



## Quarterly Report

October 2021

Our policy is to protect and increase (in that order) the value of shareholders' funds per share over the long term.

### Imbalances inflated

*"The only function of economic forecasting is to make astrology respectable." JK Galbraith*

Five years ago, when I wrote [Special Paper No. 3: The Case for Index-Linked](#), we were witnessing the beginnings of a more populist and fiscally adventurous America. Since then, the pandemic has served to fully sever the purse strings of governments, and the generosity of the US has surpassed the rest. An American household of two adults and two children, with an annual income of less than \$160,000, will have received an average \$11,400 in stimulus cheques since the start of the pandemic. Much of this windfall has been saved not spent.

This makes for an unusual recession, and an even more unusual recovery. As economies reopen, demand is returning – in many cases with a vengeance. Visa (held within PAT) saw US credit card spending levels in July and August nearly +20% higher than those seen in the same period in 2019. There will likely be more to come as the cumulative stock of savings remains elevated, (See Figure 1 in the Appendix), and further loosening of restrictions encourages consumers to get out and spend. Such pent-up exuberance is not typical in the immediate aftermath of a recession.

As well as boosting demand, the effect of the Covid-19 policy response has also been to

shutter supply. This creates another unusual dimension to today's recovery. Turning the switch back on for globally interconnected supply chains is proving more difficult to achieve than the resumption of demand itself. This is not helped by the virus continuing to spread and mutate, while countries roll out vaccine programmes at varying speeds. The loosening of restrictions is not therefore uniform around the world. The combination of these unique supply and demand dynamics is creating imbalances and inflationary pockets in many parts of the global economy, from used cars to gas prices. By dint of last year's low comparative base, when prices were depressed, today's year-on-year price increases are also amplified.

### The wisdom of crowds?

With this backdrop, it is hardly surprising that recent inflation prints (consistently above 5% in the US since May) are the highest they have been since 2008. The confluence of supply, demand and easy comparators suggests a short-term inflationary boost, but perhaps not the foundations of an abiding trend. That is certainly the stance of the Federal Reserve (The Fed), which has repeatedly described the current inflationary burst as 'transitory'. It is also ostensibly the view of the bond market which, despite the occasional show of nerves, has continued to price in lower yields (Figure 2) and muted inflation expectations. The US is our primary area of focus as it is here that the

portfolio's index-linked bonds reside. In the past few days US breakeven inflation rates have nudged above 2.5% at the 10-year maturity – still not far above the Fed's 2% inflation target<sup>1</sup>.

However, like everyone else, central bankers and bond markets have been conditioned to decades of disinflation and lower yields. Whilst the pandemic has served to accelerate several pre-existing trends, it has also thrown a few spanners into the works of price stability. Some of these speak to sustainably higher inflation, others point to lower levels, and it is unlikely that we will know the net effect of Covid-19 (Covid) on price levels for some time to come. US Treasury Inflation-Protected Securities (TIPS) are not yet a quarter-century old, the first auction having taken place in January 1997. The index-linked bond market has thus never had to price in very high or extremely volatile rates of inflation. At the very least, TIPS should be factoring in greater uncertainty.

### A melting pot of countervailing forces

As the most recent, sustained example of higher inflation in the western world, the 1970s is often cited as a precedent for how inflation might manifest itself today. Superficial parallels can certainly be drawn, not least from recent energy price rises and labour shortages. But a closer analysis more often serves to underline the differences. Perhaps the most striking one is the configuration of labour markets in the US and the UK, which in the '70s were structurally tight and heavily unionised. Although we are witnessing pockets of post-pandemic labour shortages in certain sectors, it is unclear whether these will persist as lockdowns and income-support schemes come to an end. Shifts like Brexit, which serve to stem the free movement of labour, may have a lasting effect on countries' access to workers. But not everyone is moving to reverse globalisation. Now that Covid has demonstrated the amount of work that can be done remotely, companies like Salesforce have loosened geographic

constraints on their hiring policies so that candidates applying for a role just have to live within the same time zone as their team. This expansion of the labour pool is unlikely to be inflationary, particularly for higher income countries. Companies like Alphabet (Google's parent company) have announced that workers who choose to work from an area of lower living costs will also receive commensurately lower pay. Add to this the effects of increasing automation, a trend spurred on by necessity during the pandemic, as well as continued growth of the gig economy, and it's hard to paint a long-term picture of too many jobs chasing too few workers.

That said, wage inflation could derive from non-market forces. Emergency policies to support wages during Covid may become a habit. Inequality is one of the greatest social issues facing governments today. It is increasingly at the top of political agendas, as well as on the agendas of central banks. Between the Federal Reserve's dual mandate of price stability and maximum employment, words and actions are increasingly in service of the latter. No longer citing just headline unemployment numbers, the Board of Governors at the Fed has started to reference labour market experiences of Americans by race, ethnicity and gender, as well as unemployment rates by income quartile. More focused improvements on these measures may be facilitated by the Bank's newly flexible inflation target; inflation can be permitted to breach 2% for a time to make up for prior shortfalls and, it would appear, in pursuit of additional goals. Such inflation tolerance, if sustained, may be enough to alter a population's psychology around inflation more broadly; a shift in mentality towards expecting higher prices will be crucial in determining rates of spending and saving. In this way, inflation can become self-fulfilling as consumers bring forward purchase decisions in anticipation of rising prices.

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<sup>1</sup> The breakeven inflation rate is a market-based measure of expected inflation. It is the difference between the yield of a nominal bond and a Treasury Inflation-Protected Security (TIPS) of the same maturity.

Attempting to predict the actions of policymakers is seldom a fruitful endeavour. Even if one could foretell the extent to which fiscal support for wages is to be sustained, that is only one side of the Rubik's Cube. A multitude of countervailing forces will determine where prices end up. What is very clear is that the inputs are in flux and some of them have been permanently altered by the pandemic. As a result, the risk of inflation misbehaving is greater than it has been for decades. That level of uncertainty is not yet reflected in market prices for inflation protection.

If inflation continues meaningfully to exceed the Fed's 2% target over the coming months it is likely that an increase in inflation expectations, as well as a premium for inflation protection, will begin to be reflected in TIPS. The price of these assets is determined by a combination of market inflation expectations and nominal yields. The combination of these two, the nominal yield minus the expected inflation rate, is known as the real yield and it is to this that the price of TIPS is inversely correlated. The best environment for this asset class is therefore one where nominal yields remain low even as inflation rises. With central banks' focus increasingly on factors such as income inequality, and on maintaining the affordability of debt at ever-higher levels, it is our view that nominal yields will only be permitted to rise so far.

### Grandmother's footsteps

Market volatility towards the end of September occurred as several anxieties came to the boil. Alongside Chinese real estate concerns and surging energy prices, these also included indications by the Federal Reserve that they would slow down, or taper, their rate of asset purchases in November. To be clear, this is not the central bank committing to actively selling assets on their balance sheet but rather

reducing the pace at which assets are bought. At the end of September, total assets on the Fed's balance sheet stood at \$8.5trn. That is more than double the amount in 2019 and around tenfold that of 2007. Past attempts to reduce the bloating, such as those of 2018, have been swiftly reversed.

It is not just financial markets that have become dependent upon the Fed's deep pockets. The US government is also reliant upon Quantitative Easing (QE). Since the start of the pandemic, the Fed has purchased >80% of Treasury Bonds issued, and now owns 23% of US Treasury securities, up from 6% in 2009. As we enter a new era of government spending, the Fed is going to be needed not only as a buyer of last resort for new issuance, but also as a means of controlling the cost of borrowing. The only way to keep current rates of borrowing affordable is to keep the interest cost down. This severely handicaps the extent to which policymakers will be able to put the QE genie back in the bottle.

This is not only a US phenomenon but one that affects many central banks. Andy Haldane, former Chief Economist at the Bank of England, noted that "Entering fast and large, and exiting slow and small, puts a ratchet into central bank balance sheets." The inability to meaningfully reverse stimulus will also lead to diminishing marginal returns from policy intervention when the next crisis strikes. Interest rates cannot go much lower and QE will need to be even larger to make a difference. This is also likely to call for the increased prominence of fiscal policy as a tool for dealing with the next crisis. In a perverse state of co-dependency between central banks and governments, this will need to be funded by a dependable buyer of government debt. For all the commentary around near-term restraint, it looks likely that central banks such as the Federal Reserve will own more, not less, of their governments' debt in the future.

## Microsoft: hitting refresh, again and again

*"Success is dangerous. One begins to copy oneself, and to copy oneself is more dangerous than to copy others. It leads to sterility."*  
Pablo Picasso

When Satya Nadella, the CEO of Microsoft, published his book *Hit Refresh* in 2017, he offered a window into the culture of a company that is shaping digital transformation. Since Microsoft was first bought for Personal Assets Trust in 2010, the company has reinvented itself, moving away from a model of on-premise software license sales to cloud-based software subscriptions. By placing Azure, Microsoft's cloud services platform, at the centre of the business, the opportunities for innovation and growth have ballooned. Azure today accounts for c. 20% of group revenues, with more than \$30bn in estimated annual sales, growing at over +45%.

To frame the opportunity, Microsoft is one of the two leading public cloud providers globally, enviously positioned atop a tidal wave of public cloud adoption. The company estimates that c. 20% of enterprise workloads are in the cloud today, which leaves much road to run. As the public cloud connects more people and more information, the depth of the opportunity is however greater than this number can portray. Microsoft's success is as much a function of internal attitude and imagination as it is of raw, external demand. This is a company that has the resources and business model to create entirely new markets.

It might seem reductive to try and pin down the collective character of a company with over 180,000 employees, but it is a change in culture which has partly allowed Microsoft to create more value than most would have predicted. In his book, Nadella describes a step change in attitudes that he helped instil at the start of his tenure. This was more pervasive than simply identifying the enormity of the cloud opportunity and structuring the business

accordingly. It entailed changing the way people at the firm operated, most crucially with regard to their openness to new ideas, to customer needs, and to collaborating with one another. He talks about moving from a 'know-it-all' culture to a 'learn-it-all' culture, within which engineering teams that had previously refused to share code were now starting to work effectively together.

The company's historic success had also bred an internal focus at the expense of what was best for the customer. Changing this to become more outward-looking has involved forging partnerships with third-parties, previously viewed as rivals. This enables customers to choose the combination of solutions that works best for them, rather than being forced to lock into a single provider. It has also inevitably expanded Microsoft's reach, whilst sharpening employees' incentive to win via superior innovation rather than rent-seeking contracts. In a call we hosted with the company this summer, they alluded to previous strategies which sought to 'rip and replace' SAP or Salesforce. These have given way to 'land and expand' conversations about how Dynamics 365, Microsoft's enterprise resource planning and customer management solution, can plug into customers' existing systems.

Once landed, the opportunity to expand is great. Investors often talk about a total addressable market, or TAM, for a company in an attempt to quantify the scale of its market opportunity. In the case of Microsoft's cloud business, the TAM is a moving feast as the pie continues to grow. At a recent conference Scott Guthrie, the company's head of Cloud and Artificial Intelligence (AI), spoke of growth avenues, separate from traditional enterprise workloads, which were previously not considered as part of the cloud opportunity. Arguably most exciting of these is the internet of things, the connecting of devices so that everything from your car to your coffee machine has an IP address. In this way, real-

time signals can be generated, enabling innumerable opportunities for improved customer experiences such as manufacturers proactively detecting and fixing problems before the consumer encounters them. 5G wireless networks will be vital in powering this connectivity and having invested in the capability, Microsoft is now AT&T's partner of choice for its 5G network.

This is just one example of the step change in opportunity afforded to Microsoft by the shift from license to subscription sales. By definition, today's consumption-based sales model indefinitely expands the size of the market, which is limited only by the company's ingenuity in creating new applications to intelligently harness an increasing availability of data. As more of what we do moves online, the ways in which Microsoft will be able to apply its leading-edge technology to improve customers' productivity will continue to grow.

As the world digitises, there are a number of companies which stand to benefit. My colleague Marc de Vos has written a [Special Paper – Special Paper No. 8: Digital payments – the rising tide](#) – on one such sector (we would be happy to provide hard copies on request). Like Microsoft, the payments networks collaborate with businesses in all regions of the world to power the transition. We think their strong value proposition continues to position them well in an area of attractive and sustainable growth.

### Lessons

Looking at a company like Microsoft provides invaluable lessons for investors too. One is that success breeds complacency and can result in resistance to new information and ideas. Quite often in the investment profession, complacency is mistaken for conviction and the investor might even be praised for their steadfastness in the face of change. When it is widely apparent that this steadfastness is coming at the expense of returns, it is often too late.

As we evolve these investment reports, we will seek to include more insights into the research that lies behind some of our equity holdings. Just because a stock features in this report however, does not mean that we are holders forever. As demonstrated by our investment in Microsoft, we are long-term investors but nothing in the portfolio is sacrosanct. As the world evolves at a rapid pace, so must we, and we reserve the right to change our minds.

The portfolio is centred on a number of core convictions, which we hold firmly but keep under constant review. Our holding in US TIPS, we believe, continues to provide attractively valued inflation protection and, in particular, will do well in an environment where real yields go more negative. In a world where monetary and fiscal intervention looks to be here to stay, such protection is important, as is our holding in gold. We took the opportunity over the summer to sell some of our equities, bringing the allocation down to below 40%, in acknowledgement of higher valuations and our caution heading into the autumn. As we enter the final quarter of the calendar year, a number of bullish indicators, including IPO filings, are entering record territory. Valuations are at multi-year highs on many metrics. As ever, we have a clear idea as to where we would like to deploy the Trust's cash should the recent market turbulence persist.

Charlotte Yonge

October 2021

Assistant Manager of Personal Assets Trust

Sebastian Lyon

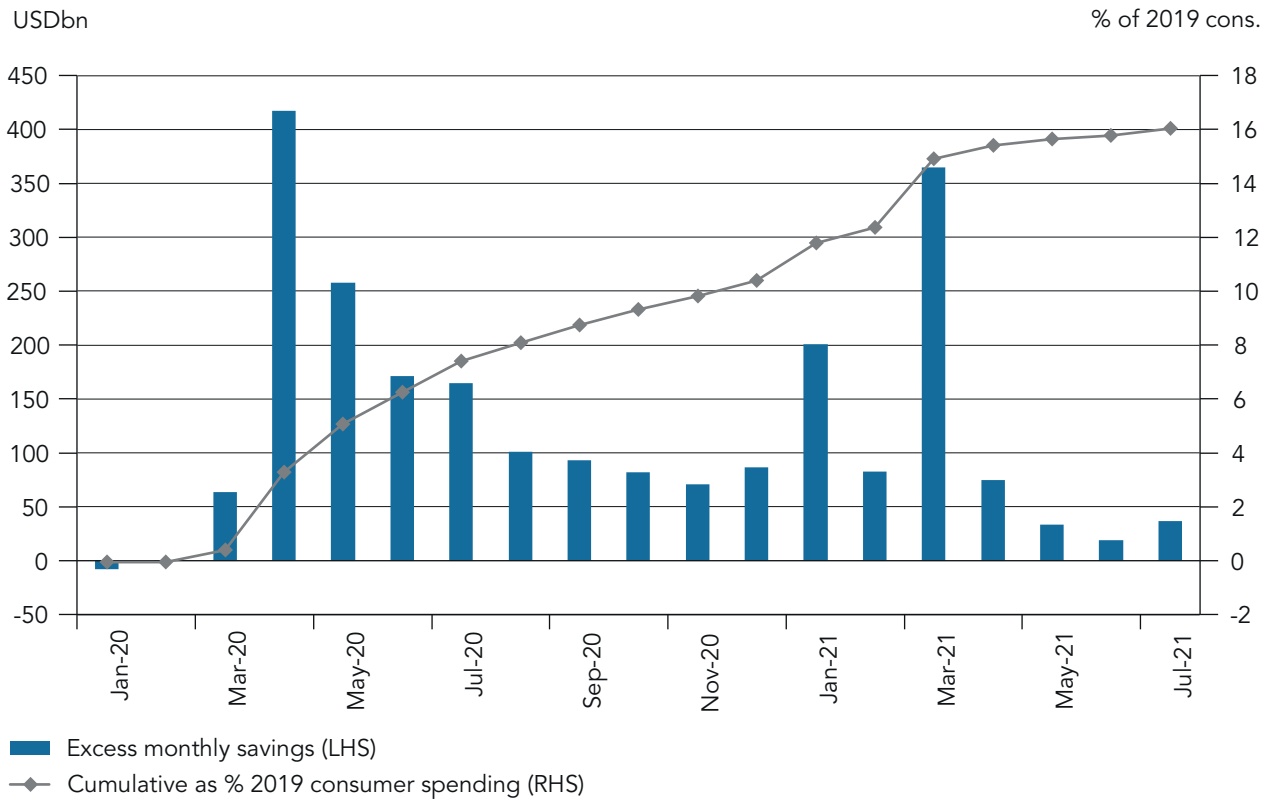
Investment Manager of Personal Assets Trust

Founder & Chief Investment Officer of Troy Asset Management



## Appendix

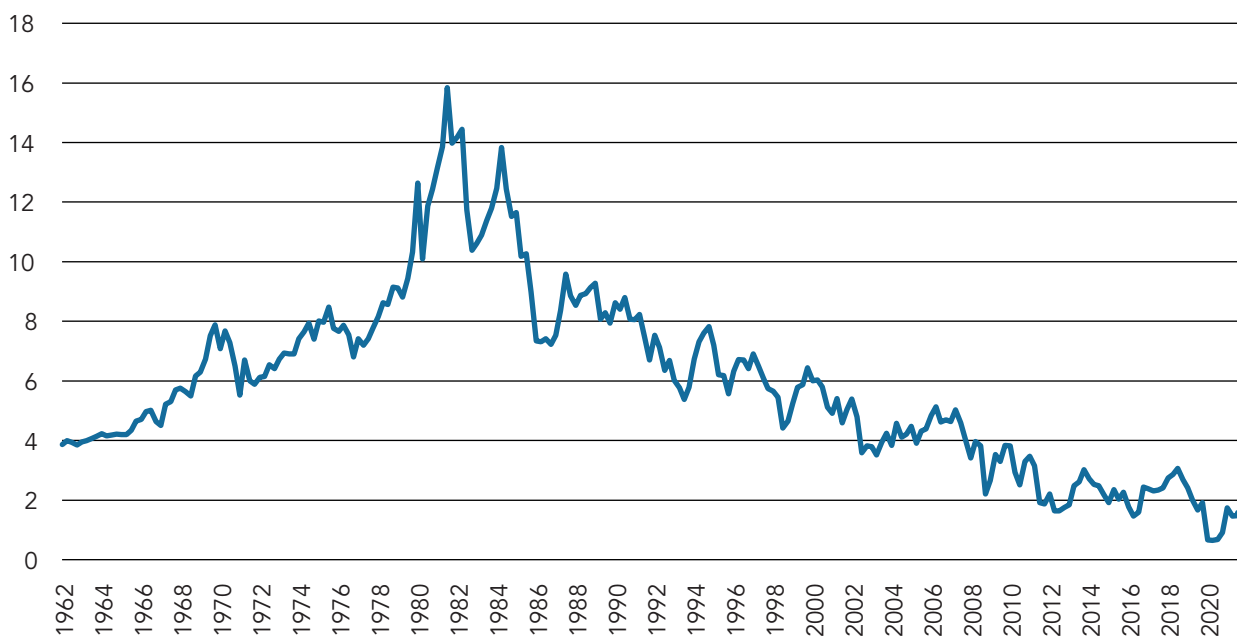
### US Household Savings Rate and Cumulative Savings



Source: Refinitiv Datastream, HSBC, 31 July 2021. Excess savings are estimated as savings above equivalent month in 2019.

Figure 1

### US 10-year Treasury Bond Yield



Source: Bloomberg, October 2021

Figure 2

Past performance is not a guide to future performance

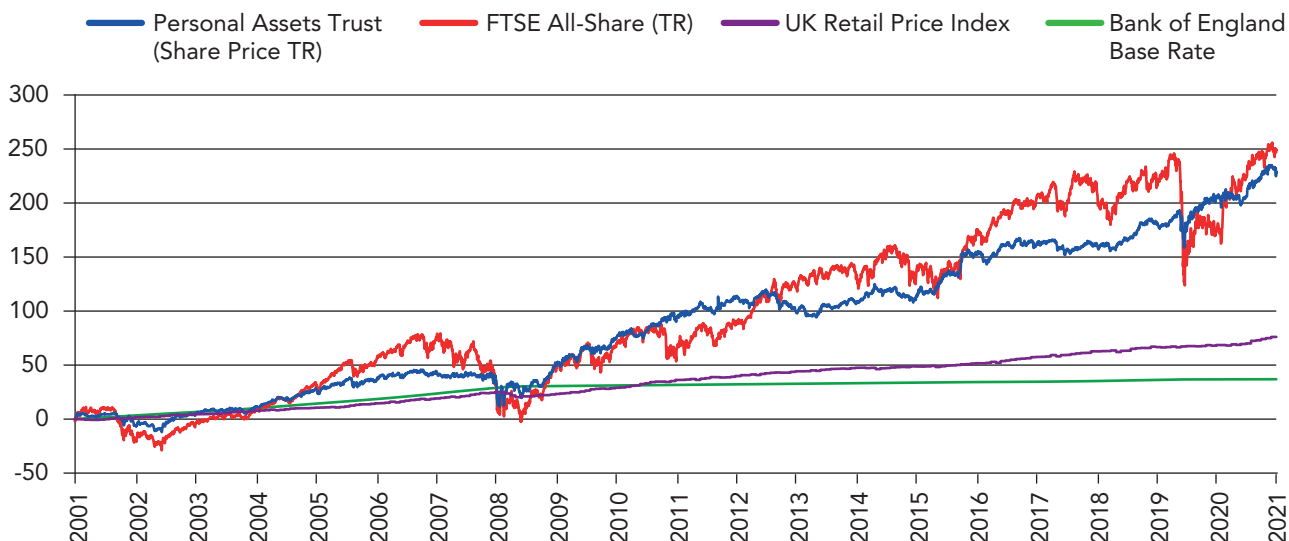


# PERSONAL ASSETS TRUST PLC

As at 30 September 2021

Share Price (£)	484.28
NAV (£)	482.16
Premium/Discount %	+0.4
Market Cap (£)	1.65bn
Shares in Issue	3.4m

## Percentage Growth from 30/09/2001 to 30/09/2021



Source: Lipper

Past performance is not a guide to future performance

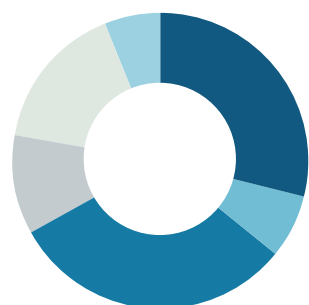
## Total Return to 30 September 2021

	20 years	10 years	5 years	3 years	1 year	6 months
Personal Assets Trust (Share Price TR)	+227.9%	+70.6%	+29.3%	+25.8%	+7.9%	+7.2%
UK Retail Price Index	+76.1%	+29.2%	+16.0%	+8.2%	+4.5%	+3.5%
FTSE All-Share Index (TR)	+249.0%	+119.2%	+29.8%	+9.5%	+27.9%	+8.0%

Source: Lipper

Past performance is not a guide to future performance

## Asset Allocation



■ International Equity	29%
■ UK Equity	7%
■ Fixed Income	31%
■ Gold Related	11%
■ UK T-Bills	16%
■ Cash	6%

## Top 10 Holdings

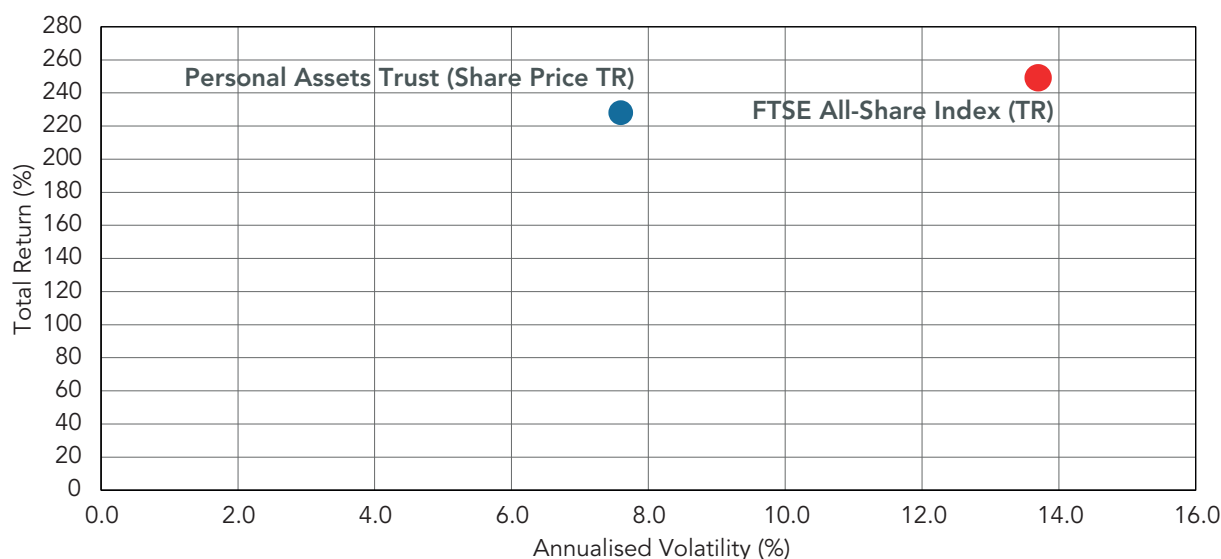
(exc. Government Bonds)

	% Trust
Gold Bar	8.2
Microsoft	5.5
Alphabet	5.2
Unilever	3.5
Nestlé	3.4
Visa	3.3
American Express	2.9
Diageo	2.9
Medtronic	2.8
Agilent Technologies	2.1
<b>Total Top 10</b>	<b>39.8</b>
6 other equity holdings	6.7
Index-Linked Bonds	31.3
UK T-Bills	16.4
Cash	5.8
<b>TOTAL</b>	<b>100.0</b>

Source: Factset, Asset Allocation and holdings subject to change.

Source: Factset, Asset Allocation and holdings subject to change.

## Risk Analysis from 30/09/2001 to 30/09/2021



Source: Lipper

**Past performance is not a guide to future performance**

### Risk analysis since 30 September 2001

### Personal Assets Trust (Share Price TR)

### FTSE All-Share Index (TR)

Total Return	+227.9%	+249.0%
Max Drawdown	-23.5%	-45.6%
Best Month	+6.9%	+12.7%
Worst Month	-7.8%	-15.1%
Positive Months	+62.9%	+60.0%
Annualised Volatility	+7.6%	+13.7%

Source: Lipper

**Past performance is not a guide to future performance**

### Fund Manager Awards



### Structure

London Listed Investment Trust

### Investment Manager

Troy Asset Management Limited  
33 Davies Street  
London W1K 4BP  
Tel: 020 7499 4030  
Fax: 020 7491 2445  
email: busdev@taml.co.uk

### Manager

Sebastian Lyon

### Assistant Manager

Charlotte Yonge

### AIFM

Juniper Partners Limited  
28 Walker Street,  
Edinburgh, EH3 7HR  
0131 378 0500

### Board of Directors

Iain Ferguson CBE (Chairman)  
Mandy Clements  
Gordon Neilly  
Paul Read  
Robbie Robertson  
Jean Sharp

### Currency

£ Sterling

### Established

22 July 1983

### ISIN SEDOL

GB0006827546  
0682754

### Ongoing Charges (30 April 2021)

0.73%

### Year End

30 April

### Pricing

Share price is listed daily in the FT

### Auditor

PricewaterhouseCoopers LLP



## Disclaimer

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