Investment Bulletin

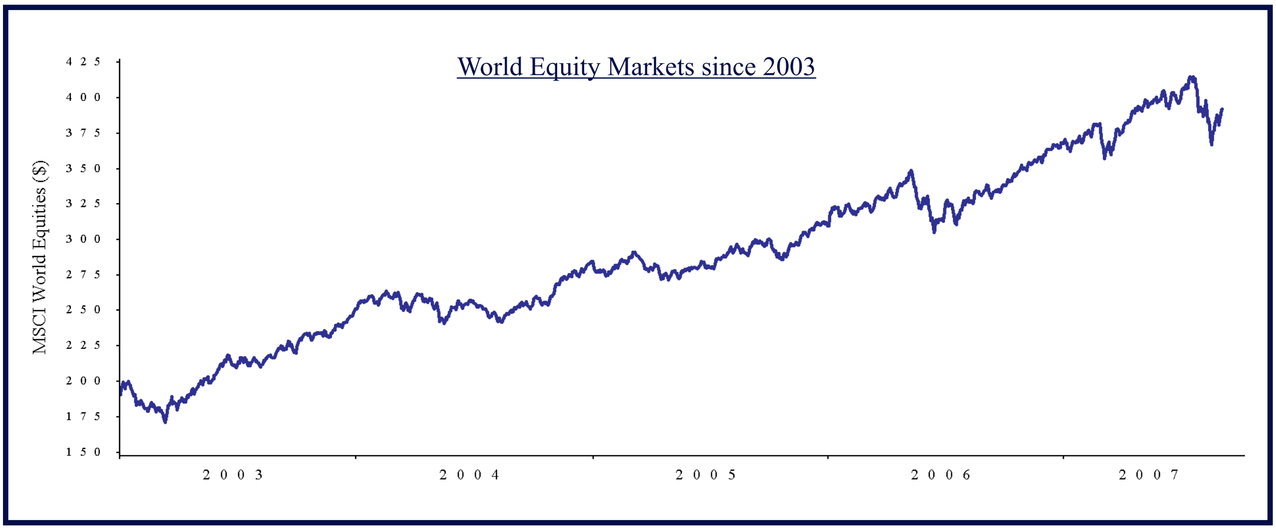
SAUNDERSON HOUSE

31 August 2007

FOCUSED FINANCIAL ADVICE

GREY SKIES, RED SCREENS: SUMMERTIME BLUES?

It is quite conceivable that many investors are suffering from summertime blues given the grey weather and falling share prices. It has been one of the wettest summers on record in the UK and a poor one for world equity markets, which fell by c9% in the month to mid-August. Market adjustments such as this are not uncommon (see chart below) and they will continue, which is why careful and cautious financial planning is essential. Long term investors with well-planned asset allocations, across a diversified range of quality assets, have no cause for undue concern.



The root of this summer's financial turmoil lies not in equity markets but in credit markets where some investors, particularly hedge funds, have bought into baskets of loans backed by low quality, or sub-prime, mortgages. These types of financial instruments are relatively new and untested by economic cycles and, as the US housing market has weakened, they have fallen in value. The resulting losses have been exacerbated by the purchase of these products using borrowed money. This has been bad news for investors who bought into hedge funds which have done anything but 'hedge' their clients' risks. It is likely that, for such investors, more bad news is to come. We continue to recommend the avoidance of esoteric hedge funds.

Share prices have fallen along with the value of mortgage backed securities and hedge funds. Importantly, this weakness is not due to the usual factors that can undermine equity markets, such as profits warnings or rising inflation. Instead, equities have suffered due to a general rise in risk aversion and concerns that the problems in US housing and credit markets might spread to the wider economy. We believe that a period of adjustment in credit markets was long overdue. Given that the resulting losses appear to be small relative to the size of global bond and equity markets, and are confined to a limited number of hedge funds and investment banks, the risks to global growth and equity markets seem quite remote. Global growth remains strong and should continue to support company profits and dividends which, in the longer term, underpin equity markets. Despite rising share prices over the last four years, strong corporate earnings growth has left equities looking reasonable value by historic standards.

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