expected to grow at least in line with GDP. (Indeed, demand for banking services grows at around twice the rate of GDP.) Both these sectors achieve substantially above average returns on equity, yet they are still priced competitively relative to the stock market. Our investment company holdings give us exposure to areas we do not hold directly, such as commodities and property, together with assets at a discount with generalist trusts.

Including 'look-through' exposure from FTSE 100 futures as well as direct shareholdings, Banks represent 18.7% of our shareholders' funds compared to 17.9% of the FTSE All-Share. The corresponding figures for Oils are 15.8% and 15.1%, and for Investment Companies 5.1% and 2.4%.

Leaving aside the market as a whole, people outside the market (foreign investors, private equity funds, etc) are extracting enormous value from UK companies. How do you reconcile this with your present bearish stance?

It's only a supposition that foreign investors and private equity funds have extracted a lot of value from UK companies, but it's a matter of record that the FTSE 250 outperformed the FTSE 100 over the last six years by 80%, driven by debt-financed cash bids for medium cap companies. We have yet to see if such acquisitions will provide the *bidders* with any returns!

As our Annual Report says:

'We cannot satisfy the needs of all investors. Our aim is to serve the needs (including decisions about gearing and liquidity) of Sterling-based equity investors who share our view that the protection of capital ranks in priority even above pursuing capital growth. Accordingly, shareholders who want to diversify their portfolio through a stake in an aggressively-managed investment trust, or in specialised investment areas either in the UK or overseas, should look for this elsewhere, over and above their holdings in Personal Assets.'

Why not hold hedge funds?

Are there any such things as 'hedge funds'?' The phrase today seems to describe not so much a homogeneous asset class as a charging structure investors pay when investing in disparate vehicles prepared to take considerable risks with investors' funds in making geared investments in exotic illiquid assets. A typical fee structure of 2% of funds under management and performance fees of 20%, perhaps against a benchmark or perhaps not, has an obvious built-in bias towards high risk taking that runs counter to Personal Assets' investment philosophy. We don't understand them, don't want to and don't need to. The standard of disclosure is generally low, we don't trust them and we fear what may go wrong. John Plender in the *Financial Times* for 16 February 2006 memorably described the prime brokerage services the banks offered to them as *'the crack cocaine of global finance.'* In *The Scotsman* for 18 September Bill Jamieson wrote of Hermes' decision to move a substantial percentage of funds from equities into private equity, hedge funds and commodities:

'How do we know for sure that such asset categories are either inherently superior as an inflation hedge or inherently less volatile than a portfolio of ordinary shares? Indeed, much of the commentary in the financial press over the last five years has reflected concern over the potential for hedge funds to amplify the risk characteristics inherent in equities and their potential to destabilise markets . . . Some may suspect that the increase in interest in alternatives reflects their superior performance in recent years and the Hermes move is thus a fashion stampede to be avoided. It also runs the risk of creating a classic "bubble" in asset classes that are less liquid than mature equity markets. . . . The problem with alternative investments is that they are not as transparent and subject to market accountability as equities, posing big problems for governance, and they are not as readily turned into cash as a portfolio of ordinary shares.'

Like private equity *(see the answer to the last question)*, hedge funds are something shareholders may want to invest in over and above their holdings of Personal Assets. But they are not, in our view, a natural investment for us.

You don't seem keen on 'stock picking', which other fund managers use to great advantage.

In February 2004, in Quarterly N° 32, I described the *Stockpicking*

Fallacy — that, despite the belief so frequently expressed to Ian and myself, that *'it's all about picking the right stocks'*, one thing that does *not* make an investment manager is stock selection. I turn here to Sir George Williamson, Chairman in the 1950s of Scottish Northern Investment Trust:

'If you get 5 out of 10 right, you're good. If you get 6 out of 10 right, you're brilliant. If you say you get 7 out of 10 right, you're a bloody liar!'

My only quibble is that getting 6 out of 10 right would be not brilliant but incredible. In the summer of 1983 I was lunching with Ian, who then managed Atlantic Assets and the Independent Investment Company (not to be confused with today's Independent Investment Trust). The NASDAQ index of US smaller companies was at its peak, Atlantic's results were going to be extraordinary, and Ian, in his self-disparaging (*he* claims!) way, turned to me and asked, *'Robin, why am I so good?'*

Like the slave in a Roman Triumph muttering in Cæsar's ear, *'Remember you are mortal'*, I replied, *'You're not. Your decisions are no better than anyone else's. You just make fewer of them.'* I still believe this to be true. Major decisions determine performance, not a lot of minor ones.

What progress are you making with the SIPP you mentioned?

The Chairman commented in his 2006 Statement that this year we were working on a Personal Assets Self-Invested Personal Pension ("SIPP") within which holders would be able to balance their investment between cash and Personal Assets shares. We are still working on this and hope to have it ready before the end of the tax year on 5 April 2007.

WHERE ARE WE NOW?

The supposed summer lull in financial markets is celebrated in the old stock market rhyme:

Sell in May and go away,
Come back on St Leger Day.

St Leger Day 2006 was, of course, 9 September, and the prophecy in the old rhyme was fulfilled, albeit modestly. The market's 2006 peak was 6,105.6 (9 May). Having been as low as 5,506.8 on 14 June, by St Leger Day it stood at 5,879.3, 3.7% below its May peak.

We have not seen a sustained fall in the market, but we have seen the market falter. What is now happening that may have an impact on the future? Here are three straws in the wind. They concern the US housing market, the derivatives market and US inflation.

STRAWS IN THE WIND?

The first is from a *Money Week* article (4 September) on the US housing market by John Stepek:

'The US housing bubble has popped. Sales of existing homes fell to their lowest levels in two years in July, while sales of new homes dived 22% on the previous year . . . New York University economics professor Nouriel Roubini goes as far as to say that: "Every possible indicator of the housing sector that has been coming out in the last few weeks . . . suggests the housing market is in free fall . . . This may end up being the biggest housing bust in the last 75 years . . . " US consumers have been spending more than they earn for quite some time. For 2005, the savings ratio (the percentage of annual income that consumers are putting away for a rainy day) actually went negative for only the first time since — you guessed it — the Great Depression . . . [By] *borrowing more money against the increasing equity in their homes, US consumers have maintained their standard of living despite wages that have been flat or falling, adjusted for inflation, for several years now.'*

The second is from the *Financial Times* of 8 September 2006 and concerns the GUS £350m bond issue. The FT claimed that £6.8 billion of Credit Default Swaps (CDSs)[1] were based on the bond issue, nearly 20 times the total value of the bonds themselves.

This is a staggering figure. The same article went on to state that whereas four years ago the value of all cash bonds matched the value of associated derivatives, last year there were (according to Lehman Brothers) nine times more CDS contracts by value than bonds. Here I can't help being reminded of Fonthill Abbey, the vast mansion — a cross between St Pancras Station and Salisbury Cathedral — built between 1795 and 1813 by William Beckford, said then to be the richest man in the world. It had an extraordinary 300ft tower which collapsed no fewer than four times owing to the inadequacy of its foundations (on one occasion destroying the kitchens after Beckford's Christmas dinner). Beckford ought to have learned his lesson from the first collapse, but he went on building. It would be reassuring if markets were more concerned about the inadequate foundations of some of the derivatives dealt in today.

Lastly, US inflation figures were announced on September 15. The Fed focuses on what it calls 'core inflation', which excludes those two obvious inessentials, food and energy. At 2.8%, this is more flattering than the 3.8% headline rate for the Consumer Price Index, ("CPI"). The Federal Open Market Committee ("FOMC"), however, has indicated in the past that the core inflation rate it was comfortable with was around 1.8% — well below the current level.

Despite this, at its 15 September policy meeting the Fed again left interest rates unchanged at 5.25% following its August decision to end its unbroken sequence of 17 consecutive rate rises. This obviously indicates that the Fed's worries about slowing growth now outweigh its worries about inflation. The price of oil and other commodities has come down significantly in recent weeks, reducing pressure on the CPI (although not on 'core inflation'), but wage and unit labour costs have risen quite sharply in the first half and wage pressures may rise as companies pass on higher wage costs in higher prices rather than absorbing them in lower profits. In 1996 I wrote, in Quarterly N$^{o.}$ 9:

The sad truth is that democracy and sound money are not compatible except by the exercise of almost superhuman vigilance and self-denial on the part of elected governments.

Not much has changed.

ROBIN ANGUS

[1] CDSs provide insurance against non-payment of corporate debt. Measuring the value of CDSs outstanding is difficult because they are not registered beyond the parties to each deal. The figure of £6.8 billion quoted was derived from a poll of large dealers conducted by the *Financial Times.* It suggested that 25% of the £6.8 billion was accounted for by CDSs directly related to the GUS bonds and 75% was related to GUS via index contracts or structured products.

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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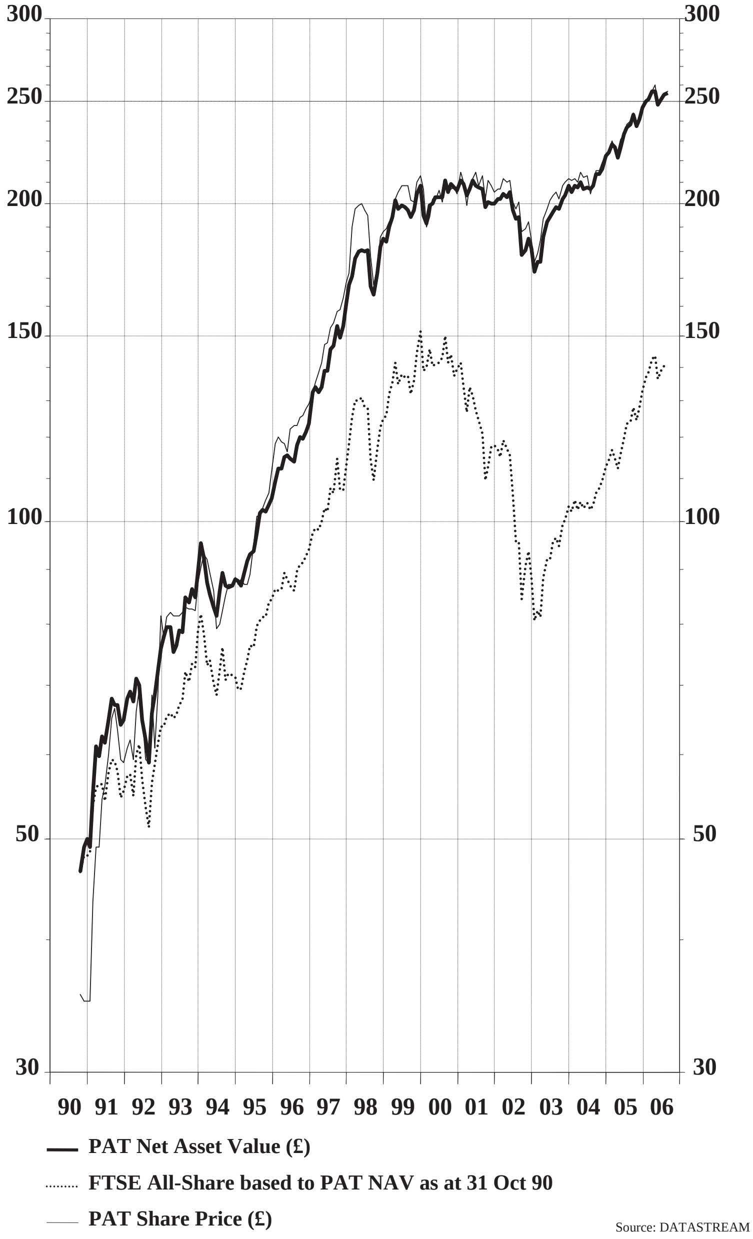
PORTFOLIO (000's)	31-Aug-06
BP	13,611
Royal Dutch Shell 'B'	13,529
RBS Group	10,532
HBOS	9,875
GlaxoSmithKline	7,440
Barclays Bank	7,358
BT Group	6,409
Scottish & Newcastle	4,510
Scottish Investment Trust	2,428
British Assets Trust	1,969
Top Ten Equities	**£77,661**
Other Equity Exposure	**£31,850**
Effective Liquidity	**£79,597**
Shareholders' Funds	**£189,108**

PERSONAL ASSETS TRUST PERFORMANCE



% Changes From	31-Oct-90	31-Aug-01	31-Aug-03	31-Aug-05	31-Aug-06
Period	15 Yrs 10m	5 Years	3 Years	1 Year	Values
SHARE PRICE	620.4%	20.1%	24.6%	6.7%	£255.75
NAV PER SHARE	448.8%	23.1%	28.5%	7.0%	£254.84
FTSE ALL-SHARE	203.0%	16.1%	45.7%	13.1%	3,007.51
NAV REL TO FTSE A/S	81.1%	6.0%	-11.8%	-5.4%	