

HALF YEARLY INVESTMENT REPORT

28 June 2006

**Saunderson House Limited
1 Long Lane
London EC1A 9HF**

**020 7315 6500 (Switchboard)
020 7315 6550 (Fax)**

Authorised and Regulated by the Financial Services Authority

SAUNDERSON HOUSE



Contents	Page
1. Overview	4
2. Summary	5
3. Economic Review and Outlook	6
4. Investment Outlook	9
4.1 Cash Deposits	10
4.2 Fixed Interest	10
4.3 Commercial Property	13
4.4 Equity Markets	14
5. Fund Performance Commentary	17

Tables	Page
Table 1. Average Fund Performance	17
Table 2. Fixed Interest	22
Table 3. Property	22
Table 4. Equities	22
Table 5. Equity and Bond Market Indices	23

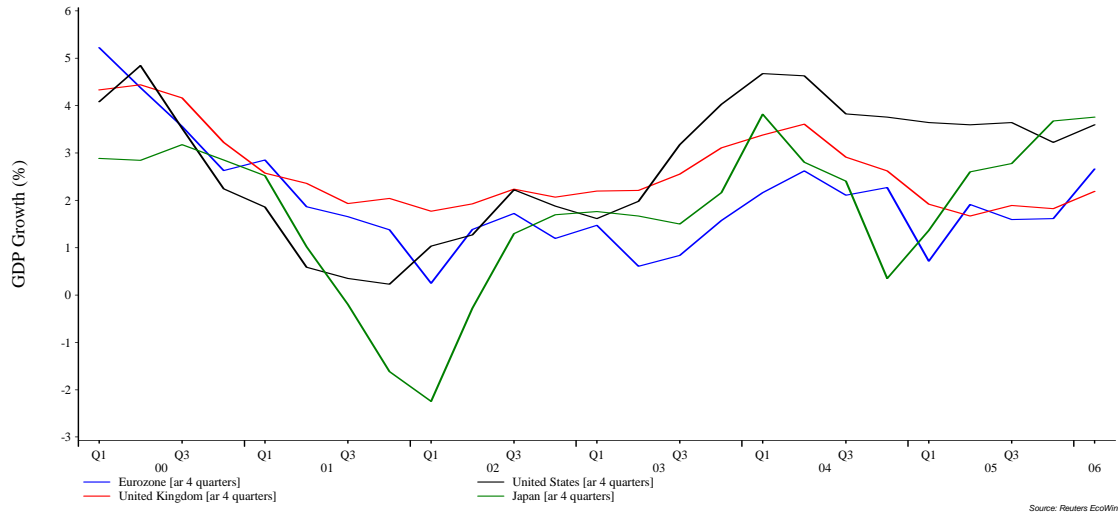
Risk Warnings

This report is for general guidance only and represents our understanding of law and HM Revenue and Customs practice as at 28 June 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 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

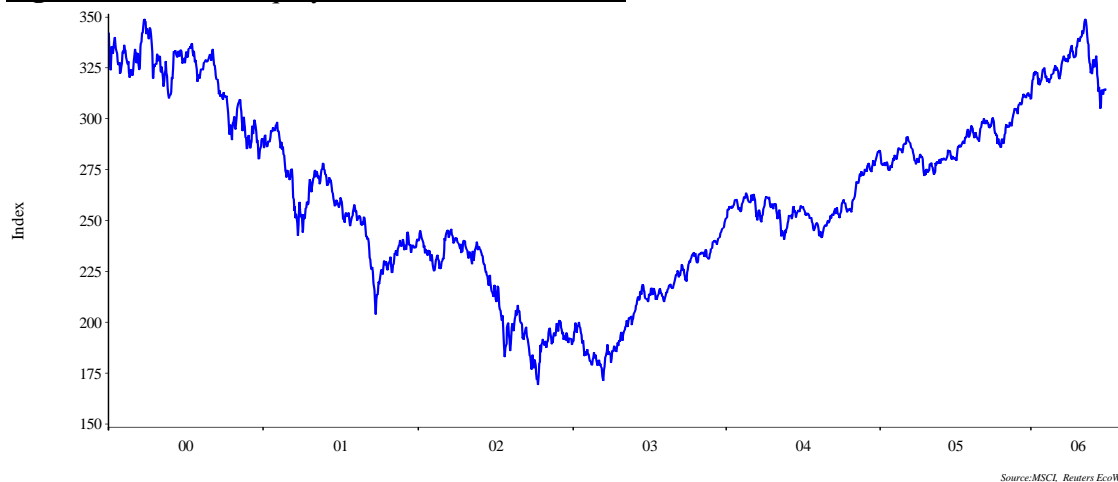
The period of weaker growth experienced by the global economy in mid-2005 has given way to strengthening activity, starting in the latter part of 2005 and gathering pace into 2006. Fears that higher interest rates in the world's largest economy, the United States, together with higher oil prices, would result in a pronounced slowdown, or even a recession, have proven unfounded and the major economies are enjoying another leg of broadly based growth (see Fig.1).

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



Maintained economic expansion, supporting continued strong corporate earnings growth, has been warmly received by investment markets with equities, as measured by the MSCI World Equity Index, regaining the heights of March 2000 by early May 2006 (see Fig.2). However, from mid-May onwards there has been an abrupt sell-off in equity markets with a sharp rise in risk aversion among investors and a flight to safer assets, such as government bonds. The immediate cause of the correction has been fear that sky-high commodity prices are leaking into higher general price inflation, raising the spectre of a prolonged period of rising interest rates and resulting in lower economic growth.

Fig.2: MSCI World Equity Market Index since 2000



2. Summary

The World Economy

- Economic growth has surprised many observers by accelerating in the first half of 2006. We expect marginally slower growth over the balance of 2006 and in 2007 as higher interest rates work to dampen global activity.
- The price of oil and many other commodities has been very strong as rapid global growth, particularly in developing markets, has boosted demand.
- Inflation has moved higher, boosted by strong economic growth in general and strong commodity prices in particular. Inflation is now testing the “comfort zone” of both the US and European central banks and prompting interest rate rises.
- US interest rates have been increased from 1% to 5% over the course of the last two years. We expect rate rises to continue until there are definite signs that the US economy is slowing. Interest rates are now also rising in Europe, and Japanese rates are expected to follow in the next few months.

Financial Markets

- The US dollar has weakened as currency markets anticipate slower US growth in response to rising interest rates.
- Sterling has strengthened against the dollar as UK economic growth has accelerated. It has maintained its value against the euro in spite of increasing interest rates in Continental Europe.
- Government bond yields have moved higher in all major markets as both the real rate of interest and the inflation premium demanded by investors have increased.
- Equity markets have moved higher over the half year period but the last six weeks have been characterised by market corrections and increased volatility as investors worry that further interest rate increases will be needed to head off rising inflation.

Investment Recommendations

- Cash deposits, earning around 4.5%, remain attractive.
- Government bonds are now fair value but the risk premiums available on corporate and high yield bonds remain inadequate.
- Property is looking increasingly expensive.
- After the recent sell-off, equities offer value in many regions. However, with the macroeconomic outlook unclear, we are now taking a more cautious approach to committing new cash to equities for the next three months.

3. Economic Review and Outlook

The **global economy** is enjoying an extended period of rapid growth. This year is likely to be the fourth consecutive year in which world output has grown by more than 4%. This contrasts favourably with the 1980s and 1990s where growth averaged only 3.5% and was periodically punctured by financial crises and recessions. Moreover, the current period of higher growth is forecast to extend into 2007. The International Monetary Fund (IMF) is forecasting global economic growth of 4.9% in 2006 and 4.7% in 2007.

A distinguishing characteristic of the current economic expansion has been the low inflation rates in most major economies. This has allowed strong growth to continue unchecked. Although we have seen rapid price adjustments in several areas, particularly oil and other commodities, these have, so far, failed to feed into general price inflation. Low inflation has allowed monetary authorities to maintain low interest rates, relative to past business cycles, which have, in turn, supported the rapid economic expansion.

Looking forward, there are two key questions for economists and other observers - the answers to which are crucial for future asset allocation decisions. These are, firstly, why has inflation stayed so low despite sustained growth and, secondly, what might cause this to reverse? The explanation most regularly advanced for low inflation is that cheap manufactured goods (due to low labour costs in the Far East) and the threat of jobs being outsourced to low cost areas, such as India, have kept downward pressure on wage rates in the developed world. This has allowed strong growth without the resultant wage pressures and accompanying higher prices that have undermined previous expansions. The counter argument is that inflationary pressures are building, as can be observed in the rising price of gold, oil and other commodities, and that underlying measures, such as the US's core Consumer Price Index (CPI), are understating this by stripping out volatile factors, such as fuel costs. While the beneficial impact of cheaper manufactured goods on inflation is indisputable, we are increasingly of the view that inflation risks are rising and that the sustained, strong growth that is now taking place in most major economies is incompatible with the maintenance of price stability at current interest rates.

It is in this context that the recent heightened volatility and weakness in equity markets can be understood. Investors have become increasingly concerned that synchronised, strong global growth implies higher competition for capital and thereby higher interest rates, while the high demand for commodities argues for increased inflation risks. Government bond yields have responded accordingly with yields in the US, Japan, Germany and the UK approximately 0.5% higher than at the beginning of the year.

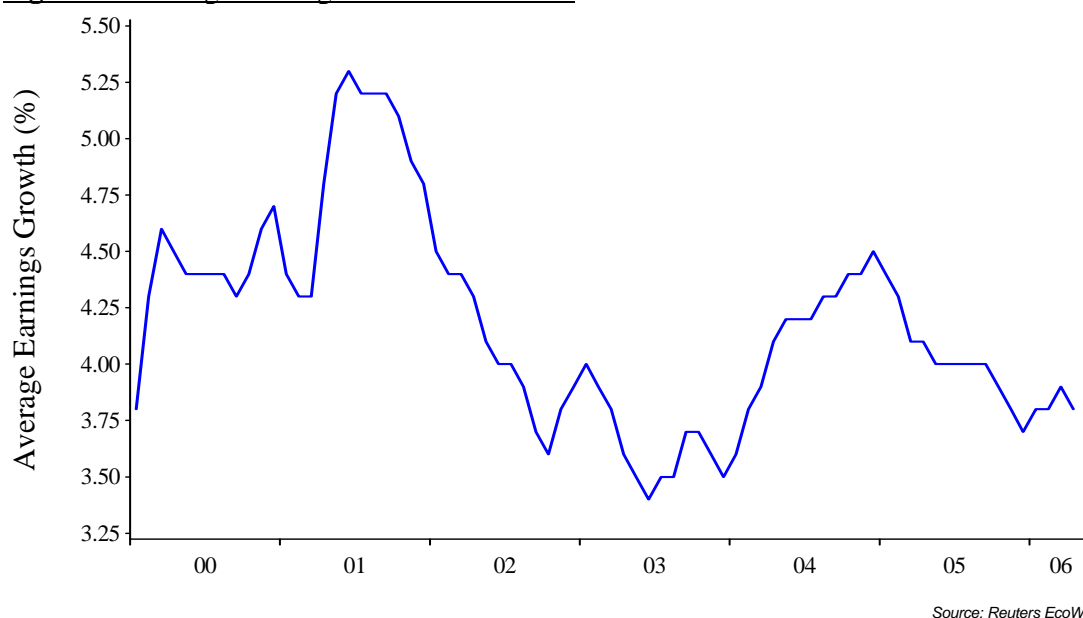
Looking forward to the second half of 2006, and into 2007, we believe that slower growth, in the US in particular, is necessary to ensure that inflationary pressures do not become unmanageable. A slowing of economic growth should take the upward pressure off wages and commodity prices and allow global imbalances to begin to ease. Without this, particularly if rising inflation becomes an issue, there may be a necessity for much higher interest rates later, which would precipitate a more rapid slowdown, or even a recession.

In assessing other risk factors to the global economy, the instability in the Middle East, most notably the increasing tension between the US and Iran over the latter's development of a nuclear capability and the interminable violence in Iraq, together with the heightened risk of international terrorism this implies, are causes for concern for the coming months.

After growing by a fairly lacklustre 1.8% in 2005, **UK** economic activity is accelerating once more. Growth in the first quarter of 2006 was 0.6%, taking the annual rate up to 2.2%. A single rate cut of 0.25%, made in August 2005 and taking rates down to 4.5%, together with accelerating growth in Continental Europe, seems to have been sufficient to lift the economy out of the soft patch in which it had been mired since mid-2004. The Organisation for Economic Co-operation and Development (OECD) is forecasting UK GDP full year growth for 2006 of 2.4%.

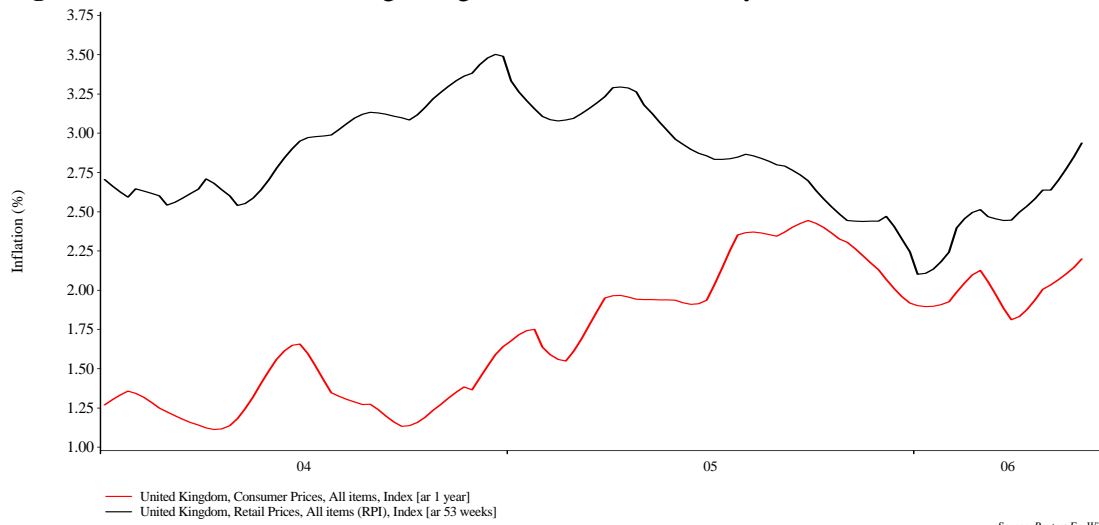
Clear signs of the firmer economic conditions are evident in survey data, such as the Confederation of British Industry (CBI) Industrial Trends, and also in average earnings growth (see Fig.3). The latter, after declining for much of 2005, is now showing signs of bottoming.

Fig.3: UK Average Earnings Growth since 2000



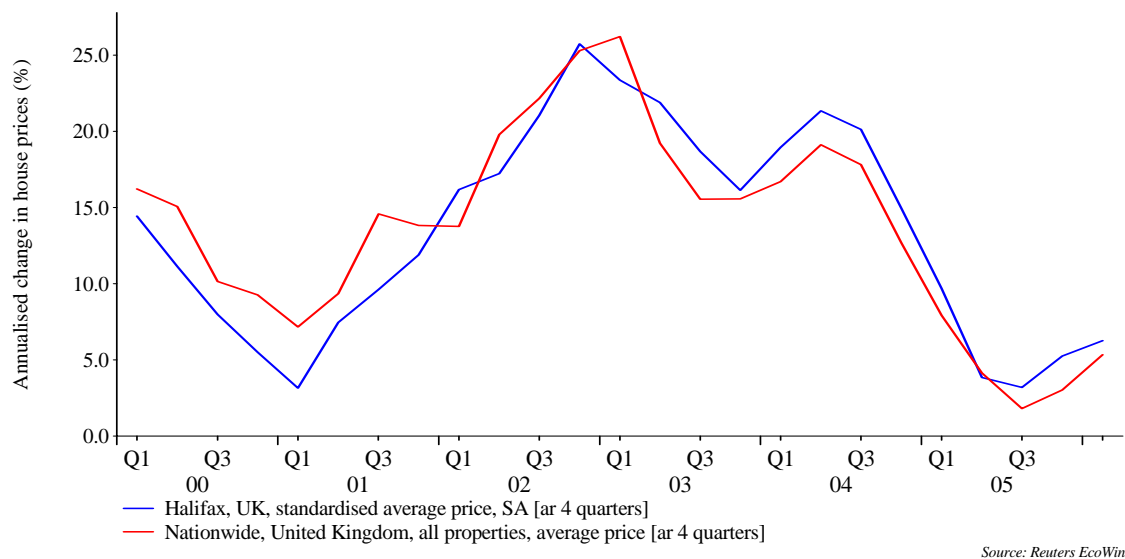
Inflation is also showing the first indications of increasing, with the Consumer Price Index (CPI), the measure targeted by the Bank of England, and the Retail Price Index (RPI), the measure to which inflation linked gilts are indexed, both moving higher (see Fig.4). Concerns about the threat of rising inflation are starting to be reflected in the voting patterns of the Bank of England's Monetary Policy Committee (MPC) where, for the first time since May 2005, a member has voted for a rate increase. Sterling money markets expectations are that base rates will increase by 0.25% by the end of the year.

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



One further indication of the strengthening economy is house price inflation (see Fig.5). This started to increase again in the final quarter of 2005 and is once again above 5% on both the Halifax and Nationwide measures. Developments here will be closely monitored by the MPC, which already regards the level of house prices relative to average earnings as high.

Fig.5: Average UK House Price Inflation since 2000



In summary, the UK's economic performance is improving, helped by a stronger global growth picture. This accelerating growth is likely to require marginally higher interest rates in future to head off the threat of higher inflation.

Turning to possible developments that might upset this scenario, we must consider the risk that inflation, driven by cost pressures in areas such as energy, increases more sharply than currently expected. This would necessitate higher interest rates and, potentially, a rapid economic slowdown.

4. Investment Outlook

The outlook for the global economy, outlined in the previous section, raises some issues for investment markets for the immediate future. After a very strong run since the end of the bear market in early 2003, some equity markets now offer less compelling value, while rising interest rates threaten to undermine the low yield environment that has supported the fixed interest and property markets.

Considering the future path of interest rates, Japan is likely to join the US and Continental Europe in raising rates, with the UK now looking increasingly likely to follow. The US central bank, the Federal Reserve, is watching statistical data releases in order to monitor inflationary pressures. The new chairman of the Federal Reserve, Ben Bernanke, has made it clear in recent speeches that core CPI, at 2.4%, is too high. If inflationary pressures increase further the Fed. will have little choice but to continue raising rates. In Europe, the European Central Bank, having held rates at 2% for two and a half years is now increasing rates steadily as the economy gathers strength. Japanese rates are set to move away from zero in the coming months as the Bank of Japan's aggressively easy monetary policy is finally being rewarded with a strengthening economy.

Given this interest rate outlook, and noting that prices have fallen over the first five months of the year, we believe **UK government bonds** are fair value at present. UK government bond prices have retreated along with those of other major economies as global growth prospects have improved. However, interest rate rises and the risk of an inflation surprise mean that, in our view, it is too early to take a more positive stance.

With the exception of US treasuries, the yields on most **overseas government bonds** are lower than on UK government bonds. The risk of continued dollar weakness, possible further US interest rate increases, and the size of the US Federal budget deficit, continue to argue against an exposure to US treasuries for UK based investors.

Investment grade bonds have maintained their narrow yield premium over government bonds. **Non-investment grade bond** yield spreads fell earlier in the year, as the economic picture improved, but have since increased marginally. We believe neither offers a sufficient yield premium over the comparable sovereign issues to compensate for the additional risk of holding them at this point in the economic cycle. Our view therefore remains that exposure to fixed income should be achieved through holding government bonds.

Despite three years of rising equity markets the yield available on **equities** remains attractive relative to that on fixed interest, and valuations in terms of price/earnings ratios are not stretched. However, the backdrop of rising interest rates, together with evidence of speculative excess, prompts us to take a slightly more cautious view of this asset class.

The yield on **UK cash deposits** is linked to the base rate, which is 4.5% p.a. at present. This is similar to 10 year UK government bond yields and, given the elevated risk levels elsewhere, remains relatively attractive.

Commercial property has performed strongly and remains a firm favourite with retail investors. The combination of an attractive yield, the prospect of rental growth and lower volatility than equities might appear to offer the best of all worlds to investors. However, in a rising interest rate environment, we believe there is little further upside to property prices.

4.1 Cash Deposits

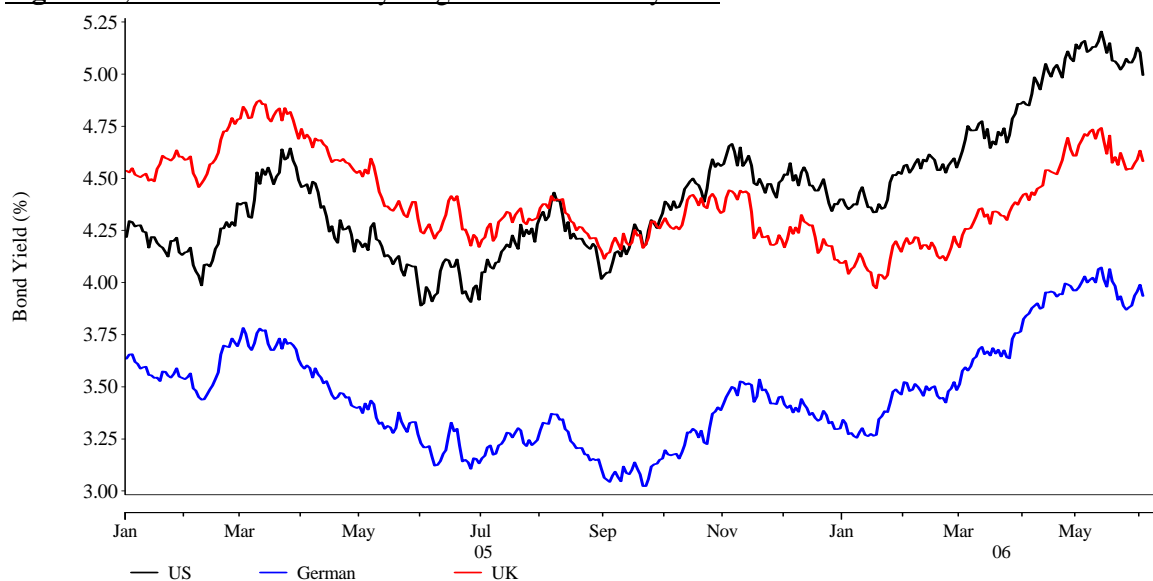
Sterling cash deposits offer a yield of around 4.5% p.a. Although this is similar to the yield on 10 year UK government bonds, the likelihood of interest rate increases and the possibility of an inflation surprise mean that the flexibility offered by cash deposits remains attractive. Inflation, as measured by the CPI, increased to 2.2% in May. This is above the Bank of England's target of 2.0% and the minutes of the MPC's May meeting noted that near term inflation risks are skewed to the upside. Cash deposits are one of the most defensive asset classes and the current uncertainty merits their inclusion within portfolios.

4.2 Fixed Interest

The debate over why government bond yields remained so low for so long (known as the "Greenspan conundrum" after the recently retired Chairman of the Board of the Federal Reserve) has largely been solved. Government bond yields have moved markedly higher from a low point in mid-January to a peak in early May, as the simultaneous effect of improving economic growth and rising inflation risks finally shook bond holders from their complacency (see Fig.6). Importantly, during the recent weakness in equities and the spike up in market volatility, the yield on government bonds has fallen back. This underpins our view that, despite increased inflation risks, bond investors now trust independent central banks to deliver low inflation. This implies that any upward pressure on the price level will be met by higher interest rates, and that any consequential pain felt in asset markets would fall upon equity investors, as economic growth slows down, and not on bond investors as a result of inflation eroding the value of fixed interest investments.

We believe that a buying opportunity in bonds may present itself in the next few months but that, in the meantime, yields may move marginally higher. We maintain our preference within fixed interest for sovereign debt. This is attractive as a low volatility, low default risk asset class that is a beneficiary of slowing economic growth. Government bonds will also provide some protection within portfolios in the event of exogenous shocks – such as a bird-flu pandemic or a major act of terrorism.

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



- UK Government Bonds

As noted earlier, the yield on UK government bonds has risen markedly this year. Treasury 4.75% 2015 gilts currently yield 4.75%, having increased steadily from a low of 3.97% in mid-January. At these levels medium dated government bonds are offering better value, but yields may have further to rise if growth continues to accelerate or inflation continues to trend higher.

UK government bonds have defensive characteristics and should be held within portfolios to give protection against events such as recessions, natural disasters and terrorist attacks which would be expected to cause falls in the value of other assets.

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, which reduce the yield.

- UK Index-Linked Government Bonds

Real interest rates have risen markedly in 2006 as renewed strength in economic growth has driven up the cost of capital. The yield on 2.5% Index-Linked 2016 gilts has increased from a low of 1.16% in January to 1.80%. Although this yield remains on the low side, the value of the inflation proofing element of index-linked stocks is very valuable in portfolio construction.

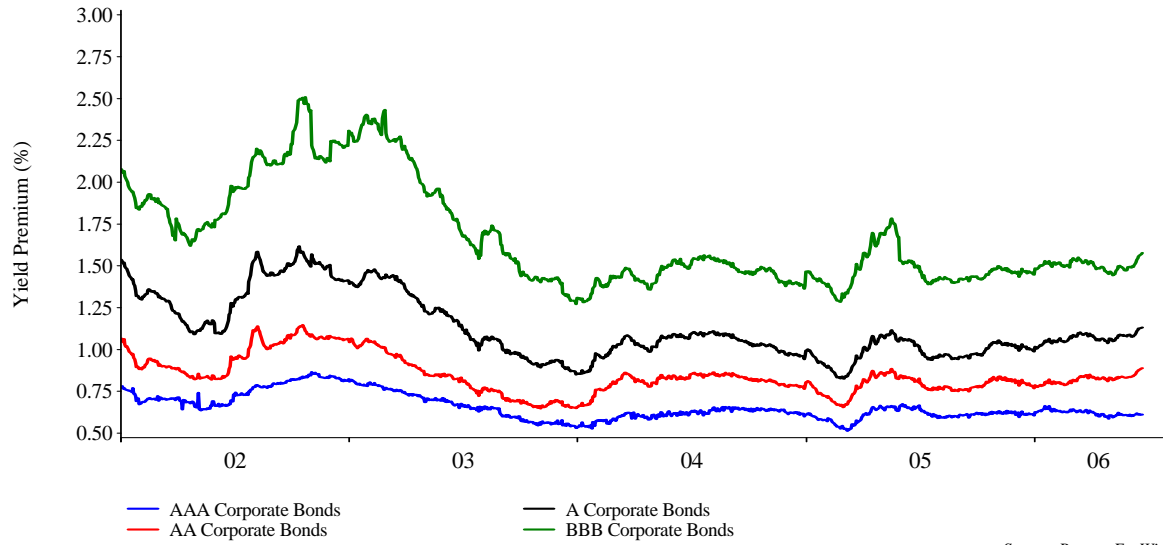
The government has responded to increased demand for index-linked stock from institutions such as defined benefit pension schemes. In the financial year 2006/07 the Debt Management Office, on behalf of the Bank of England, intends to issue £16bn of new index-linked stock. This is twice the amount issued only two years ago and represents 25% of total funding raised in the gilt market, compared with 13% raised via index-linked gilts two years ago. By increasing issuance of index-linked stock the government is not only meeting the requirements of the defined benefit pension schemes but also taking advantage of a cheap source of funding for its deficit. Longer dated index-linked gilt yields are the lowest as these are the most sought after stocks by pension schemes for asset/liability matching purposes. For example, the yield on the 1.25% 2027 index-linked gilts is only 1.23%.

We continue to prefer medium dated index-linked stocks such as 2.5% 2013 and 2.5% 2016 to give portfolios an element of inflation protection.

- Investment Grade Corporate Bonds

Corporate issuers of debt have to offer fixed interest 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 the government. A company with a strong financial position, as measured by rating agencies such as Standard and Poor's (S&P), will only have to offer a low risk premium to investors and vice versa. Yield premiums vary widely with the business cycle as the perceived risk of default ebbs and flows. The recent period of good economic growth, accompanied by strong corporate earnings growth, has driven down yield premiums on corporate debt (see Fig.7). At present levels, and given the current increase in risk aversion and market volatility, we do not believe that investment grade bonds are attractive. We therefore advise that fixed interest exposure should be gained through government bonds.

Fig.7: Yield premiums on 10 year UK Corporate Bonds over a 10 year UK Gilt, 2002 to date



Source: Reuters EcoWin

- Non-Investment Grade Corporate Bonds

Non-investment grade corporate bonds are those rated below BBB by S&P. They are judged to have a much higher risk of default than investment grade bonds and therefore must offer correspondingly higher yields.

The Merrill Lynch High Yield Bond Index shows yields on these bonds edging higher since mid-2005. However, relative to history, yield premiums are still low (see Fig.8). We therefore continue to believe that fixed interest exposure should be obtained predominantly through government bonds.

Fig.8: Merrill Lynch High Yield Bond Index from 2000 to date



Source: Reuters EcoWin

4.3 Commercial Property

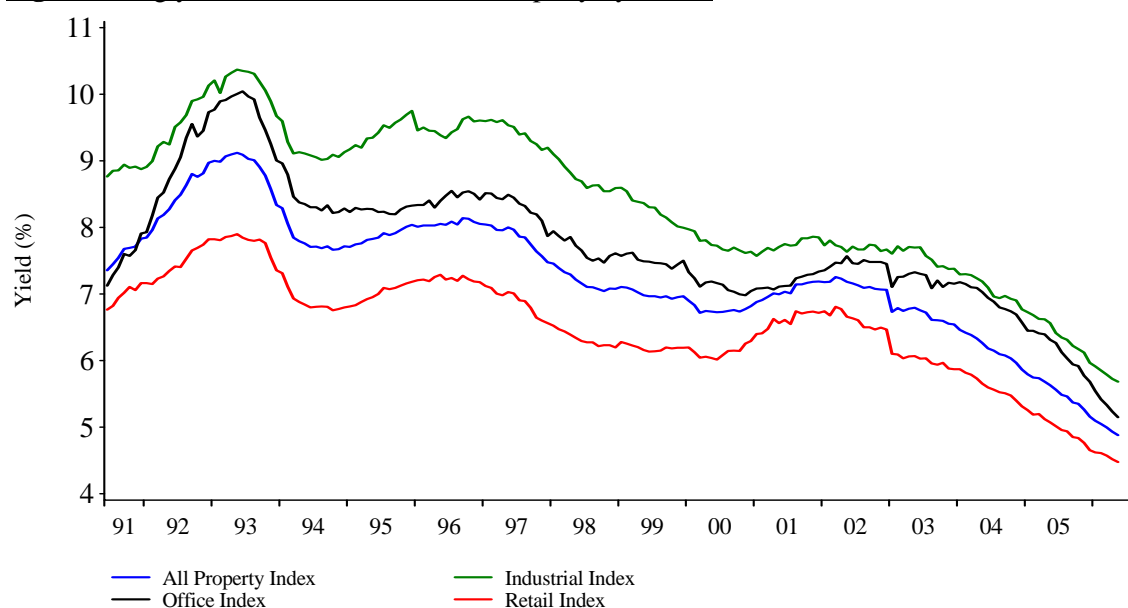
Commercial property continues to provide good returns. Property has a strong appeal to investors as an asset class that has traditionally delivered a higher yield than gilts, but also has the prospect of capital appreciation through rental increases, which are linked to increasing demand for property space and, ultimately, to economic growth. Lower volatility than equities coupled with the added security provided by owning a tangible asset are also positive features of this asset class.

More recently, commercial property has received two additional boosts. The first is that, following legislative changes, property funds are now eligible for inclusion in ISAs. The second is the interest generated in commercial property investment by the introduction to the UK of real estate investment trusts (REITs). This is now scheduled to occur at the beginning of 2007 and will allow property companies to convert to a more tax advantaged structure, whereby they will be able to pass rental income through to shareholders without suffering corporation tax, in exchange for meeting various criteria.

These factors have driven another strong year of returns for property investments. According to Investment Property Databank (IPD), a property performance monitoring service, commercial property returned 18.8% in 2005. This year to date has also been robust with returns of 5.9%. However, this performance has taken yields down to very low levels (see Fig.9). The IPD's All Property Index yield measure fell below 5% in March for the first time since data collection began in 1987. Retail property (shown in red below) is now yielding just 4.5%.

With gilt yields having moved higher and the balance of probability pointing to higher interest rates in the UK, we believe that commercial property is beginning to look expensive. We remain holders of property funds for diversification purposes but would caution against the expectation of continued capital gains.

Fig.9: Falling yields on UK Commercial Property by Sector



Source: IPD, Reuters EcoWin

4.4 Equity Markets

- UK Equities

The UK equity market, excluding resources, is offering a prospective yield of 3.6% and is trading on a prospective price/earnings ratio of 12.9x for 2006.¹ These figures assume earnings and dividend growth of 10% and 9% respectively for 2006. The price/earnings ratio is not high in absolute terms, and despite rising gilt yields, the UK equity market yield remains relatively attractive. The FT All-Share Index has almost doubled since the low point in March 2003 but equities have not enjoyed a re-rating. Most of the rise in prices has been matched by corporate earnings growth, meaning that UK equities are not much more expensive than three years ago. This contrasts sharply with commercial property as discussed above.

Despite these positives, two factors compel us to take a slightly more cautious view of UK equities than we have for the last two years. Firstly, corporate profit margins are at record highs as cost increases, particularly wages, have remained under firm control. With the labour market easing only gently, and employees suffering cost pressures from higher utility bills and petrol prices, employment costs may start to rise. There is also a risk that corporate profit margins come under pressure directly from higher input costs, such as energy price increases. Secondly, the strength of the markets has been driven in part by takeovers, leveraged buyouts and private equity deals, with much of this activity predicated on deals being funded at low interest rates. With the possibility of UK interest rate increases, and global liquidity being mopped up by central banks, we suspect that support from this quarter may begin to ebb.

Given the above, while we continue to view UK equities as offering good value, we believe that they may struggle to make further progress until the outlook for interest rates, and therefore the future path of economic growth, becomes clearer.

- European Equities

Continental European equities also offer good value, trading on a 12 month forward price/earnings ratio similar to that of the UK market. Economic growth is accelerating and many of the positives relating to restructuring and the expansion of the EU remain in place. However, our positive view is now tempered by the backdrop of interest rate increases, which are unhelpful so early in Europe's recovery. A further consideration, which may act as a drag on potential future gains, is that European corporate profits have been boosted by strong global economic growth – particularly the demand for export goods from the US and Far East. Slower growth in these areas, coupled with a stronger euro against the dollar, may act to undermine the strength of European economic growth.

European equities remain relatively attractive but, like the UK equity market, further gains may be difficult in the near term.

¹ Source: UBS. This p/e ratio excludes resource stocks. The p/e ratio including these would be lower as the earnings of these companies have been boosted by high commodity prices.

- North American Equities

The US equity market was the laggard amongst world equity markets last year with the S&P 500 Index rising by just 3.0% in dollar terms, compared to the MSCI World-ex US Index, which rose by 8.8%, measured in the same currency. Rising interest rates, concerns about the dollar and relatively expensively rated equities are the easily identifiable causes for this underperformance.

This year the long awaited dollar decline has resumed. Measured to mid-June the US currency has fallen 6.6% against the euro, by 2.7% against the yen and 7.3% against sterling.

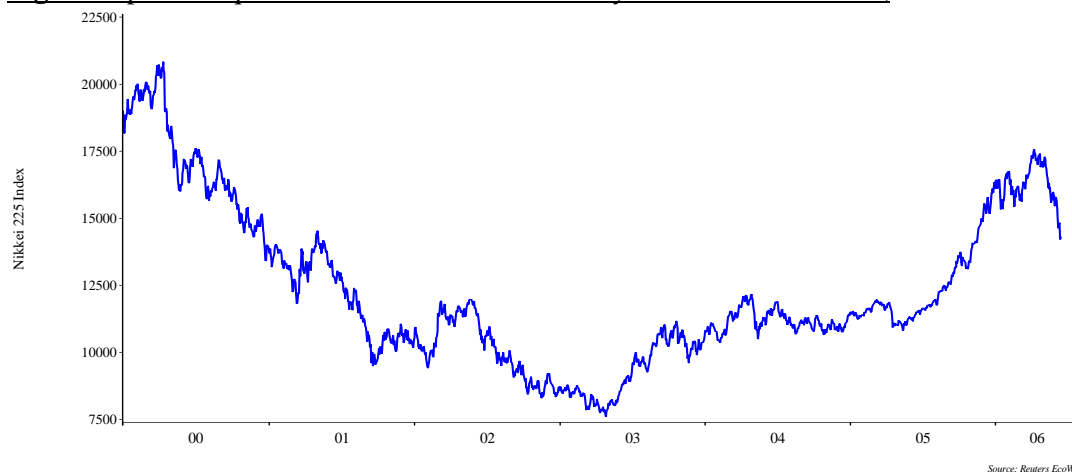
Our view on US equities is becoming more positive as a result of the weakening dollar and the relative underperformance of the US market. The latter has resulted in the US equity market trading at only a small premium, in price/earnings terms, to the UK and Continental European markets. However, the US economy is the most advanced in the current business cycle and should be the first to see a peak in interest rates, which could prompt a further bout of dollar weakness.

We believe that we should continue to avoid US equities for the present but we are looking for buying opportunities, possibly later in 2006 or early in 2007.

- Japanese Equities

The Japanese equity market, having been the strongest major market in 2005, has retreated in 2006 (see Fig.10). The Japanese economy is still strengthening and the OECD is forecasting 2.8% growth in 2006. Investors appear to be worrying about Japanese interest rates rising from zero and the potential effect of a slowing global economy on Japanese exporters. On the former, while interest rate increases are inevitable, the Bank of Japan will remain extremely sensitive to deflationary risk, so monetary policy will remain relatively loose. On the latter concern, we believe that while Japan's economy is not immune to international factors, the current recovery from its extended deflationary recession means Japan's growth drivers are more domestically orientated than in the past. Both strengthening consumer spending and a long overdue capital replacement cycle should provide underlying support for the Japanese economy independent of developments in the global economy. As a result, we continue to believe that Japanese assets remain relatively attractive.

Fig.10: Japanese equities since 2000 as measured by the Nikkei 225 Index.



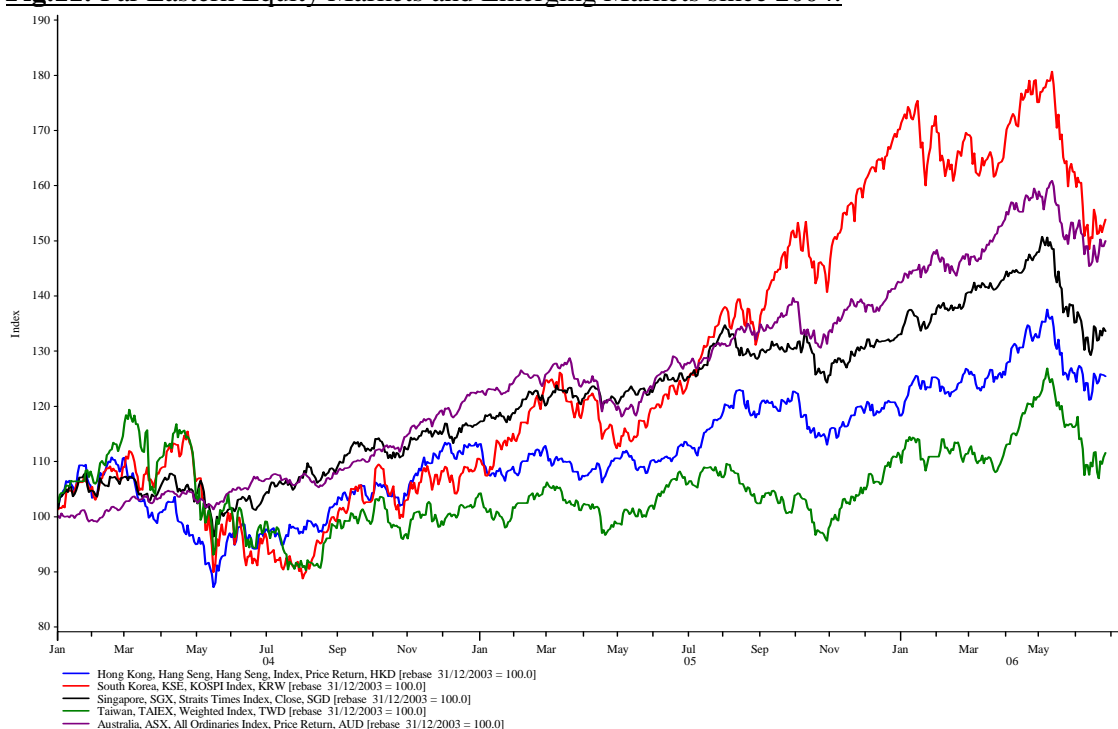
- Far East and Emerging Markets

Far Eastern and emerging market equities have made strong progress over the last two years buoyed by sustained economic growth, strong commodity prices and demand from investors in developed markets for exposure to these fast growing areas (see Fig.11). The recent falls have been equally steep as positive sentiment has waned amid growing fears that these economies will be adversely affected by slower global growth.

While equity markets in many Far East and emerging markets were starting to look fully valued prior to the recent correction, we maintain that the economic and currency related risks in these economies are much lower than in the past. This is due to their much stronger foreign currency reserve positions and strong current account surpluses, helped by the high prices of raw materials that many export.

In this context we believe the current market falls are a necessary correction after money flows and subsequent market moves had reached speculative proportions. We remain cautious that, in the short term, this correction will continue. However, over the longer term, these economies are becoming increasingly integrated into the global economy and their companies better managed. We therefore recommend that equity exposure is maintained.

Fig.11: Far Eastern Equity Markets and Emerging Markets since 2004.



5. Fund Performance Commentary

Table 1 below contains performance figures for the major fund sectors. On pages 22 and 23 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 %
UK Equities – All Companies	7.4	21.6	62.8	18.6
Fixed Interest Sterling	0.3	4.3	17.7	32.1
Index-Linked	0.5	5.5	16.1	35.6
Property	9.2	17.8	55.3	75.0
Money	1.9	3.9	11.5	19.7
Balanced Managed	4.1	16.7	48.1	16.7
Managed Stockmarket	4.7	19.3	57.5	16.1
Overseas Sectors				
Global Equities	2.3	18.7	56.2	7.3
North America	-6.5	5.8	22.0	-23.3
European (excl UK)	9.8	26.5	76.9	25.6
Far East (excl Japan)	6.7	26.2	92.4	55.3
Japan	1.1	30.9	85.4	1.4
Global Fixed Interest	-2.7	-0.7	3.2	19.2

(Source: Reuters Hindsight ABI UK Pension Fund Series on a bid to bid pricing basis to 31 May 2006).

The performance figures quoted below are in sterling terms and cover the six months to 31 May 2006. Performance figures for individual funds show total return on a bid to bid basis. Sector performance figures are shown mid to mid.

UK equities have continued to advance over the last six months as evidence of renewed strength in the UK and global economies increased investor confidence that strong corporate profit growth could be maintained. The FTSE All-Share Index, including income, returned 8.1% over the six month period to 31 May. However, towards the end of the period, equity markets suffered a sharp sell-off. Between 9 May and 31 May the FTSE All-Share Index, measured in capital terms, fell by 6.5%.

One notable characteristic of the recent turbulence has been the sharp spike up in risk aversion, which has resulted in aggressive profit taking in those areas of the market that had previously provided the best returns. Hence, funds heavily weighted in oils, metals and mining stocks have suffered. Also, some of the funds in both the IMA UK All Companies sector and the IMA UK Equity Income sector, which had enjoyed strong performance through heavy weightings in mid and small cap. stocks have underperformed more recently.

Taking the period as a whole, the IMA UK All Companies sector generated average returns of 7.4%. Of our recommended funds, Standard Life UK Opportunities, GAM UK Diversified, Framlington UK Select Opportunities and Schroder Recovery all performed strongly with returns of 10.3%, 8.9%, 8.8% and 8.7% respectively. The Schroder Recovery fund, managed by Ben Whitmore, held up particularly well in May's falling market, with the unit price dropping by only slightly more than 4%. This is 2% less than the average correction suffered by funds in this sector and demonstrates the defensive attractions of recovery investing.

The IMA UK Equity Income sector generated an average return of 6.8%, slightly less than the IMA All Companies sector, reflecting its higher yielding and more defensively positioned funds. Our recommended funds performed extremely well as the markets sold off. Over the six month period Invesco Perpetual Income, Rathbone Income and Jupiter Income Trust were all top decile performers returning 10.2%, 9.9% and 9.3% respectively.

Over the last six months small cap. stocks have outperformed large caps. with the IMA Smaller Companies sector generating an average return of 10.6%. Artemis UK Smaller Companies has performed extremely well. Helped by its heavy weighting in oils and mining in the five months to the end of April it returned 14.7% over the six monthly period under review. Merrill Lynch UK Smaller Companies also performed creditably returning 11.6%. Aberforth UK Smaller companies was slightly disappointing returning only 9.3%. It outperformed its peers as the equity market fell back in May but its bias towards value stocks meant it had not benefited as much as other funds earlier in the period.

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 2.6% in the six month period but this translates into a return of -5.1% for sterling based investors. We have not favoured US equities due to relatively high valuations and our conviction that the dollar would weaken as US interest rates peaked. The performance of Gordon Grender's GAM North American Growth fund and Tom Walker's Martin Currie North American fund has been resilient relative to the peer group, producing returns of -3.3% and -4.6% respectively compared to the average fund in the IMA North America sector which returned by -7.2%.

Continental European equities have marginally outperformed UK equities. Over the last six months the average fund in the IMA Europe excluding UK sector returned 9.3%. Jupiter European Special Situations, managed by Cedric de Fonclere, performed very strongly. It has benefited from its emphasis on high quality companies with strong cash flows and returned 17.5% over the period. Schroder European Alpha Plus, managed by de Fonclere's predecessor at Jupiter, Leon Howard-Spink, also produced strong returns of 17.0% over the period.

Japanese equity markets are lower over the six month period. After hitting a five year high in April, Japan's main stock market index, the Nikkei 225, has fallen back sharply as investors have taken profits amid concerns that higher interest rates around the world will impact disproportionately on export led economies, such as Japan. The average fund in the IMA Japan sector has outperformed the index, managing a creditable 0.6% over the last 6 months. However, our recommended funds lagged. Schroder Tokyo, with its bias towards high quality, larger cap. stocks, returned -0.1% which was significantly better than both JP Morgan Japan and Fidelity Japanese Special Situations which returned -5.9% and -5.3% respectively. Both of these funds have excellent long term records and we believe they will resume their out performance in future.

The **Asia Pacific excluding Japan** sector also fell back sharply as a result of the recent turmoil but had provided stronger performance in the early part of the year. The average fund in the IMA sector returned 6.1% over the period under review. First State Asia Pacific Leaders returned 2.3% over the period, while the Edinburgh Dragon Trust returned 2.0%. Both of these funds have solid long term records and we continue to recommend them. Returns from the **Asia Pacific including Japan** sector were dragged lower by the relatively weaker performance of Japan (see Table 5). The average fund in the IMA sector returned 3.1%. Of our recommended funds, Invesco Perpetual Pacific performed slightly better, returning 5.8%, while Martin Currie Pacific Trust performed slightly worse, returning 0.5%.

Like the Asia Pacific equity markets, **Emerging Markets equities** suffered sharp declines recently, though over the last six months returns remain in positive territory. The equity markets of emerging economies tend to be much more volatile than those of the developed economies, thus they performed extremely strongly as the world economy prospered, and have sold off more sharply as risk aversion has risen. The IMA Global Emerging Markets sector returned 5.3% over the six month period. The Templeton Emerging Markets Investment Trust returned 4.0%.

Stockmarket Managed and **Managed Equity** funds have generally performed well over the period as a result of solid returns and a narrowing of discounts to net asset value (NAV). RIT Capital Partners, which invests in both quoted and unquoted securities, has increased its exposure to quoted equity to from 56% to 62% of its assets over the last twelve months. This was driven, in part, by the strength of the quoted part of its portfolio. Over the period under review it generated a return of 7.1%. It is now trading at close to its NAV indicating that investors believe the strong track record can continue. Caledonia Investments, which has approximately 20% of its assets in private equity and unquoted securities, has sold a number of holdings recently and the board have proposed returning a proportion of the proceeds to shareholders in the form of a special dividend. The proposal to return capital via a £128m special dividend will be conditional on shareholder approval at an EGM at the end of June. Caledonia Investments is currently trading at a discount of 4.9% and has generated returns of 4.3% over the last six months. British Empire Securities and General Trust has returned 6.3%.

Private Equity funds have also been actively returning cash to shareholders. At an EGM in early May, Candover shareholders voted through a cash return of £100m through either a 'B' or a 'C' share issue. Payment in respect of these shares was made on 15 May. Candover's strong cash position derived from realisations of investments generating strong profits over book cost. They have retained some cash for future co-investment alongside the Candover Managed Funds. Electra Private Equity Plc (previously known as Electra Investment Trust) has continued returning cash to shareholders. Since the start of the year the trust has purchased 2.785m shares for cancellation at a total cost of £35.85m – this represents 6.4% of the company's market capitalisation. Management have stressed that they regard it as more important to return cash to shareholders through buy-backs than to achieve regular dividend payments, as the timing of revenue receipts is difficult to predict. Candover and Electra have generated returns of 10.4% and 9.8% respectively over the 6 month period. Other private equity funds held by clients include Graphite Enterprise Trust, HG Capital Trust and Pantheon International Participations, which have generated returns of 9.4%, 11.3% and 3.7% respectively.

Funds in the **Balanced Managed** sector have generally performed in line with expectations, given the performance of the underlying markets in which they invest. Balanced Managed funds have a substantial portion of their assets invested in non-equity securities which, over the whole period, have not performed as well as equities. The AXA Framlington Managed Balanced fund is however the exception among its peer group with a return of 7.3% against the sector average of 4.7%. This fund has outperformed the sector average over most time periods. The lower risk Morley Sentinel Managed (4.0%) and Investec Cautious Managed (3.4%) 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 3.0%.

Investment grade sterling **Fixed Interest** securities returned -0.3% over the period as rising bond yields (falling prices) cancelled out the income received. The Morley Corporate Bond, Legal and General Fixed Interest and Invesco Perpetual Corporate Bond funds all outperformed the IMA sector average, returning 0.4%, -0.1% and 0.2% respectively. High yield bonds have performed slightly better over the period returning 2.0%. However, as described earlier in this report, the yield premium on these bonds compared to that available on government bonds, looks insufficient to compensate for the additional risk.

Property funds have continued to attract strong investment inflows and we continue to be concerned that commercial property values are being driven as much by money flows as by tenant demand. This raises the risk that managers purchase properties at high prices in order to get new subscriptions invested. We saw some evidence of this in a recent FT interview with Francis Salway, the chief executive of Land Securities (which is Britain's largest quoted property company) who explained why his company recently sold a London property for £83m to a fund manager in an off-market deal. His explanation highlights the risks involved with investing in an illiquid asset class at a time when demand exceeds supply. He said, "It is known that some of the unit-linked property funds have strong inflows of money ... the fund manager made an unsolicited approach to us and we set a very high, aspirational figure, which they met. The yield was about 5% on a building which is over-rented and has leases which have expiries and break clauses in the next two years".

Large inflows 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. It has now lowered this proportion from 25% to 15% in an attempt to reduce inflows. Similarly, investors are increasingly subject to dilution levies for access to "bricks and mortar" funds (such as through a pension or unit trust) and premiums to net asset values for investment trusts on new investments as the cost of acquiring new properties (including 4% stamp duty) is being passed on to new investors.

Considering performance, Isis Property Trust 2 Ltd has returned 9.1% in the last six months. The Morley Property fund has also continued to perform well returning 8.4%. 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 20.4%.

To address the concerns expressed above we have recently researched some new global property securities funds. These invest, as the name suggests, in the equity of property companies worldwide. These 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 2.7% and 5.3% respectively. The Fidelity fund pays a yield of approximately 4% while the Schroder fund yields less than 0.5% as the majority of the yield generated on the underlying securities is recycled into the portfolio.

We recommend clients maintain a strategic weighting in commercial property and global property shares but, for those clients with an overweight position, we are suggesting some tactical sales.

Venture Capital Trust (VCT) subscriptions in the last tax year reached record highs with just over £700m invested. From April 2004 the government increased the income tax relief to 40% from 20% to encourage higher funding for small businesses. This improved tax break prompted more investment into the sector than anticipated and led the chancellor to announce that, with effect from 6 April 2006, the income tax relief would be restricted to 30%. He also increased the minimum holding period (to qualify for this relief) from 3 years to 5 years and further limited the size of companies in which VCTs may invest. As a result of these rule changes we expect 2006/07 to see much lower commitments to VCTs. Appropriate VCTs represent a good opportunity for many investors. However, we regard diversification as key, and we recommend that clients investing in VCTs spread their exposure.

We have met with several **Hedge Fund** managers and continue to monitor developments in the industry with great interest. While acknowledging that absolute returns have appeal for investors, we remain sceptical about how many hedge funds can deliver this consistently. We are also concerned that the high charges made by hedge funds (typically an annual charge of 2% with a performance fee of 20%) create asymmetrical pay-offs for hedge fund managers. This type of charging structure rewards managers who achieve strong performance far more highly than it penalises poor performance, thereby encouraging excessive risk taking with investors' capital. 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.

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 4.5% gross Annual Equivalent Rate (AER) using ING Direct or 4.75% with First Direct, though large cash holdings should be held with several institutions to diversify risk.

We continue to look at all **With Profit** policies on their own merits. In our view with profit funds suffer from a lack of transparency and investment performance is often mediocre at best. Subject to policy guarantees and the individual insurer's internal procedures for setting transfer values relative to asset share, we recommend, subject to specific advice, that clients transfer their pension policies to a unit-linked policy or a SIPP and sell or surrender life policies. Many with profit funds over the last two to three years have changed their asset mix, increasing fixed interest with a corresponding reduction in equities. This has the effect of securing the guarantees made to policyholders but limiting the upside potential from equity investment, which would have normally materialised in the form of higher bonus rates.

Christopher Sexton
Investment Research Manager
June 2006

Main Client Funds Performance Summary to 31 May 2006

Table 2: Fixed Interest

	Gross Redemption Yield (%)	Average Duration (Years)	Performance Over 6 Months (%)
<u>Investment Grade</u>			
Morley Gilt Fund	4.5	8.8	-0.7
Winterthur Fixed Interest	4.8	7.8	0.5
Legal & General Fixed Interest	5.5	N/A	-0.1
Morley Corporate Bond	5.1	9.5	0.4
Morley Long Corporate Bond	4.9	13.5	-0.2
<u>Non-investment Grade</u>			
Legal & General High Income	7.5	N/A	2.2
Threadneedle High Yield Bond	3.7	3.4	4.5
F&C Strategic Bond	6.5	5.4	1.6

(Source: Individual companies actual portfolio yields and duration, Hindsight ABI UK Pension Fund, IMA Series bid to bid pricing basis to 31 May 2006).

Table 3: Property

	6 Months %	One Year %	Five Years %
<u>Pension Funds</u>			
AXA Sun Life	5.6	11.6	65.8
Legal & General	6.6	16.5	86.7
Norwich Union (4)	9.6	18.0	71.2
Prudential (Scottish Amicable)	7.6	16.2	67.9
Scottish Widows	10.0	19.8	86.4
Standard Life	9.9	19.6	78.6
Morley	8.4	19.4	93.7
Zurich (Allied Dunbar)	9.5	18.3	84.2
<u>Other Property Funds</u>			
Isis Property Trust 2	9.1	20.4	N/A
Morley Property	7.8	15.5	N/A
Standard Life Investment Property	13.1	20.5	N/A
TR Property Investment Trust	20.4	38.2	252.6

(Source: Reuters Hindsight ABI UK Pension Fund, IMA, AITC Investment Trust Series on a bid to bid pricing basis to 31 May 2006).

Table 4: Equities

	6 Months %	One Year %	Five Years %
Aberforth Smaller Companies	9.3	23.9	107.4
British Empire Securities & General	6.3	40.8	149.1
Candover Investments PLC	10.4	23.2	139.7
European Assets	15.7	39.5	88.2
GAM UK Diversified	8.9	24.6	61.4
Liontrust First Income	6.6	19.3	66.7
Martin Currie Pacific	0.5	39.0	70.7
Merrill Lynch UK Special Situations	8.6	28.8	51.0
North Atlantic Smaller Companies	-2.6	20.0	38.8
RIT Capital Partners	7.1	31.0	122.1
Schroder Recovery	8.7	19.8	74.1
Standard Life UK Opportunities	10.3	27.8	N/A
Standard Life UK Equity	7.3	21.4	25.6
Winterthur Credit Suisse Income	5.8	17.4	46.6
Winterthur Fidelity Special Situations	8.9	26.1	79.0

(Source: Reuters Hindsight ABI UK Pension Fund, IMA, AITC Investment Trust Series on a bid to bid pricing basis to 31 May 2006).

Table 5: Equity and Bond Market Indices

	6 Months %	One Year %	Five Years %
FTSE 100 TR (Total Return)	7.3	19.3	16.3
FTSE 250 TR	13.0	34.2	63.4
FTSE Small Cap. TR	8.0	23.7	24.1
FTSE All-Share TR	8.1	21.3	21.7
S&P 500 (\$) TR	2.6	8.6	10.2
FTSE Eurofirst 300 ex UK (€) TR	8.5	24.0	5.3
FTSE – Asia Pacific ex Japan TR	4.3	24.3	63.5
FTSE Japan TR	3.3	32.3	1.5
Nikkei 225 (Japan) CR (Capital Return)	4.0	37.2	16.6
FTSE All World Emerging TR	6.4	39.0	99.4
FTSE Index-Linked British Govt All TR	0.8	5.7	39.7
FTSE British Govt All Stocks TR	0.3	3.5	32.2
IPD All Property	10.4	21.1	94.2
Brent Crude Oil	20.9	37.9	85.7
Gold Troy Ounce	21.8	53.4	86.0

(Source: Reuters Hindsight on a mid pricing basis to 31 May 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.

Saunderson House...

- is a City firm with over 35 years experience of financial planning and investment advice;
- has more than £1 billion of funds under its investment advisory agency;
- helps more than 1,000 current and retired Partners of the leading Legal and Accountancy firms;
- helps executives in industry (especially with occupational pensions schemes);
- helps family estates (especially with inheritance tax planning);
- operates on an hourly rate basis to avoid the conflict of interest inherent in the selling of products for a commission;
- service hallmarks are integrity, professionalism, personal attention, continuity, confidentiality, creativity and a positive approach.

For a complimentary meeting, please contact Nick Fletcher, Managing Director, on 020 7315 6504 (direct) who will help you or guide you to an appropriate adviser.

SAUNDERSON HOUSE

