

HALF YEARLY INVESTMENT REPORT

15 December 2006

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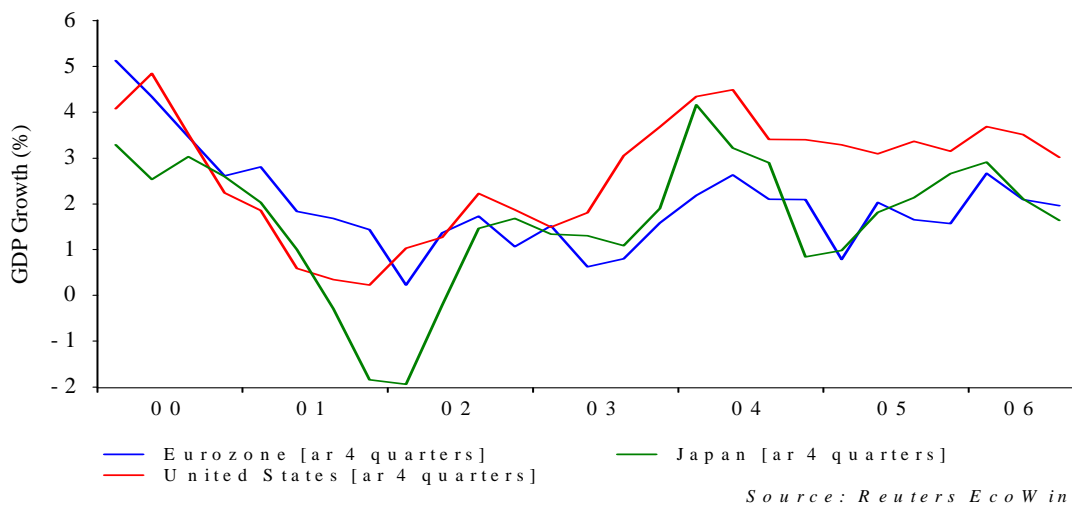
This report is for general guidance only and represents our understanding of law and HM Revenue and Customs practice as at 15 December 2006. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments and any income from them may go down as well as up and you may not get back the full amount you invested. Levels and bases of, and relief from, taxation are those currently applying but are subject to change and their value depends on the individual circumstances of the investor.

1. Overview

This year has been a challenging one for the global economy. Three years of strong growth have put upward pressure on prices, particularly for commodities such as oil, and sparked fears of accelerating inflation. At such times, central banks, such as the Federal Reserve Bank of the United States ('the Fed'), have little choice but to use measured interest rate increases to engineer a slowdown in growth, thereby releasing the build up of inflationary pressures.

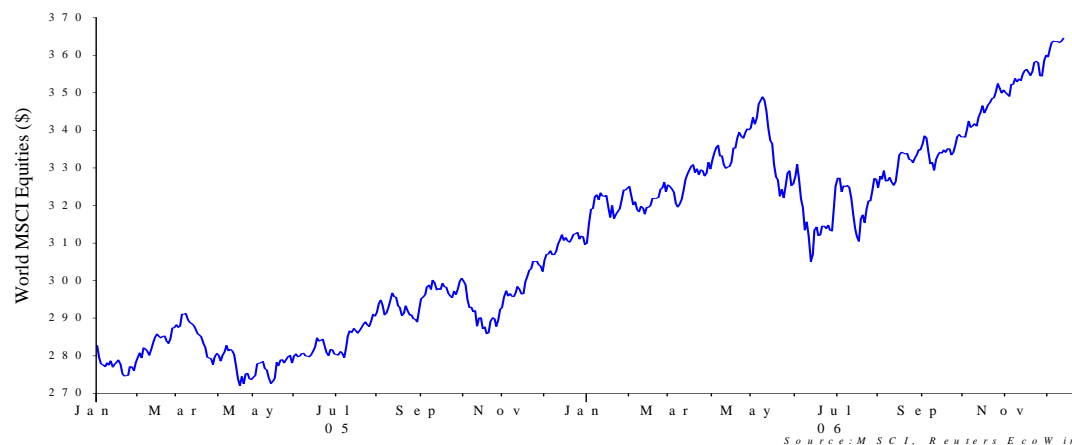
As 2006 draws to a close there can be little doubt that the required slowdown in the US is starting to happen (see Fig. 1). However, some uncertainty remains about whether the Fed has tightened monetary policy too aggressively, which might lead to a recession.

Fig. 1: US, Japanese and eurozone annual GDP growth rates since 2000



Uncertainty about the extent of interest rate increases required to squeeze out inflation has kept investors fully occupied this year. After a strong start to the year, world equity markets fell sharply in May and June as higher than expected US inflation figures sparked fears that the inflation problem was more intractable than previously believed. As shown in figure 2, investors regained their poise in late June as commodity prices eased. Equity markets, as measured by the MSCI World Equity Index, have recovered steadily since.

Fig. 2: MSCI World Equity Market Index since 2005



2. Summary

The World Economy

- After a prolonged period of higher growth, evidence of emerging inflationary pressures have prompted central banks to raise interest rates, triggering an economic slowdown. We expect growth in 2007 to be marginally lower than in 2006.
- The price of oil has eased from over \$78 per barrel to around \$64 in expectation of both weaker demand, as the effects of slower economic growth feed through, and a supply-side response to high prices from producers.
- The threat to economic stability posed by accelerating inflation appears to be easing. We expect inflation to stay close to the top of central banks' 'comfort zones' for the next few months before moving back towards the middle of target ranges.
- US interest rates have, for now, peaked at 5.25%. Given continued good news on inflation, the Fed has scope to cut rates if the economy weakens too sharply.

World Financial Markets

- The US dollar has weakened against most major currencies as interest rate rises elsewhere reduce the dollar's yield premium.
- Sterling has been very strong as accelerating growth and fear of mounting inflationary pressures have prompted the Bank of England into another round of rate increases.
- Government bond yields peaked in mid-year and have since fallen back in anticipation of slower growth and lower inflation.
- Sustained corporate profits have driven equity markets higher. The low absolute level of interest rates together with easy access to bond finance has allowed takeover activity to continue unabated.

Investment Recommendations

- Sterling cash deposits earning around 5.00% are relatively attractive.
- Government bonds in the major economies are fairly valued. The risk premiums available on corporate and high yield bonds remain, in our view, wholly inadequate.
- Commercial property is now looking very expensive. We have revised down recommended allocations within portfolios.
- Equities remain the most attractively valued asset class. We have recently increased our recommended weighting to US equities in response to the market's reasonably attractive valuation basis and the weaker US currency.

3. Economic Review and Outlook

According to the International Monetary Fund (IMF), the **global economy** looks set to record output growth in the region of 5.1% in 2006, extending the era of growth in excess of 4.0% into a fourth consecutive year. An IMF forecast made in September indicated that this era might extend still further with the expansion of global output slowing only marginally in 2007 to 4.9%. Growth of this magnitude would take the total value of world output past \$50tr for the first time. Sustaining economic expansion at this pace has proved challenging to governments and central banks. Competition for scarce resources has resulted in upward pressure on prices, particularly for commodities, and has driven inflation to the upper end of central banks' target ranges. This has prompted a series of interest rate increases.

Periods of rising inflation, rising interest rates and slowing growth are rightly of great concern to economists and investors alike. Too much monetary tightening would cause a recession, while too little would allow rising prices to become entrenched and lead to the wage-price spirals and accelerating inflation so characteristic of the 1970s. Either outcome is damaging for the economy and for the value of equities. At such times there is much discussion and press comment on the likely achievement or otherwise of a 'soft landing', where the pace of growth is reined back to levels compatible with stable inflation, but where a destructive recession is avoided. As figure 1 demonstrates, a US slowdown is now underway.

US data is being scrutinised for clues about the extent of the slowdown. The early signals are mixed, as they often are when significant change is occurring. Observers have been focusing on three factors. Firstly, close attention is being paid to inflation and whether pricing pressures are easing. Secondly, on employment, economists are trying to judge whether payroll data are indicating that the economy is slowing too quickly. Finally, housing related data is being examined for evidence supporting the view that the housing market is weakening so sharply that it risks dragging the rest of the economy into recession. Despite the mixed data, we believe the prognosis is good. Recent core inflation data shows a promising absence of persistent pricing pressures, with core inflation peaking mid-year and now moving lower. The employment statistics remain robust with hourly workers' earnings rising at 3.9% p.a. in October and unemployment near a five year low at 4.5%. With regard to the housing market, there is little doubt that this is slowing rapidly but the regional nature of the housing boom should mean that the impact is not felt on a national scale. This evidence leads us to conclude that the US economy will achieve a soft landing in 2007.

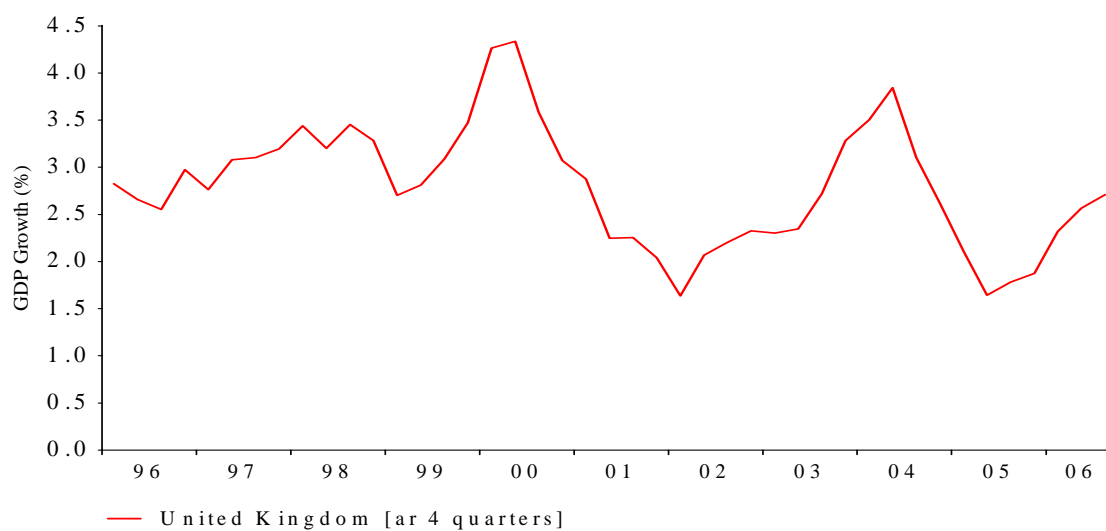
The fall in oil prices that saw the benchmark Brent crude price fall from a peak of over \$78 per barrel in early August to \$64 at the end of November is supportive of a soft landing. Lower oil prices have helped ease the pressure on inflation and given a welcome fillip to stretched consumers, particularly in the US where low petrol tax means that drivers feel oil price changes keenly.

As the US slows the global economy should get some support from the other major economic regions in 2007. Germany, the engine of European growth, is set to grow at its fastest pace for five years while the economies of the Far East, driven by China and India, will continue to grow rapidly. If the world economy can achieve more balanced growth, and if inflationary pressures continue to ease, a further extension to the era of rapid growth looks possible.

Risks to this view, aside from the US slowdown turning into a full recession, include a further rapid increase in oil prices, perhaps sparked by a major act of terrorism or a decline in political relations between the western economies and OPEC or Russia. This would reignite inflation concerns and worries about further interest rate increases.

The **UK economy** has surprised many forecasters with its performance in 2006. After growing by only 1.8% in 2005, output had accelerated to an annualised rate of 2.7% by the end of the third quarter of this year (see Fig. 3) with growth in the financial services sector being a major contributor. This pace of growth, if sustained for the full year, will make the UK comfortably the fastest growing of the four major European economies. The IMF is forecasting UK growth to be maintained at 2.7% in 2007.

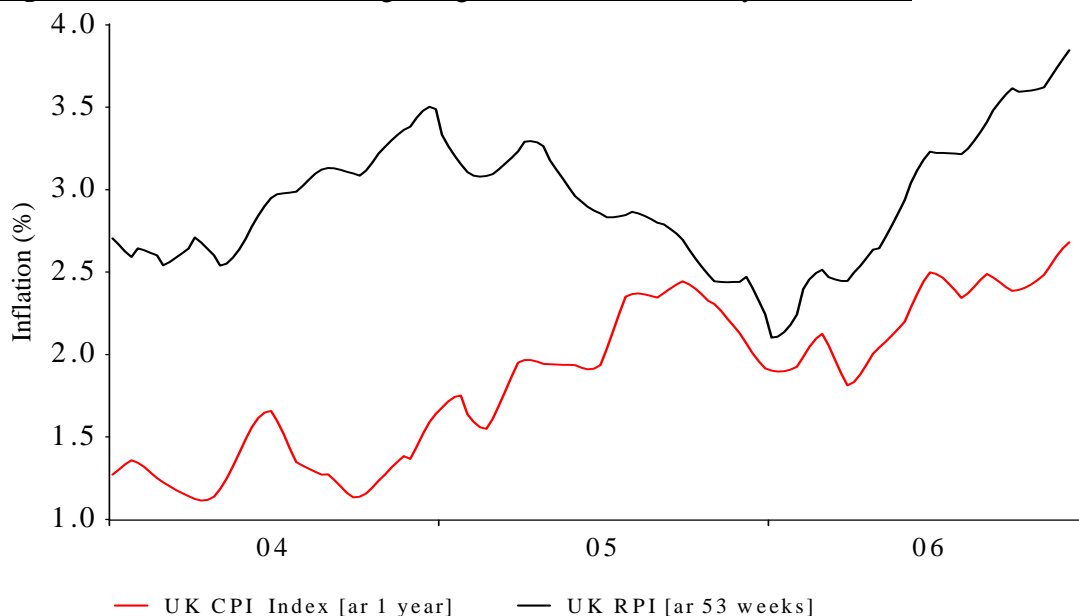
Fig. 3: The 10-year record of UK GDP growth (annualised)



Source: Reuters EcoWin

Strengthening economic growth and continuing concerns about inflation (see Fig. 4) have prompted the Bank of England's Monetary Policy Committee (MPC) to raise rates twice this year, on both occasions by 0.25%, taking the base rate up to 5.00%.

Fig. 4: UK Inflation since the beginning of 2004 as measured by CPI and RPI

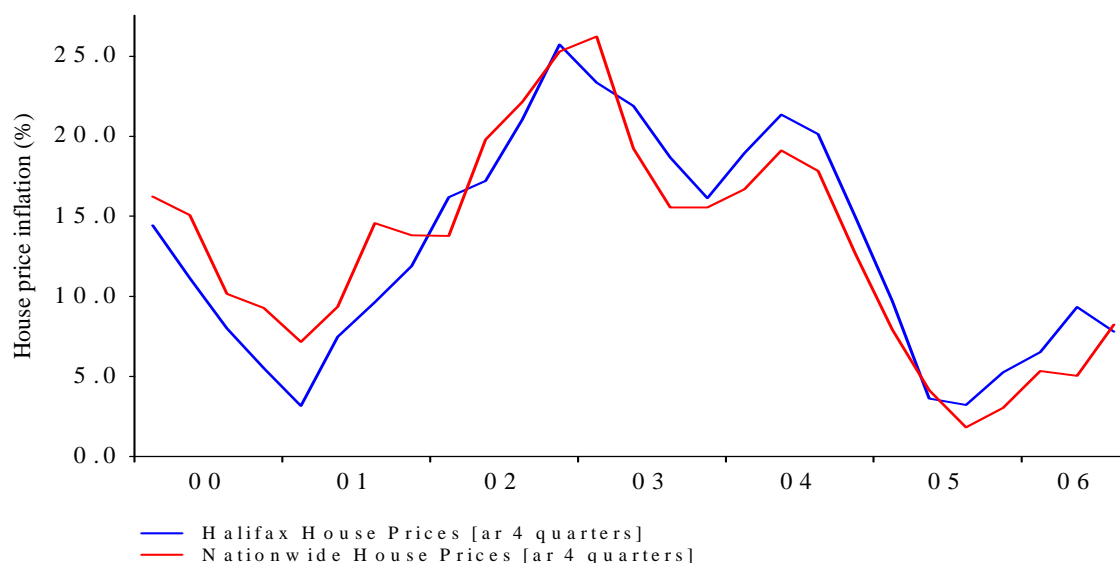


Source: Reuters EcoWin

As figure 4 above shows, inflation, as measured by the Consumer Price Index (CPI), currently stands at 2.7%. CPI has been higher than the Bank of England's 2.0% target level since May. In its November Inflation Report the Bank of England stated that it expected inflation to stay above 2.0% in the near term as a result of the increase in university tuition fees and higher utility bills before falling back during the course of 2007.

Further cause for caution on the interest rate outlook comes from the resurgence in house price inflation (see Fig. 5). Mervyn King, the governor of the Bank of England, was widely quoted earlier in the year when he said that house prices were remarkably high relative to average earnings. He will not have been encouraged by house price data since, with annualised inflation on both the Nationwide and Halifax indices accelerating towards 10.0%.

Fig. 5: Average UK House Price Inflation since 2000



Source: Reuters EcoWin

While CPI and increasing house prices give the MPC ample reason to remain vigilant on inflation, other indicators of pricing pressure, such as earnings growth, have remained relatively muted. The annualised measure of average earnings, excluding bonuses, has dropped back to 3.5% from 4.0% a year ago, indicating that inflation is not resulting in higher wage settlements. Subdued wage settlements are due to immigration creating more competition in the labour market and the trend towards outsourcing which has reduced employee wage bargaining power.

In summary, the UK economy is growing at a relatively healthy pace, inflation is above its target range but is expected to fall back over the course of 2007 and interest rates are likely to move up to 5.25% in the first quarter of next year before falling back as inflation declines.

This scenario is much more likely to be derailed by international factors than national ones. For instance, another surge in the oil price would spark more inflationary concerns at the Bank of England and cause it to increase interest rates to a higher level than might otherwise have been the case.

4. Investment Outlook

Two related factors are exercising investors' minds as 2006 comes to a close. The first factor is the size and duration of the US slowdown as discussed in the section above. The second is the US dollar which has weakened substantially through the course of the year. The two factors are inter-related; pronounced weakness in the US economy could prompt the Fed to cut interest rates, thus undermining support for the US currency. The alternative scenario, a gentle slowdown to a sustainable growth rate, would imply a longer period of interest rates at current levels and therefore offer yield support to the US dollar.

For investors, the benign outcome, that of a gentle slowdown in the US economy with the dollar stabilising or recovering somewhat, should allow a continuation of steady corporate earnings and cash flow growth. This would probably be accompanied by further good returns from investments in equities. The negative outcome would require a shift to a much more defensive asset allocation stance - one dominated by government bonds and cash.

There are two areas where we have some concerns regarding the investment outlook. Firstly, the ever increasing pace of financial innovation from investment banks serving their yield-hungry clients. For example, developments such as Collateralised Debt Obligations (CDOs), where bonds and loans are repackaged to achieve a higher rating from the rating agencies, appear to be no more than financial alchemy. Secondly, there is the ever increasing use of leverage in the purchase of stable cash flow businesses. Infrastructure businesses, including many in what were previously perceived to be dull sectors such as utilities and transport, are much sought after by private equity and specialist funds whose returns come from employing very high gearing and profiting from the spread between the yield on the asset and the cost of the debt finance. Both factors, the proliferation of new financial instruments and the increasing use of leverage in transactions, appear to us to be symptoms of a high appetite for risk among investors and access to very cheap capital. Further rises in interest rates, particularly in Japan, may undermine these developments and result in some high profile failures in the debt markets.

Turning to asset allocation, within the major asset classes the above discussion leads us to prefer equities and cash to property and bonds. Equities are relatively attractively valued and stock market investors are often on the receiving end of the high bid premiums being paid as private equity investors look to deploy their funds. Cash now carries an attractive yield and offers defensive qualities.

Within bond allocations we remain of the view that the yield premiums paid by corporate and high yield bond issuers over the comparable government issues remain inadequate. This may in part be due to the financial innovation discussed above, or may reflect the confidence of bond investors that the strength of corporate balance sheets and earnings outlook justify the low premiums. Whatever the explanation, in our view, investors are better served by combining equity with sovereign debt within portfolios.

Within property we now believe that yields have fallen too far and are recommending that clients take profits.

The following sections cover our views on asset classes in more detail.

4.1 Cash Deposits

Cash deposits in sterling now offer a yield of about 5.0% p.a, with every likelihood that rates will rise by a further 0.25% early in the new year. We regard this as attractive relative to both inflation, which on the CPI measure is 2.7% and UK government bonds which are yielding 4.5% for 10 year issues. Cash deposits are highly defensive assets. This, combined with the flexibility afforded by having funds available to take advantage of investment opportunities as they arise, merits their inclusion within portfolios.

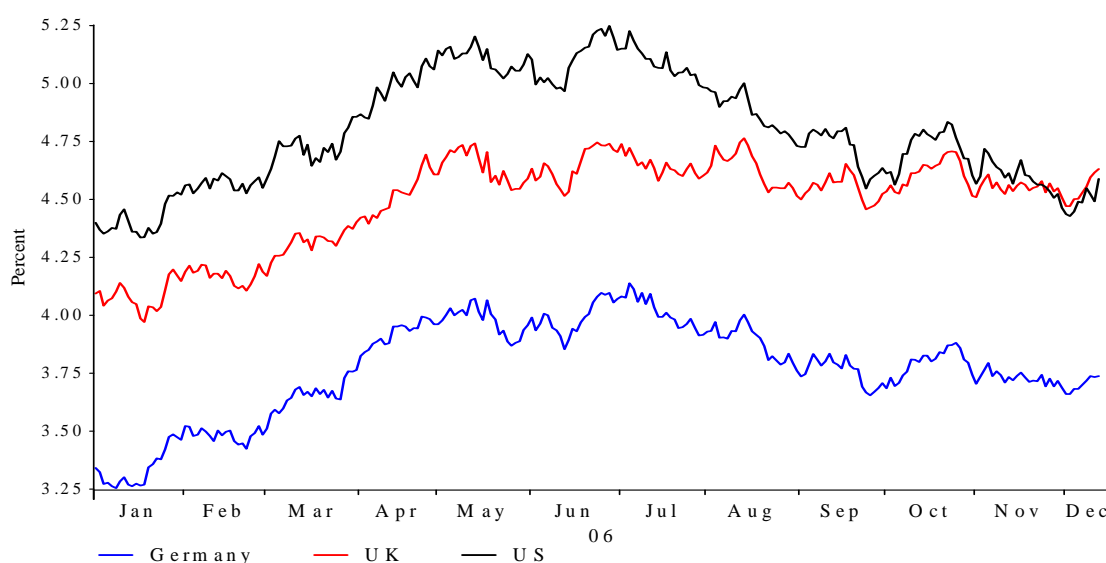
4.2 Fixed Interest

The movements in US Treasury bond yields through 2006 give a clear picture of the impact of the developing economic picture on investor sentiment (see Fig. 6). Yields rose through the first half of the year, in step with rising US base rates and in anticipation of sustained growth and the increasing threat of inflation. The peak came at the end of June at 5.25% from where yields fell as it became apparent that the economy was slowing and the Fed would cease its monetary tightening with base rates also peaking at 5.25%. Bond yields had fallen back by 0.75% by October amid concerns that the slowdown was gathering momentum and would turn into recession. Since then they have traded within a 0.25% range, rising and falling as the latest data indicates economic strength or weakness. Moves in European bond yields have tracked the US closely, albeit at a lower absolute level, indicating both the influence that developments in the US have on the rest of the world and the global nature of sovereign bond markets. UK government bond yields also tracked those of the US upwards though they have not fallen back to the same extent due to the UK's greater economic resilience (see Fig. 6).

We expect bond yields to move higher once again in 2007 as economic growth accelerates. The timing of this, however, is uncertain and depends on both the length and the depth of the US economic slowdown.

In the remainder of this section we consider the outlook for the various categories of fixed interest investment.

Fig. 6: US, UK and German 10 year government bond yields



Source: Reuters EcoWin

- UK Government Bonds

The yield on UK government bonds peaked in mid-August and has since traded gently lower in sympathy with falling yields elsewhere. The 4% Treasury 2016 gilt currently yields 4.51%. This is similar to that of the 10 year US Treasury bond which stands at 4.48% and higher than that available on the 10 year German government bond which is currently offering 3.68%.

At current yield levels UK government bonds offer reasonable value. The highly defensive characteristics of government bonds means that they should be included in portfolios to give protection against events such as recessions, natural disasters and terrorist attacks which would, in most circumstances, be expected to cause falls in the value of other assets. Investing in the government bonds of foreign countries undermines the defensive qualities of the asset class to some degree by bringing an element of currency risk into consideration. For this reason we recommend that sterling based investors gain exposure through UK government issues.

Capital repayment at par is guaranteed by the government if UK government stock is held to maturity. We generally recommend that clients buy government bonds directly rather than through funds thereby avoiding ongoing management charges.

- UK Index-Linked Government Bonds

Having risen earlier in the year, real interest rates, as measured by index-linked bond yields, have fallen over the last six months resulting in capital gains for holders of index-linked bonds. An increase in inflation expectations over the same period has meant that holders of conventional gilts have not benefited from this fall to the same degree. This is illustrated in the yield figures: the 2½% Index-linked Treasury 2016 gilt yield has declined from 1.63% to 1.48% whereas that on the conventional 4% Treasury 2016 gilt has only fallen from 4.59% to 4.51%. This yield fall has given holders of index-linked bonds a return of about 5% over the period, comfortably ahead of conventional government bonds and investment grade corporate bonds, despite the lower risk profile. The spread of returns highlighted above demonstrates the different drivers of index-linked and conventional bonds. Where index-linked bond returns are driven by changes in real interest rates, conventional bonds are driven by inflation expectations. This supports the case for combining holdings of both within portfolios.

The Debt Management Office, on behalf of the Bank of England, has increased the issue of index-linked gilts to almost 30% of the required total funding of £63bn for the current financial year. This is a meaningful increase given that only 10 years ago funding via the index-linked market accounted for only about 10% of gilt issuance. Despite increased issuance new index-linked stocks are finding willing buyers, especially of the longer dated issues. For example, the £650m auction of 1¼% Index-linked Treasury Gilt 2055 at the end of October received bids for three times the stock available and was issued with a yield of only 0.83%

We prefer medium dated stocks such as the 2½% Index-linked 2013 and 2½% Index-linked 2016 to give portfolios an element of inflation protection. These two stocks carry real yields of 1.70% and 1.52% respectively.

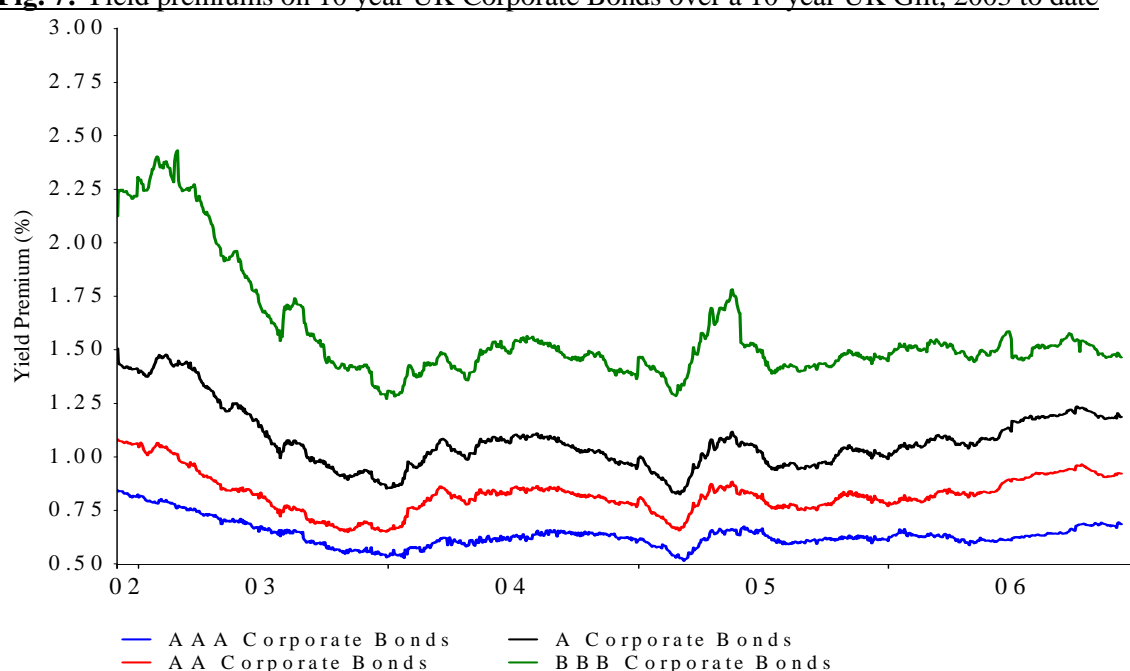
We continue to believe that the element of inflation proofing provided by index-linked stocks is vital in portfolio construction.

- Investment Grade Corporate Bonds

Corporate issuers of debt have to offer investors a higher yield relative to government bonds of a similar maturity to compensate for the higher default risk associated with lending to a company rather than a government. This is typically known as yield premium or spread. As shown in figure 7, yield premiums have narrowed markedly over the last four years as strong corporate profit growth has increased investors' confidence that default risks are declining. However, it is also notable from figure 7 that over the last six months premiums on sterling corporate bonds have risen somewhat. This has resulted in small capital losses for corporate bond investors cancelling out the income received during the period.

Despite the increase, we continue to maintain that yield premiums are inadequate. We are therefore continuing to advise that fixed interest exposure should be gained through government bonds rather than corporate bonds.

Fig. 7: Yield premiums on 10 year UK Corporate Bonds over a 10 year UK Gilt, 2003 to date



Source: Reuters EcoWin

- Non-Investment Grade Corporate Bonds

Non-investment grade corporate bonds are those rated below BBB by the Standard & Poor's credit rating agency. They carry a much higher risk of default than investment grade bonds and therefore must offer correspondingly higher yields. Hence they are often referred to as 'high yield bonds' or 'junk bonds'.

Relative to their history, the yield premiums offered by this category of bonds are now very low. They fell lower still over the last six months, generating a small capital gain for holders. In a similar vein to the investment grade category, we believe that yield premiums at current levels offer inadequate compensation for the risks involved. We recommend that fixed interest allocations within portfolios are met through the purchase of government bonds.

4.3 Commercial Property

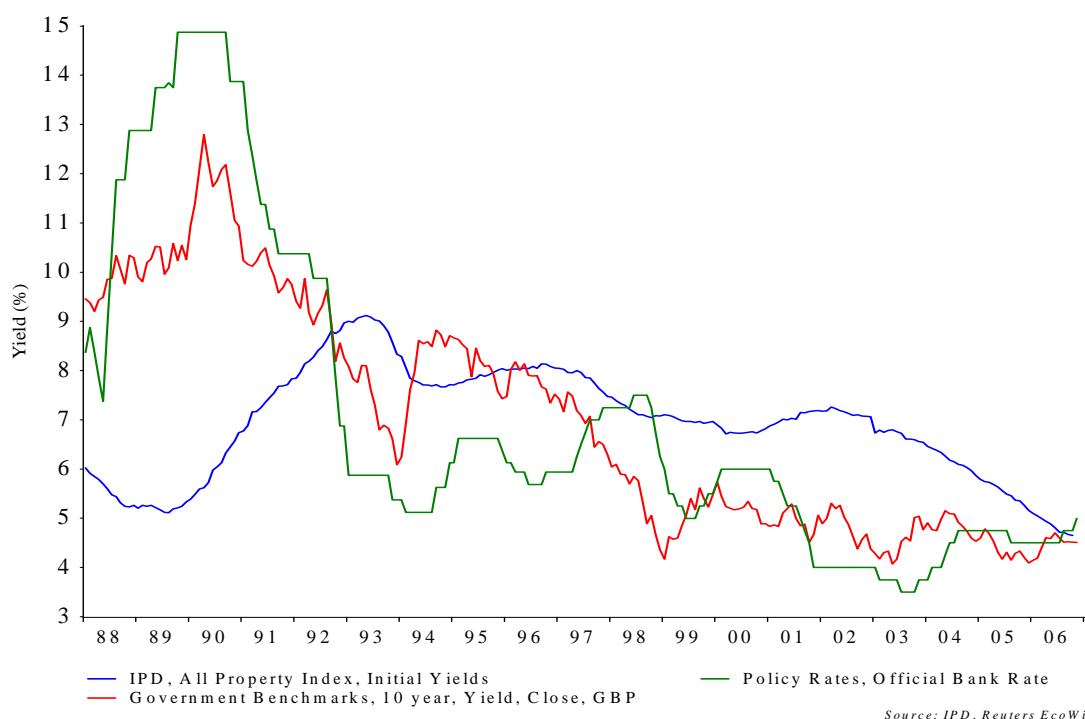
In October we recommended to clients that they reduce their exposure to commercial property. This recommendation was prompted by the continued fall in the yield available on commercial property compared to that available on cash deposits or UK government bonds.

Commercial property continues to hold a strong appeal for investors as an asset class with lower volatility than equities but with the prospect of some capital appreciation through rental growth. It has performed extremely strongly, generating an average annual return over the last five years of 15.10% according to Investment Property Databank (IPD). This compares very well with other asset classes, including equities.

The strong performance has been driven, however, not by growth in rent but by yield compression. IPD's All Property Index yield has now fallen to the lowest level since the index was launched in 1987 (see Fig. 8). While falling yields on commercial property investments were justified for much of the last decade by falling interest rates and falling bond yields (both driven by falling inflation), recent moves look anomalous. We accept that strong rental growth may take property yields higher once more, but believe that, at such low yield levels, commercial property valuations reflect extrapolation of past returns into the future rather than any fundamental belief that rental growth is about to accelerate.

The introduction next year of real estate investment trusts (REITs) is one factor that has been providing additional support to property valuations. The adoption of REIT status will allow property companies to pass rental income through to shareholders without suffering corporation tax. We believe that the advantages of REITs are already priced into valuations and expect returns from commercial property funds to fall back into single digits.

Fig. 8: Falling yields on UK Commercial Property by Sector



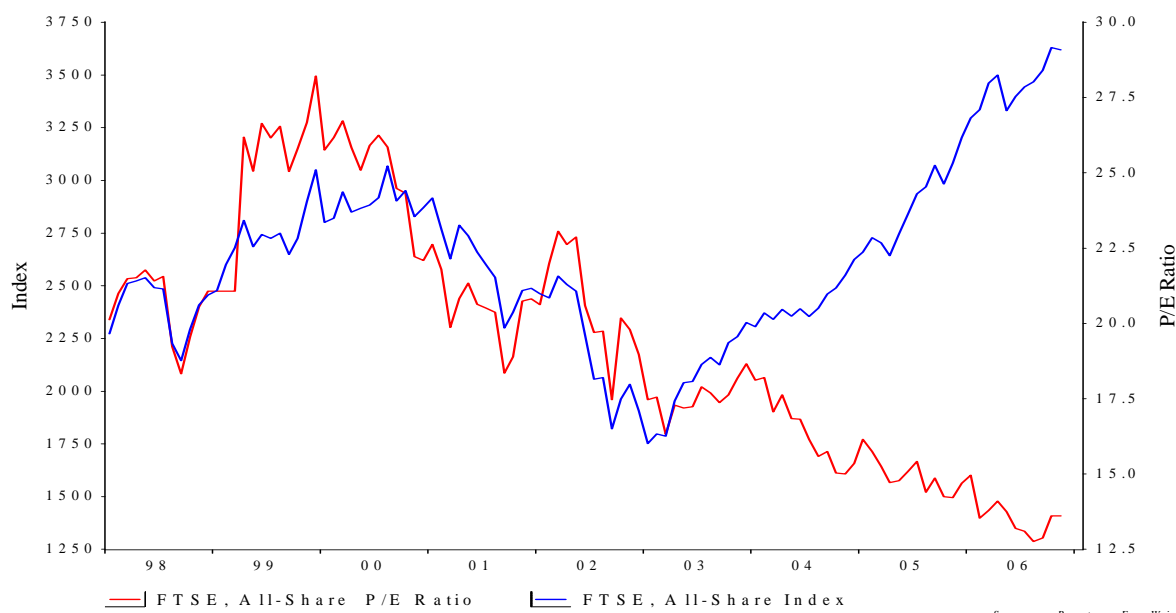
4.4 Equity Markets

- UK Equities

The UK equity market continues to offer reasonable value. The price/earnings ratio remains about 14x based on prospective earnings growth of about 8.0% to the end of 2007¹. The prospective dividend yield is 3.6%.

The FTSE All-Share Index has shown fairly steady upward progress since the end of the bear market in 2003 (see Fig. 9). The index now stands at almost double the level of the early 2003 low but, importantly, this rally has been driven by earnings growth rather than a re-rating of the market. This is a factor often overlooked by investors who assume that, as the market has regained its past peak, it must now be expensive. In fact, the UK economy has grown by 35% over the last six years and if corporate earnings had done no more than keep pace with economic growth we might expect the market to have risen by this amount. In fact, corporate earnings growth has been greater than this, leaving equities considerably cheaper in price to earnings ratio terms than they were at the market's previous peak in 1999.

Fig. 9: FTSE All-Share Index and price to earnings ratio from 1998



Turning to the outlook for 2007, we believe that the ongoing strong performance of the UK and global economy will continue to drive steady earnings and dividend growth at the corporate level. Augmented by ongoing mergers and acquisitions activity this will, we believe, allow UK equities to provide attractive returns. We continue to believe that holdings of UK equities should form the core part of equity portfolios for long term investors.

¹ Source: UBS.

- European Equities

Continental European equities have performed well this year despite two headwinds. The first is the normalisation of interest rates by the European Central Bank which has seen rates rise from 2.25% at the beginning of the year to 3.50%. The second is the strength of the euro against the US dollar. The euro has appreciated by 12.50% against the US currency during 2006, making life more difficult for Europe's important export sector.

Continental European equities are supported by reasonable valuation levels (similar to those in the UK) and the improving economic picture continuing to drive profits forward. Longer term positives include the scope for improved profits from corporate restructuring in continental European companies and the benefits accruing from the expansion of the European Union.

We recommend maintaining exposure to European equities within portfolios.

- North American Equities

After a prolonged period during which US equities have underperformed other major world equity markets, we now believe that the time has arrived to add US equity exposure to portfolios.

This change of view is based on two factors. Firstly, the weak performance of US equity markets, despite steady earnings growth, has addressed the market overvaluation. US equities are now trading at a price to earnings ratio of about 15x. Secondly, the US dollar has fallen by close to 15% against sterling this year. This not only makes US assets cheaper for sterling based investors but also means the US export sector should receive a boost from improved competitiveness abroad.

- Japanese Equities

Japanese equities have provided the major surprise of 2006. After rising by more than 40% in 2005, Japanese equities, as measured by the Nikkei 225 index, have failed to make further progress with the index close to its 2006 starting level of 16,100. For sterling based holders of Japanese equities, the story is worse still with the yen's depreciation against sterling inflicting losses in excess of 12% on investors.

Despite the lacklustre performance of the equity market, Japan's economic recovery after fifteen years of stagnation is still very much intact. The economy will have grown by approximately 2.7% in 2006 after growing 2.6% in 2005. Driven by strong corporate investment and private consumption, growth of this magnitude should be maintained into 2007.

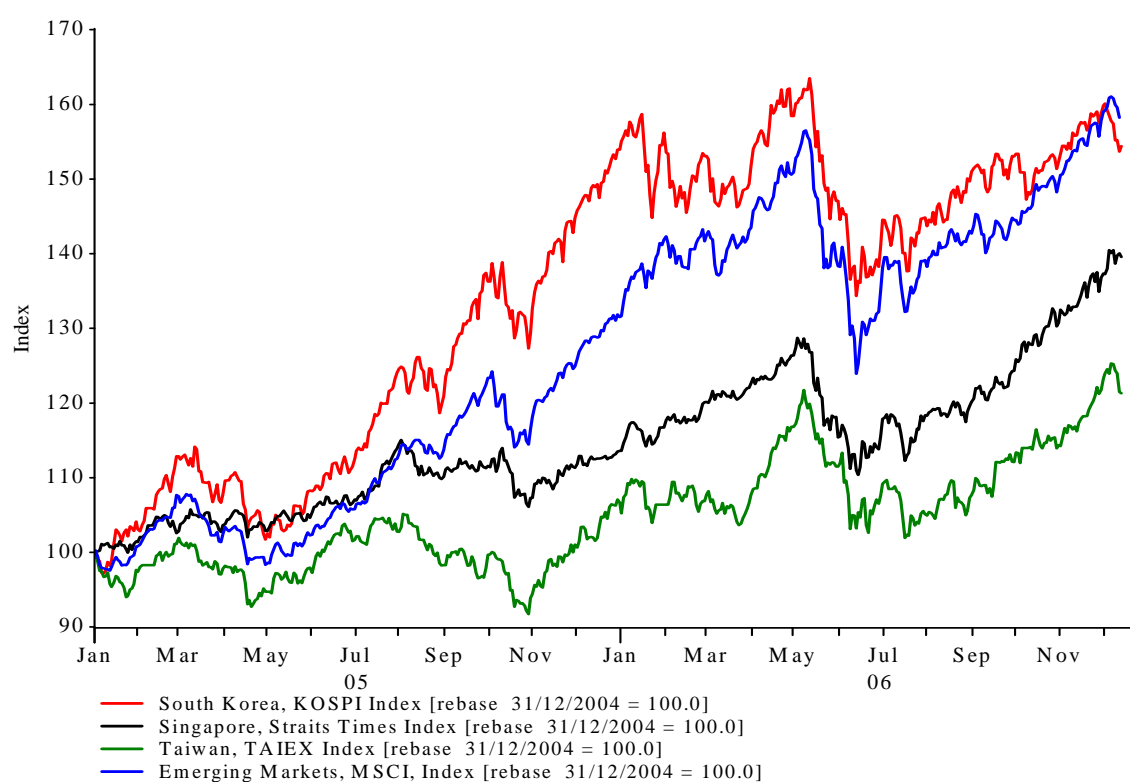
We expect the performance of Japanese equities to improve in 2007 and believe investors should maintain exposure.

- Far Eastern and Emerging Markets

Far Eastern and emerging market equities fell hardest as a result of the bout of risk aversion which disrupted equity markets earlier this year (see Fig. 10). This was understandable as investor enthusiasm for equities in these regions had reached speculative proportions and taken valuations for equities to a premium to those in developed markets. The recovery has been more considered; emerging markets, as measured by the MSCI Emerging Markets index, did not recover their May peak until late November.

Our view remains that some exposure to these regions should be maintained within portfolios. The economic underpinnings of the Far Eastern economies in particular look sound with increasing consumer spending and regional trade making the area much less prone to economic developments elsewhere than in the past.

Fig. 10: Far Eastern Equity Markets and Emerging Markets since 2005.



Source: Reuters EcoWin

5. Fund Performance Commentary

Table 1 below contains performance figures for the major fund sectors. On pages 21 and 22 there are tables with performance figures for some of our selected funds and indices.

Table 1: Average Fund Performance

UK Sectors	6 Months %	1 Year %	3 Years %	5 Years %
Money	1.95	3.87	12.08	19.43
Fixed Interest Sterling	3.04	3.33	21.08	30.15
Index-Linked	4.75	5.25	24.77	35.68
Property	9.46	19.51	60.01	89.20
UK Equities – All Companies	9.33	17.52	59.99	45.71
Balanced Managed	6.91	11.37	45.73	36.36
Managed Stockmarket	7.13	12.31	50.95	39.93
Overseas Sectors				
Global Fixed Interest	1.11	-1.31	7.31	15.57
Global Equities	5.75	8.13	45.73	29.67
North America	4.80	-1.98	18.14	-7.72
European (excl UK)	9.12	19.98	71.30	58.02
Far East (excl Japan)	11.43	19.08	72.34	88.92
Japan	-9.28	-8.31	30.77	19.26

(Source: Reuters Hindsight ABI UK Pension Fund Series on a bid to bid pricing basis to 30 November 2006).

The performance figures quoted below are in sterling terms and cover the six months to 30 November 2006. Performance figures for individual funds show total return on a bid to bid basis. Sector performance figures are shown mid to mid.

We favour the Morley Deposit and Merrill Lynch Institutional Sterling funds for **Cash** held in SIPPs. These funds carry low charges and have consistently outperformed their peers. For cash not held in pension funds, investors can achieve in excess of 5.00% with the Investec High 5 Account or 4.75% gross Annual Equivalent Rate (AER) using ING Direct, though large cash holdings should be held with several institutions to diversify risk.

Investment grade sterling **Fixed Interest** securities returned an average of 1.78% over the period as a deterioration in capital value has detracted from the income generated. The Morley Corporate Bond, Legal & General Fixed Interest and Invesco Perpetual Corporate Bond funds all outperformed the IMA sector average, returning 2.95%, 2.08% and 3.73% respectively. High yield bonds have performed slightly better over the period returning 3.12%. However, as described earlier in this report, the yield premium on these bonds compared to that available on government bonds continues to look insufficient to compensate for the additional risk. Considering non-investment grade corporate bond funds, the F&C Strategic Bond fund and the Legal and General High Income Trust both outperformed their IMA sector, returning 4.39% and 4.21% respectively.

Property funds have continued to attract strong investment inflows. We remain concerned that commercial property values are being driven as much by money flows as by tenant demand for space or achieved increases in rent. Strong inflows give rise to concerns that property fund managers may purchase properties at high prices in order to get new subscriptions invested rather than wait for attractively priced opportunities.

Rapid inflows of cash have also caused operational issues for the managers of property funds. Scottish Widows has been imposing a limit on the proportion of assets held within a policy that can be invested in their property fund. Similarly, investors are now often subject to dilution levies for access to open ended “bricks and mortar” funds (such as through a pension or unit trust) and higher premiums or lower discounts to net asset values for closed ended vehicles such as investment trusts.

Considering performance, Isis Property Trust 2 Ltd has returned 1.17% in the last six months. The Morley Property fund has continued to perform very well returning 9.27%. The TR Property Investment Trust, which buys some commercial property directly, as well as investing in the quoted equity of UK and European property companies, has had another exceptional six months returning 27.65%.

Global property security funds have the advantage over UK “bricks and mortar” property funds of broader diversification and lower costs at the individual property level. Property exposure via these types of funds also solves the problems of dilution levies and premiums to net asset values. The Fidelity Global Property fund and the Schroder Global Property Securities fund have returned 18.11% and 21.92% respectively over the last six months.

After the mid-year set back, **UK equities** have continued to advance over the last six months due to an improving economic background, robust corporate earnings growth and a swell of merger and acquisition activity. The FTSE All-Share Index, including income, returned 8.62% over the six month period to 30 November.

The IMA UK Equity Income sector produced an average return of 10.64%, slightly ahead of the IMA UK All Companies sector as the higher yielding value orientated areas of the market remained in favour. The Invesco Perpetual Income fund and Invesco Perpetual High Income fund, both managed by Neil Woodford, returned a remarkable 15.91% and 16.58% over the six month period thanks to heavy weightings in tobacco and utilities. Elsewhere, Tony Nutt’s Jupiter Income Trust produced a respectable 11.89%.

Over the six months, the IMA UK All Companies sector generated average returns of 9.25%. Of our recommended funds, Standard Life UK Opportunities and Schroder Recovery performed best with returns of 18.64% and 12.27% respectively. The Standard Life fund, managed by Mark Niznik, benefited from takeover activity in the mid cap. area of the market while the performance of the Schroder fund has been helped by its emphasis on value stocks. Elsewhere, AXA Framlington UK Select Opportunities and F&C UK Opportunities both outperformed, returning 10.45% and 10.35% respectively. Rathbone Special Situations, with its high weighting towards Aim listed stocks, struggled, generating a return of only 1.51%.

During the last six months, small cap. stocks have marginally underperformed the IMA All Companies sector with the IMA Smaller Companies sector generating an average return of 8.78%. However, the sector is still ahead of the All Companies sector over the past year. The Old Mutual Select Smaller Companies fund was the best performing fund in the whole sector, outperforming steadily over the period and returning a very impressive 18.57% in total. Old Mutual announced that the fund would be capped with effect from 15 December 2006 to guard against future performance being compromised by large cash inflows. Aberforth UK Small Companies and Merrill Lynch UK Smaller Companies also performed well returning 13.77% and 12.06% respectively. However, after a very impressive first half, Artemis UK Smaller Companies has performed poorly over the past six months producing returns of just 0.36%. The manager, John Dodd, maintained the high exposure to the oil and mining stocks that led to the fund's strong run in the six months to June and this hampered subsequent performance as the oil price dropped in the months after the August peak.

Funds in the **Balanced Managed** sector have generally performed in line with expectations, given the performance of the underlying markets in which they invest. The IMA Balanced Managed sector has returned 6.00% over the period. Both the Schroder Managed Balanced and the AXA Framlington Managed Balanced funds have outperformed the sector, having returned 8.17% and 7.52% respectively. The lower risk Morley Sentinel Managed and Investec Cautious Managed funds also performed relatively well considering they have approximately 45% of their assets in bonds, property and cash. The IMA Cautious Managed sector average return was 4.60% whilst the Morley fund returned 5.54% and the Investec fund returned 6.20%.

Stockmarket Managed and **Managed Equity** funds have generally performed well over the period as a result of good management, the use of gearing and a narrowing of discounts to net asset value (NAV). One exception has been RIT Capital Partners, which generated a return of -0.20% over the period. RIT invests in both quoted and unquoted securities. During the last six months it adopted a cautious stance, decreasing its exposure to quoted equity from 62% to 52% of its assets and increasing exposure to unquoted securities from 16% to 28%. Thus RIT missed some of the recovery of quoted equity, particularly at the large end of the capitalisation scale. Despite this, shares are currently trading at a premium to NAV indicating that investors believe the strong historic track record will resume.

Caledonia Investments, which has approximately 20% of its assets in private equity and unquoted securities, sold a number of holdings in the first half of 2006, enabling the board to propose returning £128m to shareholders in the form of a special dividend. The holders of 88% of the total shares offered for cancellation accepted the proposal, resulting in a special dividend of 1,902.17p per share at a total cost of £102.9m. Caledonia Investments has recently been trading at a premium and has generated returns of 13.75% over the last six months.

Over the same period British Empire Securities and General Trust has returned -1.89%. John Pennink, British Empire's manager turned more cautious in the first half of the year and maintained a large cash weighting throughout the last six months. Also, of the 80% of the portfolio exposed to equities, 15% has been invested in Japanese equities which have lagged this year.

The weakness of the US dollar relative to sterling has been detrimental to UK holders of **US equity** funds. In dollar terms, the S&P 500 increased by 11.3% in the six month period but this translates into a return of only 5.9% for sterling based investors. Over the past two years we have not favoured US equities due to relatively high valuations and our view that the dollar would weaken as US interest rates peaked. Our caution has been justified. We believe that, with valuations having fallen to more attractive levels and with the dollar's decline this year having reduced currency concerns, now is an appropriate time to begin adding US exposure to portfolios. Of our recommended funds, UBS US Equity and Martin Currie North America have performed well, returning 7.3% and 6.9% respectively against a IMA North America sector return of 5.4% over the period. Elsewhere GAM North American Growth, managed by Gordon Grendar, has struggled losing 1.3% of its value. Gordon Grendar follows a highly individual style and his performance usually deviates a long way from the index return. Over the long term his track record is extremely strong returning 24.47% over five years against the sector which is still in negative territory over this period.

Continental European equities have marginally underperformed UK equities over the period under review with the average fund in the IMA Europe excluding UK sector returning 9.83%. The Old Mutual European team's quantitative overlay performed very well in the relative stability of European stock markets over this period, producing returns of 12.74%. Schroder European Alpha Plus, managed by Leon Howard-Spink, also performed strongly, returning 11.64% over the period while Artemis European Growth and Merrill Lynch European Dynamic both outperformed the sector generating returns of 10.17% and 9.98% respectively. Jupiter European Special Situations, managed by Cedric de Fonclare, lagged the sector marginally over the period, returning 8.58%. However, the fund remains in the top decile over a 12 month period. European Assets Trust, which invests in smaller European companies delivered another strong performance, returning 17.77%.

Japanese equity markets are lower over the six month period as measured by the FTSE Japan index which returned -4.49%. Though the macro-economic fundamentals in Japan remain supportive, the equity market has, until recently, continued the slide that began in April after the market reached a five year high. The average fund in the IMA Japan sector has underperformed the index, returning -7.56% over the last 6 months reflecting the misjudgement by many fund managers who expected a continuation of strong performance into 2006. Our recommended funds have been among the laggards. JP Morgan Japan and Fidelity Japanese Special Situations, both with a bias to small cap. growth stocks, have returned -14.31% and -17.10% respectively. Japanese Small Caps. have underperformed over the period, despite attractive valuations and recurring profit growth in the group as a whole, as investors have sought the safety of large cap. value stocks.

The **Asia Pacific excluding Japan** sector has produced impressive returns given the volatility at the end of the last reporting period and investors' concerns over Japan (which has tended to heavily influence the direction of the region's markets in the past). The average fund in the IMA sector returned 12.21% over the period under review. First State Asia Pacific Leaders returned 15.87% over the period, while Aberdeen Asia Pacific returned 13.29%. Returns from the **Asia Pacific including Japan** sector were dragged lower by the weak performance of Japan. The average fund in the IMA sector returned 4.47%. Martin Currie Pacific Trust and Invesco Perpetual Pacific both outperformed, returning 5.84% and 5.51% respectively.

Like the Asia Pacific equity markets, **Emerging Markets equities** have thrived in the second half of 2006. Though the equity markets of emerging economies have tended in the past to exaggerate the trends seen in more developed markets, emerging markets have delivered consistent growth over the six month period while other equity markets have suffered periods of weakness. The IMA Global Emerging Markets sector returned 12.83% over the six month period. The Templeton Emerging Markets Investment Trust has performed broadly in line with the index, returning 12.67% over the same period.

Private Equity funds have been actively returning cash to shareholders, but in the case of Electra Private Equity, this strategy is about to change. Having reduced its capital to a more manageable size Electra announced in October that it would refocus on investing funds rather than selling holdings and returning cash to shareholders. Since 1999 it has returned over £1.2bn to investors. Electra has generated returns of 14.86% over the six month period. Candover, which has recently strengthened its European investment team, returned 9.67% over the period. Other private equity funds held by clients include Graphite Enterprise Trust, HG Capital Trust and Pantheon International Participations, which have generated returns of 6.45%, 8.07% and 5.88% respectively.

The tax advantages of investing in **Venture Capital Trusts (VCTs)** were reduced by the chancellor in April this year. The changes have limited the available income tax relief to 30%, increased the minimum holding period (to qualify for this relief) from three years to five years and, significantly, halved the size of companies in which VCTs may invest. As a result of these rule changes, we expect 2006/07 to see lower commitments to VCTs than last year's record aggregate investment of over £700m. Though the range of open VCTs is narrower than in previous years, we maintain that appropriate VCTs still represent a reasonable opportunity for some investors. We regard selecting the right VCT as key and have focused our research efforts on the lower risk generalist trusts as opposed to those investing in Aim listed companies.

Hedge Funds continue to generate a great deal of investor interest and press comment on their diverse investment styles, their performance record and their charging structures. Recent performance has been disappointing with the CSFB /Tremont Blue Chip Investable Index returning only 6.44% over the year to date. We acknowledge that funds demonstrating consistent absolute returns are attractive but remain sceptical about how many hedge funds can deliver this. We are also very concerned that the high charges made by hedge funds (typically an annual charge of 2.00% with a performance fee of 20.00%) create asymmetrical pay-offs for hedge fund managers. Funds of hedge funds offer some advantages over individual hedge funds, such as diversifying away specific risks but they carry the disadvantage of levying fees at several levels, obscuring exactly how much the investor is paying. Our research is targeted towards identifying hedge funds which have transparency of process, a demonstrable track record over at least ten years and low correlation with other asset classes.

Christopher Sexton
Investment Research Manager
December 2006

Main Client Funds Performance Summary to 30 November 2006

Table 2: Fixed Interest

	Gross Redemption Yield (%)	Average Duration (Years)	Performance Over 6 Months (%)
<u>Investment Grade</u>			
Morley Gilt Fund	4.17	8.52	3.25
Winterthur Fixed Interest	4.83	8.02	2.21
Legal & General Fixed Interest	5.01	7.31	2.08
Morley Corporate Bond	5.28	7.29	2.95
Morley Long Corporate Bond	4.86	12.66	3.82
<u>Non-investment Grade</u>			
Legal & General High Income	6.39	n/a	4.21
Threadneedle High Yield Bond	4.09	3.30	5.49
F&C Strategic Bond	4.56	4.55	4.39

(Source: Individual companies actual portfolio yields and duration, Hindsight ABI UK Pension Fund, IMA Series bid to bid pricing basis to 30 November 2006).

Table 3: Property

	6 Months %	One Year %	Five Years %
<u>Pension Funds</u>			
AXA Sun Life	4.67	10.50	68.07
Legal & General	8.24	15.37	94.07
Morley	9.27	18.48	103.27
Norwich Union (4)	6.18	16.32	79.65
Prudential (Scottish Amicable)	5.51	13.57	68.77
Scottish Widows	7.09	17.62	92.61
Standard Life	8.99	19.56	84.84
Zurich (Allied Dunbar)	7.42	17.65	90.73
<u>Other Property Funds</u>			
Isis Property Trust 2	1.17	10.20	n/a
Morley Property	7.65	16.36	n/a
Standard Life Investment Property	17.99	31.69	n/a
TR Property Investment Trust	27.65	53.64	383.11

(Source: Reuters Hindsight ABI UK Pension Fund, IMA, AITC Investment Trust Series on a bid to bid pricing basis to 30 November 2006).

Table 4: Equities

	6 Months %	One Year %	Five Years %
Aberforth Smaller Companies	13.77	24.31	151.04
British Empire Securities & General	-1.89	4.28	151.49
Candover Investments PLC	9.67	20.29	185.18
European Assets	17.77	37.68	189.41
Fidelity European	7.22	15.76	120.08
GAM UK Diversified	9.19	18.87	83.42
Invesco Perpetual Income	15.91	27.69	113.60
Jupiter Income Trust	11.89	22.33	96.08
Liontrust First Income	10.23	17.53	82.67
Martin Currie Pacific	5.84	6.36	116.76
Merrill Lynch UK Special Situations	8.70	18.02	79.48
North Atlantic Smaller Companies	15.03	12.06	97.50
RIT Capital Partners	-0.20	6.92	144.54
Schroder Recovery	12.27	22.06	116.32
Standard Life UK Opportunities	18.64	30.99	n/a

(Source: Reuters Hindsight ABI UK Pension Fund, IMA, AITC Investment Trust Series on a bid to bid pricing basis to 30 November 2006).

Table 5: Equity and Bond Market Indices

	6 Months %	One Year %	Five Years %
FTSE 100 TR (Total Return)	7.40	15.27	37.52
FTSE 250 TR	16.19	31.31	110.24
FTSE Small Cap. TR	7.82	16.41	58.27
FTSE All-Share TR	8.62	17.44	46.05
S&P 500 (\$) TR	11.33	14.23	34.33
FTSE Eurofirst 300 ex UK (€) TR	10.84	19.44	35.76
FTSE Asia Pacific ex Japan TR	10.05	14.77	89.63
FTSE Japan TR	-4.49	-1.38	25.68
Nikkei 225 (Japan) CR (Capital Return)	-2.97	-0.41	17.41
FTSE All World Emerging TR	12.15	19.32	149.16
FTSE Index-Linked British Govt All TR	5.75	6.59	40.31
FTSE British Govt All Stocks TR	3.13	3.30	28.07
IPD All Property	6.92	18.08	100.98
Brent Crude Oil	-17.44	-0.17	140.95
Gold Troy Ounce	-5.78	14.74	71.08

(Source: Reuters Hindsight on a mid pricing basis to 30 November 2006).

Focused Financial Advice

If you are an individual seeking to gain or maintain financial independence (having sufficient capital and income to choose whether to work or not) in a simple and straightforward manner, we should be able to help.

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For a complimentary meeting, please contact Nick Fletcher, Managing Director, at nick.fletcher@saunderson-house.co.uk or on 020 7315 6504 (direct), who will help you or guide you to an appropriate adviser.

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