PERSONAL ASSETS TRUST PLC

DECEMBER 2018 QUARTERLY REPORT No. 90

FREQUENTLY ASKED QUESTIONS

In the last Quarterly I addressed the frequently asked question ("FAQ") of how the Board of Personal Assets and the Investment Adviser co-operate on matters to do with the running of the Company. This time I want to tackle some related subjects which give rise to even more questions. How is Personal Assets' portfolio made up? What kinds of sectors and stocks do we invest in? And how do we choose and then monitor our investments?

First, however, I want to tackle two other perennial FAQs:

- Why don't the Quarterlies contain more about sectors and stocks?
- Don't the Quarterlies sometimes become a bit repetitive?

SECTORS AND STOCKS

It was in 1995 that a shareholder wrote to me to complain that the Quarterlies contained too much in the way of *'parlour chat about generalities'*, and nearly a quarter of a century later the perceived lack of detailed comments in the Quarterlies about stocks and sectors is still one of the commonest things I get asked about.

As you'll see from my later comments about choosing investments, I'd gladly talk about stocks *ad infinitum*. But it's important to remember that (at present, anyway) equities account for not much more than a third of our shareholders' funds. Far from giving investors a clearer idea of what the Company was doing, therefore, writing too much about individual sectors and stocks might in fact mislead them.

The first investment decision for Personal Assets will typically be how much to have in equities as an asset class. After that come further choices such as sterling versus other currencies, or individual equity markets versus each other.

There are good reasons why we don't dive too deeply into what Sebastian Lyon, our Investment Adviser, calls *'the weeds'* of stock specifics. First there is the point already made, that focusing on the whole portfolio is more important than individual holdings. It's only common sense to take the big decisions before the smaller ones; strategy comes before tactics. Secondly, complaints from outside about individual holdings tend to get louder just when the trust should be buying, not selling — thus fostering an environment of distracting noise rather than constructive help. Finally, there can sometimes be shareholders who are looking for personal share tips when cross-examining the Directors and the Investment Adviser. Not only might this be a legal grey area in certain circumstances, but also it is essential to recognise that what suits one person's portfolio may not suit another's. Boring though it may sound, there are seldom 'right answers' *per se* in the investment world — just appropriate answers for individual people.

'CRAMBE REPETITA'

Next there is the accusation that the Quarterlies contain too much repetition of the kind referred to by the Latin poet Juvenal as *'crambe repetita'*: *'twice cooked cabbage'*, or, in the Scots phrase, *'cauld kail het again'*. Such a diet may be filling, but a delight to the palate it is not. Yet, like the inescapable In-Flight Safety Demonstration on aeroplanes, it is there for a reason. Frequent flyers may bury themselves behind their copies of the *Financial Times*, but to others the safety demonstration will be fresh and new, and occasionally it may even be a matter of life and death.

Writing these Quarterlies is not like writing the chapters of a book. They are more like a journal or a periodical. A book need only state a point of view or describe a methodology once, but a periodical must go over old ground (with or without a new slant) from time to time because its readership will have changed. The number of Personal Assets shareholders is constantly increasing. Calculating the number of individuals is all but impossible because many shareholders hold shares through platforms or in various accounts such as Investment Plans and ISAs as well as on the Main Register, but when I wrote the first Quarterly in 1994 we had 152,187 shares outstanding and at the time of writing there are 2,300,836, or more than 15 times as many. New shareholders need to know all the traditions of what has been called the *'family atmosphere'* (or DNA) of Personal Assets. All families have their traditions and their shared memories, their remembered triumphs and their cautionary tales, and Personal Assets is no different.

CHOOSING INVESTMENTS

Before I attempt to describe Troy's and Personal Assets' investment processes today, I'll begin by describing how my own personal views on investment were formed. In my earliest days as an investment management trainee I thought that investment management was all about choosing individual stocks, and I overdosed on stock ideas like a child in a sweetshop. The Standard & Poor's Stock Guide was endlessly fascinating — a box of delights into which I would dip not only when I was at work but also when travelling to the office, or soaking in the bath, or at nights when I couldn't sleep. And the arrival of the latest batch of Extel cards did the same for the UK market, although at that time UK stocks didn't fascinate me as much as US stocks did.

Then there were sector stockpicking services like Keefe, Bruyette & Woods on US regional banks and J S Herold's 'Appraised Worth' estimates for the smaller oil stocks. With these services to hand I would pester my superiors with pæans of praise for such obscure discoveries as WellTech, a small oil service company from which (lacking any money to invest in the company itself) I in 1978 made £1 by successfully betting one of the partners I worked for that it would be taken over within the year.

'Top Down' vs 'Bottom Up'

All this was fun and stimulating in the extreme, but gradually I came to see that if the choice of investments were left to me alone, my stock-fixated approach would produce a portfolio as unsatisfying as a main meal consisting entirely of *canapés*. Further experience taught me that there were two main ways of approaching the construction of a portfolio — *'top down'* and *'bottom up'*. Both have their uses, but in my early days *'top down'* struck more of a chord with me. And then there was *'growth'* versus *'value'*, together with shades between the two such as 'GARP' ("Growth At a Reasonable Price"). In this respect, Troy see themselves as qualitative investors with a keen eye on value.

Γνῶθι σεαυτόν, as the Greek oracle of Delphi said — *'know thyself'* — is advice every investment manager should follow. Knowing one's own temperament and biases is vital to success, so it was useful to me to discover that I was by temperament a *'top down'* investor and that I had a bias towards value rather than growth. Losing some of my money (what Jimmy Gammell, the first Chairman of Personal Assets, used to describe as one's *'grubstake'*) hurt me more than did a failure to win high returns.

However, it's essential here not to confuse my immaturity and my necessarily steep learning curve four decades ago with Troy's actual investment method today, which is a nuanced combination of *'top down'* and *'bottom up'*. As regards value versus growth, Troy's approach is carefully balanced and is described by Sebastian as follows:

'Hard definitions of "value" or of "growth" risk misrepresenting a more nuanced reality. For us at Troy, value investing involves the identification of excellent businesses at attractive prices. This is much more subjective than simply identifying companies on low price to earnings multiples, as per the generally accepted definition of "value". A very low valuation often betrays the dubious quality of a business or the weakness of its balance sheet. This is particularly so during the latter stages of a bull market. More often than not, rather than the bargains they appear, these are expensive mistakes waiting to happen.'

'This Pudding Has No Theme.'

Churchill's famous culinary comment could also be applied to those investment portfolios which are no more than bran tubs full of unrelated stock purchases. It was, however, Sebastian who first introduced me to the US investment writer and fund manager Joel Greenblatt's unforgettable *memento mori*:

'Choosing individual stocks without any idea of what you're looking for is like running through a dynamite factory with a burning match. You may live, but you're still an idiot.'

Constructing a portfolio is entirely different from this. It has to be done systematically and must be based on broad appraisals of the strengths and weaknesses of asset classes, markets and sectors. There is nothing random about it.

Looking at Troy's investment processes when Sebastian was appointed as Investment Adviser, I immediately recognised how much they had in common with the techniques and disciplines in which I was trained at Baillie Gifford, and also how much they had in common with Ian Rushbrook's techniques and disciplines — a sort of apostolic succession of investment method with which I and the rest of the Personal Assets Board immediately felt comfortable.

How does it work? The team at Troy spend a great deal of time thinking about broad asset class valuations and the influence that various macroeconomic indicators, such as inflation, have on these. They are particularly focused on credit cycles and also look to identify unsustainable economic trends that will surprise consensus opinion when they reverse.

Troy supplements its in-house study and research with input from independent strategists, seeking to remain independent of the market and sell-side research views which are often focused on different priorities and timescales. However, external sector specialists are useful in providing insight into areas such as regulation, litigation and complex technological change.

Choosing Equities

Our choice of stocks is reminiscent of Dr Primrose's not very gallant description of his wife's attributes in Oliver Goldsmith's *The Vicar of Wakefield,* where he wrote that he:

'chose my wife as she did her wedding gown, not for a fine glossy surface, but such qualities as would wear well.'

Troy's research process is thorough and exhaustive. Members of the investment team carry out independent research, marshalling information from sources such as company accounts, dependable sell-side research and the financial press. This can take several months of reading annual reports, reviewing company call transcripts and meeting with company management. Throughout the process, Troy is careful to ensure that its research sources demonstrate original and often contrarian thought.

Troy's criteria for buying new equity holdings are easily grasped:

- There must be a simple and comprehensible case for purchase.
- The Troy team must understand the company.
- Troy seeks enduring franchises.
- They are owners, not traders.

Troy tries to keep the investment process as simple and intuitive as possible, investing only in companies they thoroughly understand and which have enduring qualities that will allow an investment to compound in value over the long term. In aiming to own and not trade investments, Troy must be confident in a business's ability to deliver growing cash flows into the future. To quote Sebastian again:

'Troy has a rigorous focus on quality. We invest in businesses with high returns on invested capital which we consider to be sustained by durable competitive advantages. We favour stable and growing companies with a strongly differentiated product or service that new or existing rivals struggle to copy. These are companies with low

risk to their earnings that permit sustained high levels of profitability. We also pay particular attention to how management allocates capital and typically avoid highly acquisitive and indebted companies.'

Troy assesses companies for their competitive strengths and weaknesses in order to analyse the sustainability of current rates of profitability. Their analysis looks back a decade or more at a company's strategy and financial performance to gain a deep understanding of its qualities. Quite rightly, Troy prefers to use past performance as a rough guide to the future rather than make detailed forecasts that try to anticipate the unknowable. Management's strategy, behaviour and financial incentives are analysed to ensure they are aligned with the interests of shareholders. Financial statements are scrutinised to ensure that reported earnings reflect cash generation, priority being given to organic growth, low levels of debt and cautious management.

Lining Up Three in a Row

Having identified companies that meet their quality criteria, Troy will consider making an investment only when, in the team's view, three further conditions are met:

- The target company's balance sheet must be soundly financed so that management can allocate capital flexibly. *(An extreme example of the opposite would have been Northern Rock.)*
- The company is managed by people who act in the best interests of shareholders. *(An extreme example of the opposite would have been Valeant Pharmaceuticals.)*
- The company's shares trade at a price that underestimates future cash flows. *(An extreme example of the opposite might be Tesla. A debt-funded business with negative cash flow is not usually a good combination for equity owners.)*[1]

Troy believes that this combination of owning high quality companies purchased at reasonable prices gives their investment clients the defensive characteristics they seek.

Troy currently does not invest in emerging market companies on clients' behalf, preferring to take exposure to these markets through large international companies listed in developed markets.

What are the Ingredients?

Just as Personal Assets itself has a Green, Amber and Red set of investment categories which I described in Quarterly N°. 89, so Troy has Green, Amber and Red categories for equity market sectors in which they might invest.

- **Green (persistent opportunities).** These include Consumer Goods, Healthcare and Business Software.
- **Amber (select opportunities).** These include Business Services, Energy, Financial Services, Industrials, Non-Life Insurance, Media, Retail, Telecoms and Utilities.
- **Red (infrequent opportunities).** These include Aerospace & Defence, Airlines, Autos, Construction/House Builders, Life Insurance, Miners and Technology Hardware.

What Does Troy Avoid?

Examining this list reveals the sort of companies Troy likes to avoid:

- Companies which are capital intensive and cash hungry.
- Companies which don't add value, or don't have intellectual property in their business.
- Companies which seek growth mainly by acquisition.
- Companies with short-term and/or selfish managers.

Keeping in Touch

Once Troy has got to know a company, it places great importance on keeping in touch — meeting with investee companies and managements to maintain a dialogue about business strategy and capital allocation. Troy abhors surprises and seeks comfort that management is determined continuously to improve the competitive advantage of the firm they manage. As a long-term shareholder, Troy regards corporate governance and capital discipline as paramount. In management Troy seeks high quality, stability, consistency of strategy and a close alignment of interests with shareholders – precisely the qualities they believe their clients expect of them.

Saying Goodbye

Troy's long-term approach enables the team to look through, and take advantage of, the short-term noise generated in the markets. The stock market can be like the proverbial swimming-bath — all the noise comes from the shallow end.

Troy has identified a universe of stocks they would like to own, but the decision to invest is solely at the discretion of the relevant fund manager or adviser (in our case, Sebastian). As a rule, Troy seeks to buy when a company's share price seems significantly to understate its capacity to compound value for shareholders over the long term. Troy's belief is that the price paid for assets is crucial in determining subsequent returns. Pay too much, and you can't perform.

Troy doesn't believe in 'black box' or 'one size fits all' investment criteria, believing that no single valuation approach should be applied mechanically to different businesses, sectors and geographies.

Free cash flow yield, price-earnings ratio and dividend yield are important valuation criteria. Forecast earnings estimates, on which the market is often obsessively focused, often prove to be the least helpful measure.

Troy sells holdings when:

- pricing fully discounts expectations;
- change leads to a reappraisal of valuation; *or*
- simply when they get it wrong.

We — that is, Troy and the Board of Personal Assets — are united in aiming to be long-term owners of the companies we invest in, believing that low turnover and patience bring tangible benefits. First, we mitigate the risk inherent in making too many investment decisions and therefore making a mistake. Secondly, we reduce the frictional cost of trading, which can be a tax on investors' returns. And lastly we believe that the patient ownership of superior businesses, purchased at what we consider better than fair prices, will deliver attractive compound returns over time.

Robin Angus

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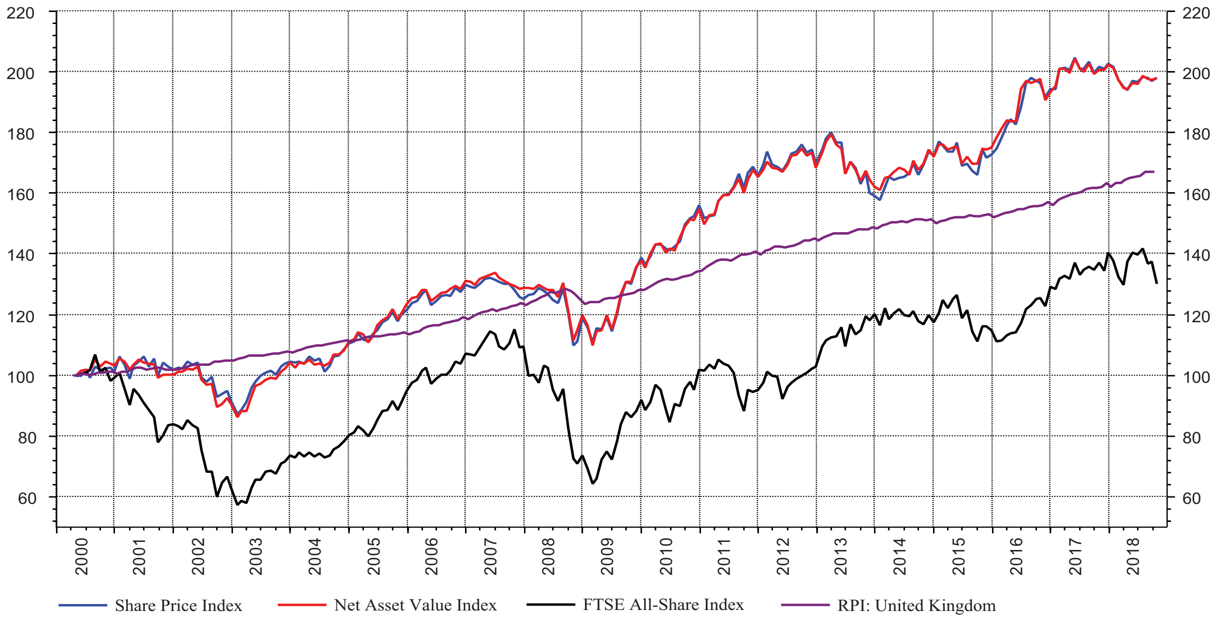
[1] A friend setting out in business once asked me what was the key to success. I replied that there were three essentials:

(a) cash flow;

(b) cash flow; *and*

(c) cash flow.

Personal Assets Trust Performance



Source: Thomson Reuters Datastream

Value	Percentage Changes 31 Oct 2018	1 Year	3 Years	5 Years	10 Years	30 Apr 2000
Share Price	£400.00	1.8	13.4	18.8	80.2	98.0
NAV per Share	£395.50	(1.3)	13.4	18.2	77.6	97.9
UK RPI	284.50	3.3	9.6	12.9	30.7	67.3
FTSE All-Share Index ("Index")	3,904.23	(5.2)	12.0	8.9	78.8	30.1
NAV relative to Index		4.1	1.3	8.5	(0.7)	52.1

Past performance is not a guide to future performance. The value of investments may go down as well as up and you may not get back the full amount originally invested.

Top 10 Equity Holdings

Company	Country	Sector	Valuation 31 Oct 2018 £'000	Shareholders' funds %
Microsoft	USA	Technology	32,209	3.6
Coca-Cola	USA	Beverages	30,376	3.3
Philip Morris	USA	Tobacco	27,582	3.0
Nestlé	Switzerland	Food Producer	26,240	2.9
British American Tobacco	UK	Tobacco	23,754	2.6
Unilever	UK	Food Producer	23,316	2.6
Altria	USA	Tobacco	22,419	2.5
Berkshire Hathaway	USA	Insurance	20,487	2.3
American Express	USA	Financial Services	17,695	2.0
Proctor & Gamble	USA	Household Products	16,251	1.8
			240,329	**26.6**

Portfolio Analysis

	Valuation 31 Oct 2018 £'000	Shareholders' funds %
Equities	338,762	37.4
US TIPS	248,273	27.4
UK T-Bills	150,541	16.6
Gold Bullion	76,248	8.4
US Treasuries	37,715	4.2
UK Index-Linked Gilts	31,816	3.5
Cash and Cash equivalents	22,874	2.5
Shareholders' funds	**906,229**	**100.0**

Further information on the Trust can be obtained from the Company's website – www.patplc.co.uk or by contacting Steven Budge on 0131 538 6605