

Market Commentary

April 2009

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Risk Warnings

This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 8 April 2009. 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 therefrom can go down as well as up and you may not get back the full amount you invested. Levels and bases of, and reliefs from, taxation are those currently applying but are subject to change and their value depends on the individual circumstances of the investor.

1. Economic and Investment Outlook

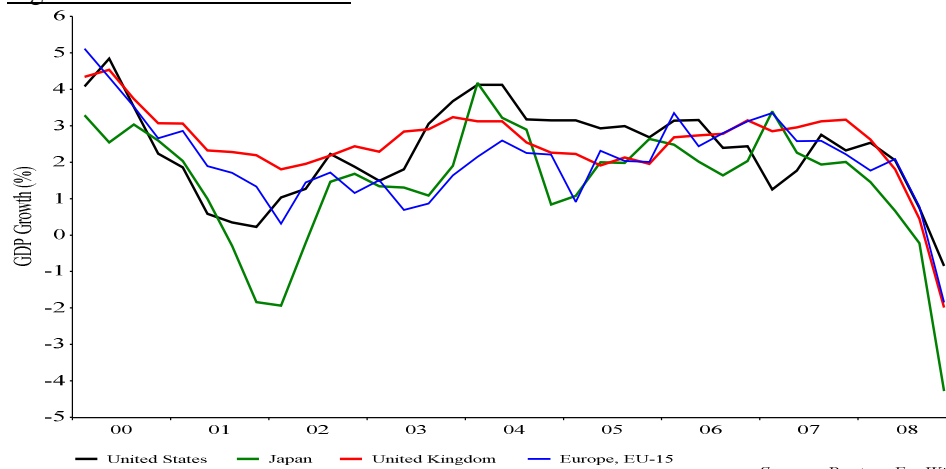
According to forecasts by the International Monetary Fund (IMF), total global output is set to decline by 0.5-1.0% this year. For the world economy to achieve no growth in aggregate is without modern precedent, however, it is perhaps the pace of decline which is more disarming. As recently as October 2008 the IMF was forecasting 3.0% world growth for 2009. This was itself a much lower figure than the 5.0% achieved in 2007. It is in this context that investment markets have remained exceptionally volatile.

Governments across the developed world, already struggling with ongoing banking crises and dysfunctional credit markets, have resorted to Keynesian-style fiscal stimuli in an attempt to breathe life back into their faltering economies. A bewildering array of new policy initiatives is now in place and, while it is too early to judge their success, aggressive action taken in September and October to underpin fragile financial systems does appear to be achieving its objective. The agreement at the recent G-20 summit to triple IMF funding to \$750bn has also boosted confidence and the total risk aversion witnessed in the final quarter of 2008 has now eased.

Having reduced official interest rates as far as practically possible, monetary authorities in the US and UK have now turned to unconventional measures to support their economies. These policies entail expanding the quantity of money in the economy, so called quantitative easing, to force liquidity into the financial system and drive up the value of financial assets. Such actions are aimed at preventing deep recessions turning into depressions or decade-long slumps caused by the deleveraging of investors, businesses and consumers.

Fig. 1 shows the extent of the slowdown in major economies thus far. Key factors in determining how long and how deep recessions will be include the extent of further falls in house prices and related financial assets, particularly in the US, and how far unemployment rises - with the attendant secondary effects on asset prices, consumer discretionary spending and confidence.

Fig. 1 GDP Growth since 2000

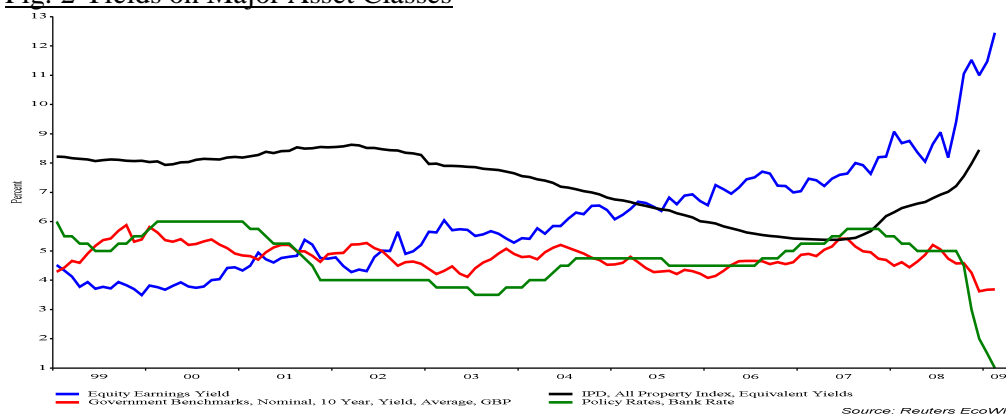


Over the last 18 months, we have seen many of the assumptions on which confidence in an ever-expanding global economy and financial markets was based turned on their heads. One such assumption was that strongly growing developing markets, such as China, and other economies where excessive asset price rises and consumer indebtedness were not apparent, would remain unscathed by the financial crisis. This has proven, emphatically, not to be the case. As demand from Western consumers has slumped, those economies reliant on exporting their goods and services have been severely impacted.

Another assumption was that credit markets would remain highly liquid and accommodating. Many businesses built on this assumption have now failed. Northern Rock in the UK and Washington Mutual in the US are two high profile examples. There are many others, from investment banks such as Lehman Brothers to hedge funds that were borrowing short term money to invest into higher yielding, longer term assets (the now infamous carry traders).

Within the mainstream asset classes, equities have suffered acutely as expectations of much-reduced economic growth and therefore lower corporate profitability have been priced into valuations. Equities have also been a source of liquidity for investors needing to raise cash. As buyers of assets such as high yield bonds, property and structured debt instruments have become scarce, forced sellers (those who need to sell regardless of price), including hedge funds facing heavy redemptions, have sold equities. Moreover, because so many investors had used leverage to gear market returns, the quantity of forced selling appears to have been far greater than in previous downturns. Thus, while equities never rose to levels at which they were clearly expensive on measures such as price to earnings ratios in the current business cycle, this provided little protection. Equity prices have fallen, taking yields much higher than at any time during the last ten years (see Fig. 2).

Fig. 2 Yields on Major Asset Classes



The yield shown for the equity market is the earnings yield. This includes retained earnings and therefore gives a fair reflection of the full earnings of equities, rather than just those distributed, which are measured in the dividend yield. It is calculated as earnings divided by price for the relevant index and is therefore the reciprocal of the price to earnings ratio.

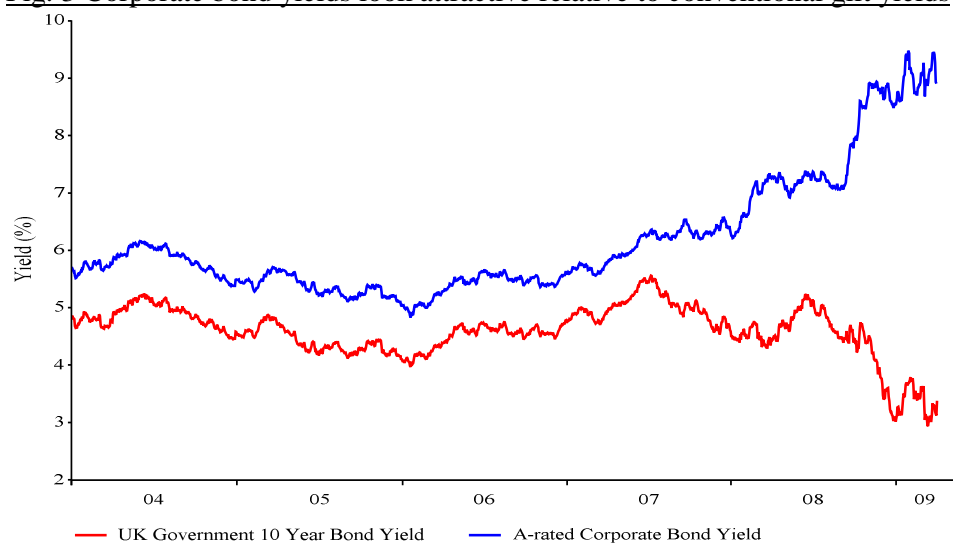
Turning to other asset classes, fixed interest markets have seen a very marked rise in risk aversion, as investor appetite for complex structured instruments, such as collateralised debt obligations (CDOs), has disappeared. As a result, government bonds have performed very strongly relative to corporate bonds, particularly non-investment grade issues. Corporate bonds are not complicated instruments, but prices have nevertheless fallen due to concerns about corporate earnings and, again, forced selling by leveraged investors. As a result, corporate bonds are offering very high yields relative to government bonds (see Fig. 3). In our view they now present an attractive opportunity for investors prepared to take a longer term view.

Commercial property values rose strongly for five years until mid-2007. Values have now been undermined both by the withdrawal of debt financing and the subsequent economic downturn which has weakened tenant demand.

Considering our recommended asset allocations, reductions in equity weightings at the end of 2007 have helped to protect portfolios from some of the market falls but, with perfect foresight, we should have gone much further. However, after the sharp falls, equity markets now look relatively attractive on a range of measures versus their long term averages. Even making generous allowance for earnings downgrades and dividend cuts, the yields on many blue chip equities look appealing when compared to those available on other assets.

The MSCI World Equity Market index has provided a total return of -14.05% in sterling terms over the last six months and -19.84% over the last year.

Fig. 3 Corporate bond yields look attractive relative to conventional gilt yields



2. Equities

2.1. UK Equities

Economic output in the UK, as measured by GDP, declined by 1.6% in the final quarter of 2008. Following a decline of 0.6% in the third quarter, the UK is now officially in recession for the first time since 1992. Recession is evident in the labour market, with unemployment passing the two million mark in the three months to the end of January. This is the highest figure for more than a decade and amounts to 6.5% of the labour force. With unemployment rising rapidly and spare capacity developing across the economy, inflation is no longer a concern for policymakers. On the government's target measure, the Consumer Price Index (CPI), prices rose at 3.2% per annum in February, down from a recent peak of 5.2% in September. The more familiar Retail Price Index (RPI) has fallen faster still and is now showing zero inflation. The main differences between the two measures are that mortgage interest payments and house price depreciation, both components of the RPI, are excluded from the CPI.

Falling inflation has freed the hand of the Bank of England (BoE) to embark on a policy of aggressive interest rate cuts, including reductions of 1.50% and 1.00% in November and December 2008, respectively, and further 0.50% reductions in each of the first three months of this year. This has taken the Bank Rate to 0.50%, comfortably its lowest level since the creation of the BoE in 1694.

The Chancellor's Pre-Budget Report in late November was used by the government to announce a fiscal stimulus package worth up to £30bn. This included a cut of 2.5% in the rate of VAT and the bringing forward of £3bn of capital projects scheduled for 2010-11. In addition to the fiscal measures, the government has continued to support the banking sector. After full implementation of the Asset Protection Scheme, the public sector will own up to 77% of Lloyds Banking Group and 95% of Royal Bank of Scotland.

Turning to the stockmarket, the path of UK equities from here will depend crucially on the depth and longevity of the recession and the extent to which earnings downgrades are already reflected in now much lower share prices. Our view is that the sizeable correction in equities seen to date means that shares offer value in all but the very worst outcomes for growth and corporate earnings. We are, therefore, recommending that current allocations to UK equities are retained, where appropriate.

The FTSE All-Share index has provided a total return of -18.34% over the last six months and -29.33% over the last year.

2.2. European (excluding UK) Equities

Continental European consumers are not as indebted as their US or UK counterparts and most European economies do not have the corresponding balance of payments deficits seen in these two countries. Continental Europe, however, has not proved immune to the credit crisis or the accompanying economic slowdown. Eurozone GDP was 1.5% lower in the final quarter of 2008 when compared to the previous year, with falling exports being the largest contributor to declining economic output.

Germany is particularly dependent on overseas markets. In 2008 it exported goods of value equivalent to 47% of its GDP. This is far higher than any other major economy. German exporters have been long term beneficiaries of both Far Eastern demand for capital goods, such as machine tools, and the ongoing, strong growth in Eastern Europe. Both regions have been impacted by the credit crisis and Germany has suffered from a very rapid decline in export orders for industrial goods. These now stand at half the level of 12 months ago.

The strength of the European single currency has exacerbated the eurozone's economic woes. The European Central Bank (ECB) was increasing interest rates as recently as July 2008 in response to the threat of inflation and has been slow in reducing them once more. A 0.25% reduction in early April took official rates down to 1.25% but the ECB's reluctance to move as quickly as the US, UK or Japan has driven the euro higher and risks creating an even deeper recession in the eurozone. We remain of the view that the ECB will join the Federal Reserve, the BoE and Bank of Japan in settling interest rates at close to zero and in employing quantitative easing in due course.

Having advised a significant reduction in weightings to European equities at the end of 2007, we recommend that remaining allocations are retained.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of -30.33% over the last six months and -40.66% over the last year. The strengthening of the euro, means that, when translated into sterling, the returns are -18.11% over the last six months and -31.06% over the year.

2.3. North American Equities

In what was an historic statement, the Federal Reserve cut interest rates from 1.00% to “between zero and 0.25%” on 16 December and stated that it will leave rates at exceptionally low levels for as long as it takes to get the US economy functioning properly again. This represents monetary easing on a grand scale; a little over one year ago rates were 5.25%. In an attempt to avert a deep recession, interest rate cuts have been accompanied by a Federal economic stimulus package, the passage into law of the \$700bn Troubled Asset Relief Program (TARP), and an injection of capital into US banks similar to that used in the UK rescue. The central bank has also stated its intention to employ further measures, including quantitative easing; buying long-dated treasury and corporate bonds to force liquidity into the financial system. Furthermore, President Barack Obama has proposed a major fiscal expansion worth hundreds of billions of dollars.

US retail sales, so long the mainstay of the US economy, declined very steeply in the second half of 2008. There are, however, now tentative signs of stabilisation. After a 1.8% recovery in January, February’s data showed stable sales. Whether further recovery is possible without an end to house price falls is a moot point. According to the Case Shiller index, US house prices were 19.0% lower in January (the latest available data), compared with the previous year. After recording more than half-a-million job losses in each of the last four months, the US unemployment rate is now 8.5%, its highest level in 25 years.

The virtuous circle of easy credit availability driving house prices ever upwards has turned into a vicious circle. Aggressive policy responses from the Federal government, designed to break this vicious circle are now being put in place. These include programs to facilitate remortgaging at lower rates and modify mortgage terms for those whose income has fallen.

After the recent weakness, US equities look inexpensive relative to their history. However, we are aware that the US economy and the US corporate sector have yet to experience the full consequences of recession and there remains the potential for further disappointments, such as the dividend cuts announced by, among others, General Electric and Dow Chemical. We believe that allocations to US equities should be maintained for the present, where appropriate.

The S&P 500 index provided, in US dollar terms, a total return of -30.54% over the last six months and -38.09% over the last year. The strengthening of the dollar, means that, when translated into sterling, returns are -13.62% over the last six months and -14.15% over the year.

2.4. Japanese Equities

Japan, having suffered its own asset price collapse in the 1990s, seemed, at least initially, one step removed from the present financial crisis. Japanese banks have less exposure to the sub-prime assets that have damaged their US and European counterparts and the economy has not seen excessive house price increases or household indebtedness. However, as a major exporter of manufactured goods, Japan is extremely sensitive to the health of the global economy. Its economy has suffered as export demand has fallen precipitately. The impact of the global downturn has been magnified by the surging value of the yen. The Japanese currency has been driven sharply higher by the narrowing of interest rate differentials against other major currencies as rates have been cut aggressively around the world. Yen strength can also be attributed to the reversal of the carry trade, in which borrowers sold yen to invest in higher yielding assets denominated in other currencies. As export demand has fallen, Japan's trade balance has turned negative for the first time in thirteen years and the economic growth has given way to recession. Output shrank by 0.5% in the third quarter and 3.2% in the fourth quarter of 2008.

Japan's already very low interest rates were cut further, to just 0.10%, in December. The interest rate reduction was accompanied by a step up in the Bank of Japan's programme of buying Japanese government bonds. Policymakers are also considering a significant public spending program, including the printing of up to ¥50 trillion (c\$500bn) to be spent on supporting new industries and infrastructure projects in an attempt to stimulate the economy.

In the 12 months to 31 March, the yen appreciated by 28.44% against sterling, mitigating, to some degree, the very weak performance of the Japanese equity market. Nevertheless, Japanese equities remain deeply out of favour with international investors, despite now appearing attractively valued versus both their own history and by comparison with international counterparts. We therefore recommend current allocations to Japanese equities are maintained, where appropriate.

The FTSE Japan index provided, in yen terms, a total return of -29.15% over the last six months and -36.05% over the last year. In sterling-adjusted terms, the returns are -5.30% over the last six months and -10.65% over the year.

2.5. Asia Pacific (excluding Japanese) Equities

The theory that the economies and equity markets of the Asia Pacific region had decoupled from their western counterparts has now been conclusively disproved. Increased intra-regional trade and proximity to the Chinese growth story have offered little protection to the export-led Pacific economies in the midst of the synchronised global slowdown. GDP growth forecasts for the region, while still relatively healthy in comparison to those for the western economies, are now being revised downwards.

Strong economic growth drove several years of excellent returns for Asian equity markets, but also pushed them to relatively demanding valuations. These valuations are now being undermined by declining corporate profitability and Asian equities have fallen along with their western counterparts (see Fig. 4).

Fig. 4 FTSE All-World Asia Pacific ex Japan compared to MSCI World over one year (rebased)



We have, since 2006, recommended only small allocations to Asia Pacific equities in acknowledgement of the relatively high valuations and investor inflows that were taking on increasingly speculative proportions. However, we believe that the long term prospects for these markets are good and will be looking for opportunities to increase weightings when the outlook for the global economy becomes clearer. For now we continue to recommend that clients maintain their current tactical equity weightings to the region, where appropriate.

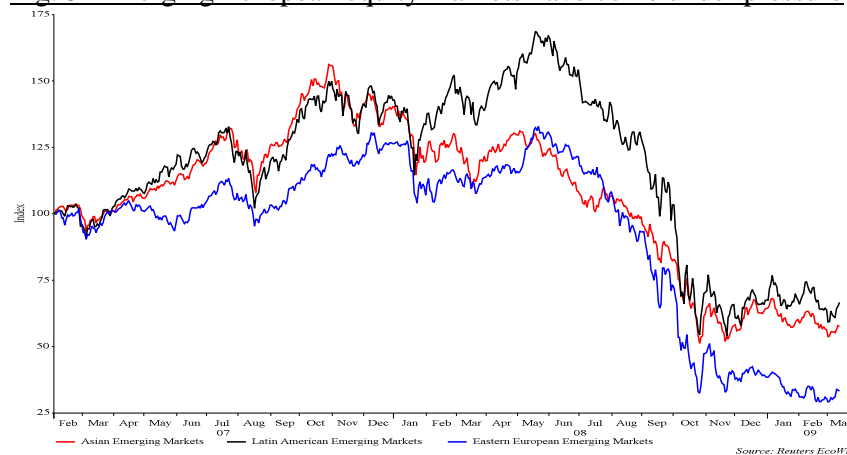
The FTSE All-World Asia Pacific ex Japan index provided, in local currency terms, a total return of -16.97% over the last six months and -33.53% over the last year. In sterling-adjusted terms, the returns are -4.49% over the last six months and -22.65% over the year.

2.6. Emerging Markets Equities

Having been a favourite destination for developed market investors, equities in the emerging markets* suffered sharp set backs as the financial crisis developed. Falling demand for exports, and natural resources in particular, means that many emerging economies are now slowing markedly from the impressive rates of growth seen in recent years.

While the emerging Asian and Latin American regions largely avoided the debt funded asset bubbles which are the root cause of the credit crunch, the same cannot be said of central and eastern Europe. Rapid increases in property prices encouraged high levels of borrowing, often in foreign currency, and many emerging European nations are now being forced to turn to the IMF and other transnational institutions for financial rescue. This has placed considerable pressure on eastern European currencies and equity markets have suffered significant losses (see Fig. 5).

Fig. 5 Emerging European equity markets have come under pressure



We have been recommending only small allocations to emerging markets equities for the last two years as, driven by strong speculative inflows, we believed these markets had become overvalued. The sell-off has gone some way to address this issue but, for now at least, we recommend maintaining current holdings, as appropriate.

The FTSE All-World Emerging index provided, in local currency terms, a total return of -27.35% over the last six months and -46.88% over the last year. In sterling-adjusted terms, the returns are -9.66% over the last six months and -26.34% over the year.

* MSCI includes 23 countries in its emerging markets indices: Argentina, Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey.

3. Fixed Interest

The value of UK government fixed interest stocks (gilts) as effective portfolio risk diversifiers has been demonstrated over the course of 2008 and early 2009. From a peak of more than 5.50% in mid-2007, the yield on the 10-year conventional gilt retreated by more than 2½ percentage points to below 3.00% by mid-March. This generated capital gains within portfolios that went some way to offsetting losses on equity holdings. Conventional gilts benefited from declining economic growth and inflation expectations and, importantly, their 'safe haven' status amid the turbulence in credit markets and falling equity prices. In cutting the base rate to a historic low of 0.50%, the Bank of England also announced its intention to increase money supply by initiating the process of quantitative easing. This initially involves the purchase of £75bn of conventional gilts from pension funds and insurance companies, who will hopefully place the funds on deposit to be used for lending to businesses and the consumer. However, such measures, together with the UK government planning record levels of new gilt issuance, have raised concerns about resurgent inflation and a lack of appetite for newly issued gilts. Yields have now risen from their sub 3.00% lows to 3.40% at the end of March.

Exposure to index-linked gilts also proved beneficial early in 2008 due to concerns about commodity driven inflation. However, as these concerns faded and investors focused instead on the possibility of recession and deflation, yields on index-linked gilts rose sharply in the third quarter of 2008 before falling back once again. Since then the performance of index-linked gilts has broadly matched that of conventional stock.

Our long-held belief that corporate fixed interest securities offered little value has meant that our recommended allocations to fixed interest have been weighted towards government bonds. While this has had a positive effect on portfolio returns, conventional gilt yields are now, in our view, too low and are vulnerable to rising inflation expectations. We have therefore been advising clients, where appropriate, to take profits in this area and look to invest in the now much more attractively valued corporate bond sectors. The lack of liquidity in the European high yield bond market means we are more cautious on the non-investment grade sector and recommend allocations to fixed interest are focused on the higher grades of corporate bonds.

The ABI UK Pension Gilt sector provided a total return of +8.35% over the last six months and +8.81% over the last year. The ABI Sterling Corporate Bond sector provided a total return of -11.13% and -15.35% over the same periods.

The ABI UK Pension Index-Linked Gilt sector provided a total return of -3.02% over the last six months and -2.39% over the last year. Shorter dated index-linked stock has performed better than this. For example, index-linked gilts with less than 5 years to maturity (as measured by the FTSE Index-Linked British Government under 5 years index), have provided returns of +0.61% over the last six months and +1.93% over one year.

4. Property

After several years of strong returns, investors in UK commercial property have suffered a major setback with property values receding substantially. Until 2007, the sector had been a major beneficiary of the large quantities of low cost debt finance that characterised the credit bubble. Increasing levels of gearing were used to leverage the steady but unexciting returns from commercial property, spurring development and, eventually, oversupply. As the credit crisis has unfolded over the last year, commercial property investors have witnessed an abrupt change in the willingness of banks to lend at low rates against property purchases. This, together with the effect of the slowing economy on property demand and, hence, falling rents, has served to drive commercial property yields sharply higher and prices correspondingly lower. UK commercial property returns, including rental income, were negative in both 2007 and 2008 as measured by the ABI UK Pension Property index.

Although commercial property yields now look attractive relative to government bonds, the level of oversupply continues to increase as projects begun before the downturn are completed and as the continued deterioration of the economic backdrop undermines demand. Commercial property valuations, therefore, are likely to remain under pressure. We are monitoring developments closely with a view to taking a more positive stance on this asset class in due course.

The ABI UK Pension Direct Property index provided a total return of -17.71% over the last six months and -22.16% over the last year.

5. Cash

Sterling deposits and monies held in AAA-rated liquidity funds can presently earn returns of around 1% over the BoE Bank Rate of 0.50% p.a. National Savings & Investments are also offering relatively attractive rates at present. However, we expect the interest rates available on both deposits and liquidity funds to trend down towards the Bank Rate in the coming months.

Despite lower rates, cash still has its attractions and we continue to favour an overweight position in the asset class, particularly where attractive fixed rates from government-backed, or good quality institutions can be secured. From an asset allocation perspective, cash deposits offer strong defensive qualities (provided the appropriate credit risk due diligence has been undertaken). Cash, whether on deposit or placed in a liquidity fund, also brings flexibility to portfolios, enabling investors to take advantage of opportunities in other asset classes as and when they arise.

Cash invested at the BoE Bank Rate would have provided a return of +1.09% over the last six months and +3.60% over the last year.

6. Note on Hedge Funds

Our view that hedge funds are riskier than generally perceived is gaining wider acceptance. While we continue to research the sector, the transparency of many hedge funds' investment processes is not sufficient for us to be comfortable recommending their inclusion in portfolios. Liquidity, valuation of assets and the level of charges are all areas where we believe investors deserve, and should demand, more clarity. The arrest of hedge fund manager Bernard Madoff for alleged fraud and the subsequent losses from many purportedly expert fund of hedge fund managers highlight the lack of disclosure in such vehicles and our consequent unease with the asset class.

According to Hedge Fund Research, a composite index of hedge funds fell 19% in 2008, the biggest annual decline since the company began tracking data in 1990. Among the casualties are some high profile names; Citadel Investment's flagship fund, which at \$10bn is one of the industry's largest, fell 55% in 2008. Atticus European, meanwhile, lost investors more than 43% over the year. Others employing high levels of gearing have found themselves even more severely impacted. As credit availability has decreased, geared hedge funds have had little choice but to sell their underlying assets at whatever prices are available in the market. This forced selling looks likely to have intensified in the fourth quarter as hedge fund investors continued to file significant redemption requests.

For completeness, we include the HFRX Global Hedge Fund index figures for hedge fund performance below. We remain, as might be expected, somewhat sceptical about the integrity of these figures. In our view, the index will almost certainly overstate returns. This is because the submission of data to the index compilers is voluntary and it is unlikely that failed or poorly performing funds would submit numbers for inclusion. The effect will be that the index figures overstate the true performance that might be expected from a range of hedge fund investments, perhaps by as much as several percentage points.

The HFRX Global Hedge Fund GBP index provided a total return in sterling terms of -13.30% over the last six months and -20.32% over the last year.

The above commentaries reflect our views as at 8 April 2009. Any material changes in economic and market conditions between then and the time of writing your report will be reflected in our recommendations.

Unless otherwise noted, all performance figures are total returns (including income re-invested) for the six month period from 30 September 2008 to 31 March 2009 and the twelve month period from 31 March 2008 to 31 March 2009 (source: Lipper Hindsight).