

Market Commentary

February 2011

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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 10 February 2011. 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.

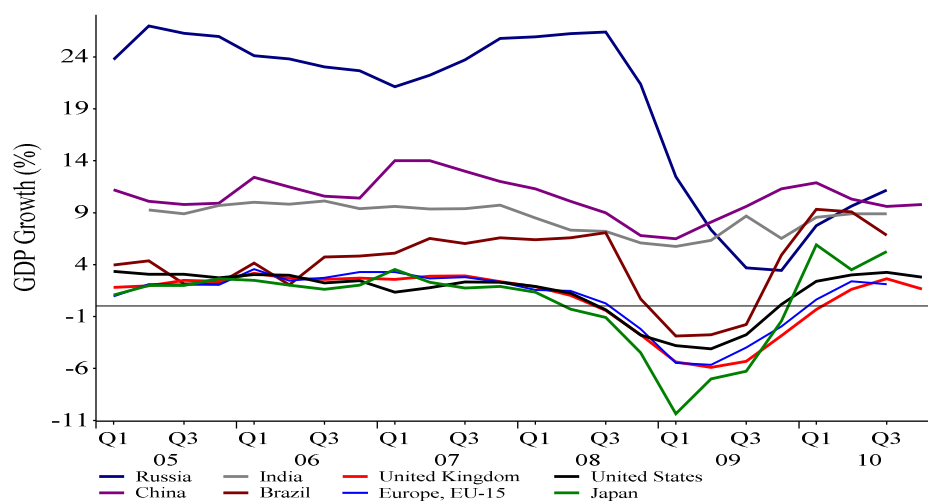
1. Economic Outlook

After shrinking in 2009, the global economy grew by 5.0% in 2010 according to figures from the IMF. While this is a healthy rate of expansion, growth has been very much skewed in favour of developing, rather than developed, economies (see Fig. 1 below). More importantly, what growth there has been in developed markets has been achieved only with the support of ultra-accommodative monetary policies, including low interest rates and quantitative easing.

December's tax-focused US fiscal stimulus, accompanying the second draught of quantitative easing (QE) from the US central bank, the Federal Reserve (Fed), stands testament to the unsatisfactory nature of the economic recovery in the United States. In the eurozone, crises in Greece and Ireland have required EU and IMF intervention to head off sovereign default, while in Japan, the authorities have resorted to currency intervention to try to regain competitiveness in their export sector. Only in the emerging markets of the Far East and South America has strong economic growth been achieved without government support.

Looking ahead, 2011 is likely to see the global economy continuing to 'muddle through', much as it did in 2010. Governments and central banks in the developed world will be keen to begin the process of policy normalisation, but will need to remain mindful of the risk of choking off growth and sending their economies back into recession. In emerging economies, inflation is the principal threat and monetary tightening is already taking place to ensure this does not become entrenched. Three other threats to the continuation of the recovery that can be easily identified include: (i) a recurrence of crisis in the eurozone, this time perhaps engulfing major economies such as Spain and Italy, (ii) a sharp slow down in China's economy, and (iii) a US bond market crisis triggered by the parlous state of the economy's public finances.

Fig. 1 Economic Growth in Developed and Developing Economies



The following sections discuss the outlook for selected markets and asset classes.

2. Equities

2.1. UK Equities

The first estimate of UK GDP for the fourth quarter of 2010 showed that the economy contracted by 0.5%. While we have said for some time that we thought the pace of the recovery would moderate, a drop in output was unexpected. Stalling growth and stubborn inflation, with prices in December 3.7% higher over one year on the CPI measure (4.8% on the RPI measure), have prompted discussion in the media about the prospect of stagflation – persistent inflation with little or no economic growth. The prospect of rising inflation increases the pressure on the Bank of England's Monetary Policy Committee (MPC) to start normalising interest rates, while also runs the risk of further undermining growth.

In our view, however, the UK economy is not heading for stagflation. A large proportion of inflation is accounted for by tax increases and higher raw materials prices. Stripping these out, domestically generated inflation falls below the MPC's CPI target of 2%, due to a weak labour market keeping wage growth low. In addition, we doubt that inflation will become entrenched, given the deflationary impact of the government's austerity measures and the fact that tax and commodity price increases will drop out of the annual inflation numbers later this year. The pace of economic growth, meanwhile, should pick up in 2011. The Office of National Statistics estimates that the drop in output in the fourth quarter was largely attributable to weather conditions. Any resumption of economic activity, put on hold by the cold weather, should provide a boost to GDP growth in the current quarter. This view is supported by the robustness of business confidence and manufacturing orders surveys, which suggests that the private sector is growing strongly.

We remain of the view that UK equities are attractive. During the economic downturn, many UK businesses cut costs aggressively and raised fresh capital to strengthen their balance sheets. This has left them in good financial shape, with scope to expand profit margins as sales recover. As a result, any increase in revenues should translate into significantly higher profits. This has been borne out by the strength of the earnings recovery to date.

Valuations in the UK remain reasonable and the stock market offers an attractive dividend yield relative to the yields available on cash, gilts and the highest rated corporate bonds. Historically, this has been a good indicator of future returns, though we are mindful that investor sentiment is a strong driver of the market in the short term. Given the value case for UK equities, our recommendation is that current allocations are maintained.

The FTSE All-Share index has provided a total return of +13.54% over the last six months and +18.13% over the last year.

2.2. European (excluding UK) Equities

January's debut bond offering by the European Financial Stability Facility (EFSF) saw strong demand, attracting orders from more than five hundred investors and totalling €44.5bn, almost nine times the €5bn of paper on offer. Demand for the AAA-rated issue, priced at a 40bp yield premium over equivalent German government bonds, was particularly robust from sovereign wealth funds and Asian investors, with the Japanese government buying over 20% of the issue. The subsequent fall in bond yields of the peripheral eurozone nations has raised hopes that, following the bailouts of Greece and Ireland in 2010, a further full-blown eurozone crisis can be avoided. With a potential expansion of the EFSF to include increasing the facility's lending capacity from its current €250bn, or allowing it to buy the government bonds of troubled countries in the secondary market, the chances of a benign outcome to the eurozone sovereign crisis have increased.

Given peripheral eurozone debt concerns, it is perhaps surprising that recent economic data in the region has been encouraging. The region's economy managed growth of 0.3% in the third quarter of 2010. However, this was heavily reliant on the German economy, where industrial production grew 10.0% year-on-year in December with factory orders growing at an annual pace of 21.9%. While the strength in the German economy was initially led by exports (boosted by a weaker euro) recent data has shown signs that the fall in unemployment, to 7.4% in January, is beginning to feed through into domestic consumer price growth.

While we expect the negative implications of the peripheral government bailouts to dominate headlines for some time yet, the core eurozone region contains many companies that generate a significant proportion of their revenues in the US, Asia and emerging markets and therefore should be relatively immune from continued weakness in the non-core eurozone economies. German companies, for instance, have spent much of the past two decades establishing strong footholds in emerging Asian and Latin American economies. Meanwhile, the weaker euro will have increased the competitiveness of, and thereby the demand for, European exports. Moreover, valuations remain undemanding relative to history and to other asset classes.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of +11.29% over the last six months and +16.85% over the last year. When translated into sterling, the returns are +14.50% over the last six months and +15.30% over the year.

2.3. North American Equities

Optimism about the US recovery has risen in recent months, fuelled by a raft of positive economic data releases. The economy expanded at an annualised rate of 3.2% in the fourth quarter, resulting in 2.9% growth for 2010, its strongest year since 2005. Growth was driven by a pick-up in consumer spending, which rose each month in the second half of the year to record a 3.5% overall increase for 2010, its fastest pace in four years. The manufacturing sector, meanwhile, continues to show strength, expanding for the 18th successive month in January to its highest level since 2004. According to a survey of estimates by Bloomberg, forecasts for US economic growth now exceed 3% for both 2011 and 2012, though it is likely that improvements in the housing and job markets will be required if this rate is to be realised.

Although the unemployment rate has fallen from 9.8% to 9.0% in the last two months, there has not been an accompanying rise in payrolls, indicating, perhaps, that significant numbers have left the unemployment list. Fed Chairman Ben Bernanke notes that the decline in the unemployment rate is likely to be slow, even with an increase in growth in 2011, adding that 'it could take four to five more years for the job market to normalise fully'. The Fed has taken action to help accelerate progress here, deciding in November to proceed with a second round of QE. President Obama followed this by extending the Bush-era income tax cuts for all Americans, renewing jobless benefits for the long-term unemployed, and granting a one-year reduction in Social Security taxes. While these measures should help to boost economic growth, they exacerbate the country's fiscal deficit, which has grown tenfold since 2001 to \$1,230bn and now equals 8.0% of GDP. An expanding economy will help America's fiscal position, though the burden will need addressing soon. This is the next challenge for US policymakers, who will want to keep the recovery on track.

Against the improving economic backdrop, company news flow has been strong, helping the US equity market return to pre-Lehman crisis levels. More than 73% of the 287 companies in the S&P 500 that have reported fourth quarter results have beaten earnings-per-share projections, according to Bloomberg. Encouragingly, sales have beaten projections by an average 2.3%, the most in two years, meaning that earnings growth is being driven not by cost-cutting, but by improving demand. A buoyant corporate environment looks set to continue into 2011 and, in our opinion, US equities are attractively valued both against history and versus US government bonds. We believe the US equity market is well placed to make progress and recommend that current allocations are maintained.

The S&P 500 index provided, in US dollar terms, a total return of +17.93% over the last six months and +22.19% over the last year. In sterling terms, the returns are +15.30% over the last six months and +22.24% over the year.

2.4. Japanese Equities

Investors received mixed signals from Japanese macroeconomic indicators released in January. The PMI Manufacturing index, which gauges manufacturing activity and is a leading economic indicator, rose to 51.4, signalling expansion in the sector. The construction industry was also buoyed by an unexpectedly sharp 7.5% jump in housing starts. However, deflation remained firmly entrenched, as prices fell 0.3% year-on-year, and a weak employment picture translated into a slowdown in consumption. The job-to-applicant ratio fell to 0.57, while wages fell 0.4%, with employers cutting back on hiring and year-end bonuses in anticipation of a tough 2011. Consumers responded by tightening their belts in spite of the festive season; household spending dropped sharply, down 3.3% year-on-year.

A major development in January was the downgrading of Japan's sovereign debt by one notch to AA- by credit rating agency Standard and Poor's (S&P), the first downgrade for nine years. S&P believes that the government debt ratio will continue to rise and by more than previously estimated, as Japanese politicians remain reluctant to make the necessary reforms to address the deficit issue.

After rising 14% against the US dollar in 2010, the yen was broadly unchanged over the month of January. The yen initially weakened 3% against the US dollar after positive US economic data and investor sentiment drove an improvement in risk appetite. However, this was reversed after flaring tensions in Tunisia culminated in the overthrow of its government, inciting similar riots in Egypt and threatening to spread to other states in the Middle East region. These political issues prompted nervous investors to seek the "safe haven" status of the Japanese currency, and at the time of writing, the yen/dollar rate trades below the 82.0 mark. This is a much stronger level than the average rate of 86.5 budgeted for by Japanese manufacturers (according to the Tankan survey), and if the yen continues to trade at these levels, it is likely that profitability will be negatively impacted.

Japan continues to face a number of headwinds, but this is, to some degree, reflected in the low valuations on which Japanese equities trade relative to their international peers – many industry-leading multinationals continue to trade close to or at a discount to their book value. The opportunities created by a global economic recovery should be balanced against the seriousness of these structural issues and, thus, we are not, for now, recommending increased allocations.

The FTSE Japan index provided, in yen terms, a total return of +8.10% over the last six months and +2.38% over the last year. Yen strength means that, in sterling-adjusted terms, the returns are +11.80% over the last six months and +13.33% over the year.

2.5. Asia Pacific (excluding Japanese) Equities

January proved to be a generally subdued month for stock markets in the region, as the benchmark MSCI AC Asia Pacific ex. Japan index fell c2% on low volatility. Strength in defensive, consumer-related sectors was offset by weakness in financials and cyclical stocks as central banks remained committed to monetary tightening measures.

Floods continued to plague Australia's eastern coastal states, destroying infrastructure and shutting down mining operations, pushing commodity prices higher. Turmoil in the Middle East contributed to higher food prices as governments stockpiled grains in anticipation of supply disruptions. These events kept inflation expectations in the Asia Pacific region elevated, to which policymakers in many economies responded by raising interest rates. Higher interest rates are likely to raise the cost of debt and negatively impact corporate profitability (and thus, stock prices) over the short term. However, in our view, these measures are necessary to prevent longer-term problems such as an overheating economy. Overall, we believe the Asia Pacific ex. Japan sector should continue to benefit from the region's strong economic fundamentals and favourable demographics.

Fig. 2 Price to Earnings Ratio of Asian and US Stock Markets



On fundamental measures of value, such as price to earnings (see Fig. 2), equity valuations in the region trade a touch above their long-term averages, but well below their historical peaks, and broadly in line with the developed world. We do not think these valuations are overly demanding given the higher growth potential of these markets. We recommend that current allocations to the sector are maintained where appropriate.

The FTSE All-World Asia Pacific ex Japan index provided, in local currency terms, a total return of +11.92% over the last six months and +19.43% over the last year. When translated into sterling, the returns are +14.72% over the last six months and +26.03% over the year.

2.6. Emerging Markets Equities

Emerging market equities stalled during the first month of 2011 as concerns regarding inflation and tensions in the Middle East affected investor sentiment. While the broader market, represented by the MSCI Emerging Markets index^{*}, fell c2% in dollar terms in January, this masked disparities across emerging markets. The Indian stock market, suffering from inflation concerns and extended valuations, fell c13%, while equity markets in Egypt remained closed. However, Eastern European stock markets were notably stronger as a result of improving stability of the peripheral eurozone economies.

Emerging market economies continue to grow at a rapid pace (China, for example, recorded GDP growth of 10.3% in 2010, while India grew at a rate of 8.5%). However, policy-makers are faced with a number of headwinds, the most notable being inflation, particularly of food prices. Food prices in emerging markets are c12% higher than at the end of 2009 and, given adverse weather conditions and structural increases in demand, prices appear unlikely to soften in the short term. In order to combat mounting inflationary pressures, many economies are raising interest rates. China has increased interest rates twice, in 25bp increments, over the last six weeks, while India, Brazil, South Korea and Taiwan are among those that increased interest rates in January. Rising emerging market currencies, driven in part by investor inflows, have also proved challenging. The Brazilian real has appreciated by c13% since May last year, while the Taiwanese dollar reached a 13-year high versus the US dollar at the end of 2010. This has resulted in some emerging economies imposing taxes on foreign investment in an attempt to cool speculative inflows. During 2011, emerging market policy-makers will face the difficult task of controlling inflation, without damaging growth too much, while trying to mitigate the effects of increased liquidity created by the West.

Emerging markets have outperformed their developed world counterparts in both of the last two years, buoyed by stronger growth prospects. While disparities between the growth expectations of various emerging market economies and the valuations of their equity markets are becoming evident, the broader MSCI Emerging Markets Index does not look overpriced – trading on c16x forward earnings, which is broadly in line with developed markets. We view this valuation as fair given the higher growth potential but more volatile, economically sensitive nature of the emerging markets. We therefore recommend that current allocations are maintained, where appropriate.

The FTSE All-World Emerging index provided, in local currency terms, a total return of +12.69% over the last six months and +22.09% over the last year. In sterling-adjusted terms, the returns are +10.18% over the last six months and +22.14% over the year.

* MSCI includes 21 countries in its emerging markets index: Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey.

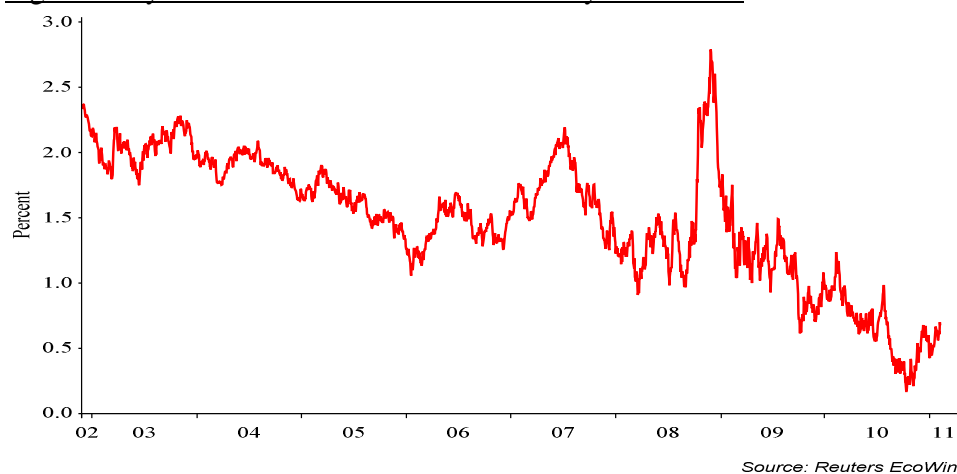
3. Fixed Interest

Since the end of August 2010, government bond yields in major western economies have risen sharply, with the 10-year gilt yield climbing from 2.83% to 3.83% at the time of writing. Inflationary pressures and positive sentiment regarding economic growth suggest that yields may go higher still, and prices therefore lower. However, we would be surprised to see gilt yields return to their more normal 4.5-5.5% range until the UK's economic recovery becomes self-sustaining. With unemployment still elevated at 7.9%, this may be a couple of years away.

At present, conventional government bonds only look attractive in a scenario that sees the global economy slide back towards recession and deflation. However, with policy measures in the developed world largely supportive of economic growth, and leading macroeconomic indicators, such as business sentiment and orders surveys, pointing towards reasonably strong growth, we think this risk is slim. We therefore continue to recommend zero allocations to conventional government debt, considering it vulnerable to rising inflation expectations and gradually normalising interest rates.

While much of the current inflationary pressures in the UK can be explained by tax and commodity price rises, there remains the risk that the extraordinary monetary stimulus employed to counter the effects of the financial crisis leads to meaningfully higher global inflation at some point in the future. As a result, we recommend maintaining existing allocations to inflation-linked bonds. However, we view UK index-linked gilts (ILGs) as fairly fully valued. Fig. 3 shows that the real yield on the 2½% Index-Linked Treasury Stock 2020 is low relative to its own history, though has started to rise over recent months.

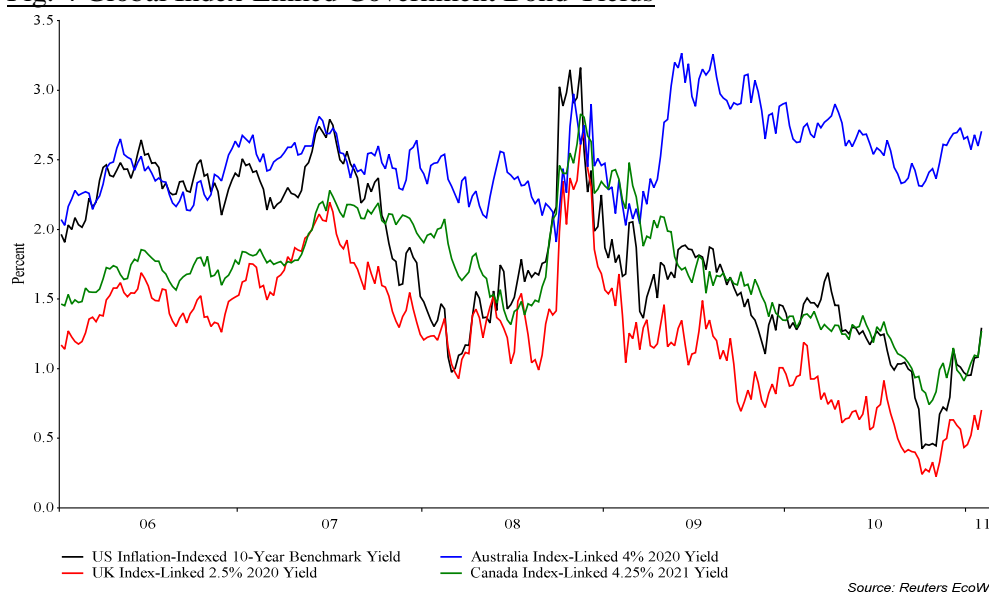
Fig. 3 Real yield on 2½% Index-Linked Treasury Stock 2020



A key driver behind the low yields on ILGs is the need for pension and insurance funds to buy them, almost regardless of price, in order to match the real liabilities of inflation-linked pensions. This structural demand for index-linked bonds is largely UK-specific. As such, Canadian, US and Australian inflation-linked bonds, among others, offer significantly higher real yields than their UK counterparts (see Fig. 4).

We therefore recommend that, where appropriate, allocations to index-linked bonds are weighted towards sterling-hedged funds of global inflation-linked bonds. As well as obtaining higher real yields, managers of such funds may also exploit duration and relative value opportunities to add further value. Our view is that such funds will offer a degree of protection if real yields on ILGs revert to the levels at which they have traded in the past.

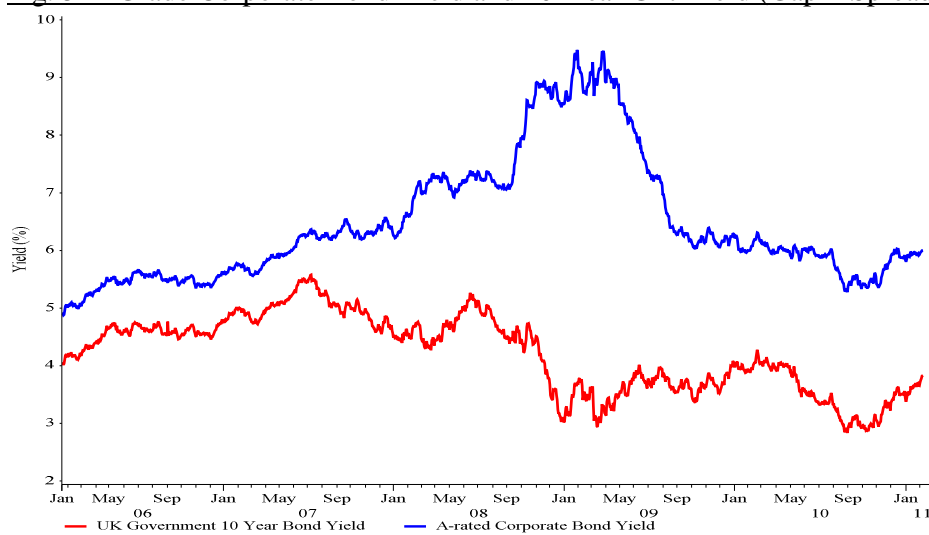
Fig. 4 Global Index-Linked Government Bond Yields



Source: Reuters EcoWin

Turning to our preferred defensive asset class, corporate bonds, we still believe that valuations are attractive despite the compression of absolute yields since early 2009. Spreads over government bonds remain wide relative to recent history (see Fig. 5), and have protected investors from rising gilt yields over 2011 to date. Implied default rates are low and, in aggregate, corporates have strong cash balances due, in part, to the outsourcing of labour and component production to cheaper areas overseas.

Fig. 5 A-Grade Corporate Bond Yield and 10-Year Gilt Yield (Gap = Spread)



Source: Reuters EcoWin

While continuing to favour corporate bonds we do acknowledge that they may be vulnerable to a further increase in government bond yields. We have therefore been recommending that corporate bond allocations are invested in bond funds with more strategic mandates. The managers of these funds invest where they believe the market is rewarding them appropriately for risk, while avoiding areas that look expensive. They can also hedge interest rate risk and exploit arbitrage opportunities between different bond issues to protect and add value. Such funds are also our preferred route for obtaining exposure to non-investment grade corporate debt, which is less sensitive to interest rates but carries greater default risk.

The ABI UK Pension Gilt sector provided a total return of -0.02% over the last six months and +3.70% over the last year. The ABI UK Pension Index-Linked Gilt sector provided a total return of +4.36% over the last six months and +6.08% over the last year. The ABI Pension Sterling Corporate Bond sector provided a total return of +1.54% and +5.78% over the same periods.

4. Property

The UK commercial property market has staged a healthy recovery since we recommended increasing allocations in October 2009 and now appears fairly valued. Property yields are, on average, c6.4% and offer a reasonable spread over gilt yields. This is necessary compensation for depreciation, the illiquidity of commercial property and the risk of default by tenants. However, yields vary across regions and sectors. Central London offices have yields as low as 4%, though rents are now rising, thanks to the capital's stronger economy and occupiers paying up for limited space – a consequence of a dearth of construction during the credit crisis. In contrast, regional industrial assets, where rents are still declining, can be purchased on yields above 9%.

Despite the relatively attractive yield on offer, the recovery in capital values has slowed recently which, in our view, is the result of several factors that may continue to persist. Firstly, some investors will be taking profits after strong gains. Secondly, we note that there has been a fall in the number and value of purchases, particularly from institutional investors, since mid-2010. Simultaneously, there has been an increase in sales, particularly by banks.

We believe that, in order for capital values to make significant progress from here, rental growth needs to become more broad-based. This is likely to depend on the pace of the economic recovery in the UK as, historically, rental growth has been closely correlated with GDP growth. Although the private sector is showing signs of a strong recovery, spending cuts in the public sector may still undermine rents, particularly in the North. However, that does not mean we are pessimistic on the prospective returns from UK commercial property over the coming year. If prices remain static, an income yield greater than that offered by cash and gilts is still attractive. We also believe that, in a reasonably stable environment, skilled fund managers should be able to add capital value through asset enhancement, lease extensions and re-lettings.

The ABI UK Pension Direct Property index provided a total return of +2.68% over the last six months and +8.83% over the last year.

5. Cash

Sterling deposits and monies held in AAA-rated liquidity funds presently earn returns broadly in line with the BoE Bank Rate of 0.50% p.a. Despite low rates, cash still has attractions, particularly where better rates from government-backed or good quality institutions can be secured. Cash, whether on instant access 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 returned +0.25% over the last six months and +0.50% over the last year.

6. Note on Hedge Funds

Our view that hedge funds are riskier than generally perceived gained wider acceptance during the financial crisis. 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.

According to Chicago-based group Hedge Fund Research, more than 1000 hedge funds were liquidated in both 2008 and 2009, including those run by a number of high profile managers. However, the third quarter of 2010 saw hedge fund launches overtake liquidations for the first time since 2008. As investment banks have downsized their proprietary trading desks, a number of traders have taken the opportunity to set up their own funds. Despite this, the number of liquidations may climb higher since, as at the end of the third quarter, 44% of hedge funds were yet to meet their high-water mark for 2010, a serious issue for those managers without substantial assets under management.

In our view, the industry's ability to justify high charges and performance fees remains questionable. Nevertheless, the hedge fund industry has emerged from the financial crisis in a very different shape. A smaller universe of funds, generally employing lower leverage, charging, on average, lower fees and offering better compliance standards, higher levels of communication, greater transparency, more appropriate and independent valuation methods and greater liquidity are, in our view, all welcome developments. For completeness, we include the HFRX Global Hedge Fund index figures for hedge fund performance below, although we are, as might be expected, somewhat sceptical about the validity of these figures.

The HFRX Global Hedge Fund GBP index provided a total return in sterling terms of +5.73% over the last six months and +5.69% over the last year.

The above commentaries reflect our views as at 10 February 2011. 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 31 July 2010 to 31 January 2011 and the twelve month period from 31 January 2010 to 31 January 2011 (source: Lipper Hindsight).