Market Commentary

March 2009

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Contents **Page**

<u>Risk Warnings</u>

This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 13 March 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

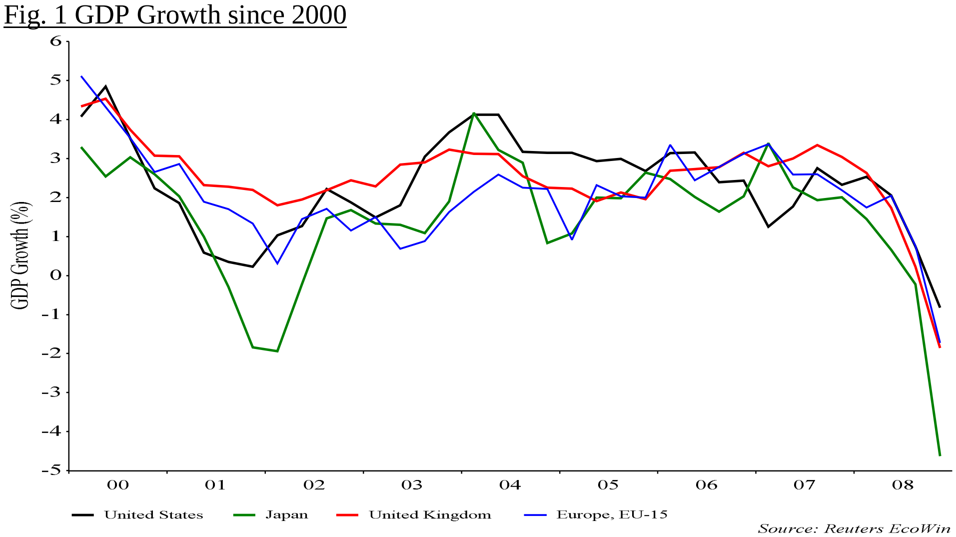
Global economic output looks likely to contract this year for the first time since the Second World War. This represents a major deterioration for the global economy; as recently as October 2008 the IMF forecast 3.0% world growth for this year, itself a much lower figure than the 5.0% achieved in 2007. With the global economy weakening at such a pace it is unsurprising that investment markets remain extremely volatile.

Governments across the developed world, already struggling with inadequately capitalised banks and malfunctioning credit markets, have now added fiscal packages to their armoury in an attempt to put their economies back onto a more stable footing. Many new policy initiatives are now in place and, while it is too early to judge the success of these, aggressive action taken by the authorities in September and October to underpin the fragile financial system does appear to have met with success. As a result, confidence has risen somewhat and the extreme risk aversion witnessed in mid-October has eased.

Having reduced official interest rates as far as practical, the monetary authorities in the US and UK have now turned to unconventional policies to support economic activity. 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 the second phase of the economic crisis – a deep global recession turning into a depression or prolonged slump caused by credit starvation and deleveraging by 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 the recession 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.

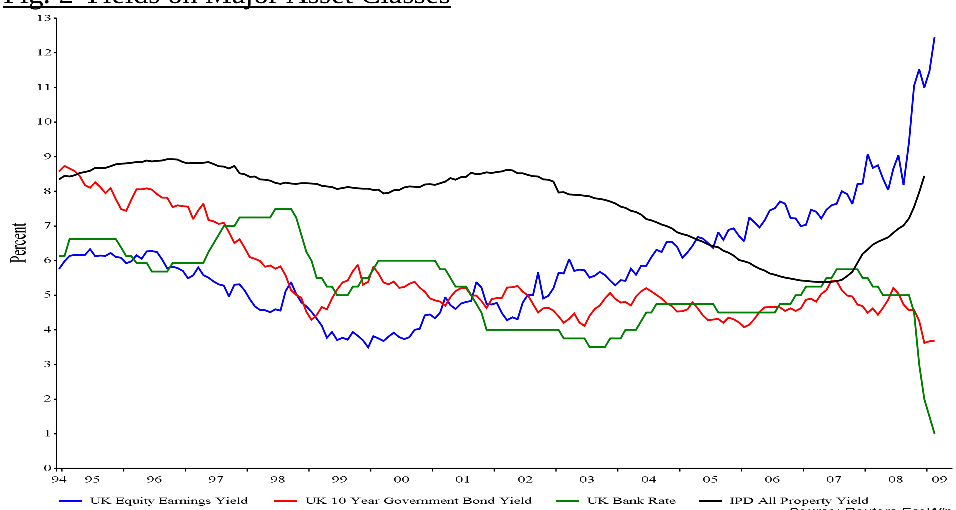
Fig. 1 GDP Growth since 2000



Over the last 18 months, we have seen many of the assumptions, on which confidence in financial markets was based, turned on their heads. One such 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 also many others, from investment banks such as Lehman Brothers to hedge funds that were borrowing short term money and investing in higher yielding, longer term assets (the now infamous carry traders). Many industrial businesses have also been affected, prime amongst them the auto manufacturers. The withdrawal of easy credit terms has caused a sharp fall in car sales and governments around the world are taking measures to support the industry, most notably in the US where General Motors and Chrysler have received bail-outs totalling $17.5bn.

Within the mainstream asset classes, equities have suffered as expectations of lower economic growth and therefore lower profitability have been reflected in valuations. Equities have also been a source of liquidity for investors needing to raise cash. As buyers for assets such as high yield bonds, property and structured debt instruments have become scarce, forced sellers, including hedge funds facing redemption requests, have sold equities. Moreover, because so many investors had used leverage to gear market returns, the number of forced sellers (those who need to sell regardless of price), appears to be 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 fifteen 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.

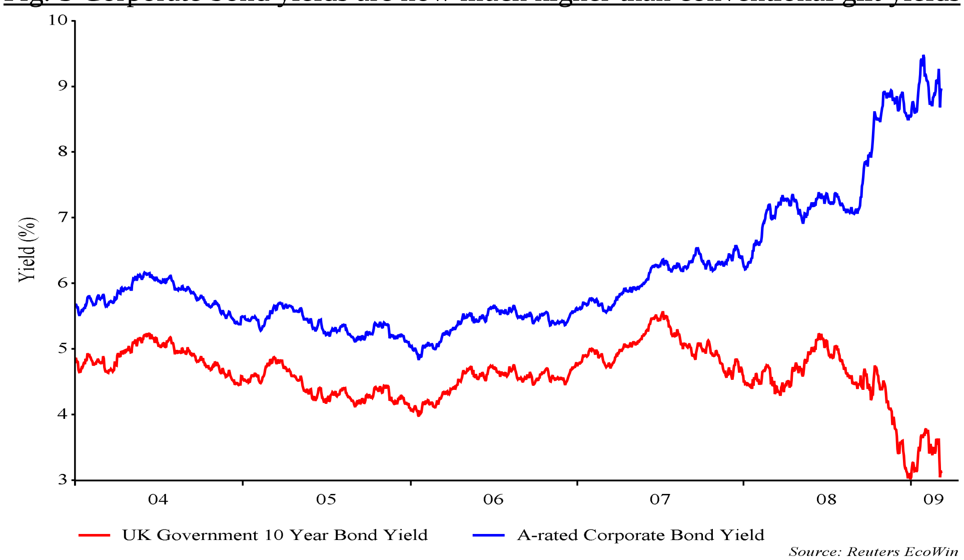
Turning to other asset classes, fixed interest markets have seen a very marked rise in risk aversion, as investor appetite for complex structured instruments, such as collateralised debt obligations (CDOs), has evaporated. As a result, government bonds have performed very strongly relative to corporate bonds, particularly non-investment grade issues. Corporate bonds are not complicated instruments, but prices have nevertheless fallen sharply due to concerns about corporate earnings. As a result, corporate bonds are now trading on some of the widest spreads over government bonds ever recorded and look attractive for investors prepared to take a longer term view (see Fig. 3).

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 asset classes.

The MSCI World Equity Market index has provided a total return of -27.54% in sterling terms over the last six months and -25.70% over the last year.

Fig. 3 Corporate bond yields are now much higher than conventional gilt yields



2. Equities

2.1. UK Equities

Economic output in the UK, as measured by GDP, declined by 1.5% in the final three months 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 now evident in the labour market, with unemployment now higher than at any time since 1998, having reached 6.3% for the three months to the end of December (the latest date for which the Labour Force Survey is available). Inflation, not long ago a major policy concern, is now easing. On the government's target measure, the Consumer Price Index (CPI), prices were rising at 3.0% per annum in January, down from a recent peak of 5.2% in September. For comparison, the more familiar Retail Price Index is showing prices increasing at just 0.1% per annum. The main differences are that mortgage interest payments and house price depreciation 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, 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 includes 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 the Royal Bank of Scotland.

Turning to the stockmarket, the path of UK equities from here will depend crucially on the depth and shape of the economic slowdown and the extent to which earnings downgrades are already reflected in 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 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 -31.40% over the last six months and -32.98% over the last year.

2.2. European (excluding UK) Equities

Until our recommendation to reduce allocations to European equities at the end of 2007, the Continent had been our favoured destination for investments into overseas markets. Clients were well rewarded by adopting this stance as European (ex UK) equities outperformed those of the US, UK and Japan over the three years to the end of 2007.

One of the main reasons for our recommendation to reduce allocations was our view that the eurozone would not prove immune to the credit crisis or the accompanying economic slowdown that was already impacting the US and UK. This, with a time lag of several months, proved to be the case. While continental European consumers are not as indebted as those in the US or UK, and while Northern Europe did not see such rapid house price inflation, continental European economies were vulnerable in other ways. They had been long term beneficiaries of both Far Eastern demand for exports and the continuing economic development of Eastern Europe. Both have been badly affected by the credit crunch. Germany, in particular, has suffered from a very rapid decline in export orders for industrial goods which fell by 42.5% over the 12 months to the end of January.

The impact of slowing export orders, particularly those from emerging economies which were building up infrastructure and industrial capacity, has been exacerbated by the recent strength of the euro. As a result, Eurozone GDP fell 1.5% in the final quarter of 2008. The European Central Bank (ECB), which was increasing interest rates as recently as July 2008 in response to the threat of inflation, is now easing rates aggressively, with a 0.5% reduction in early March taking official rates down to 1.5%. We believe that it is likely to join the Federal Reserve and the Bank of England in employing quantitative easing in due course.

After the recent weakness, we recommend that current allocations to European equities are retained.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of -40.37% over the last six months and -44.46% over the last year. The strengthening of the euro, means that, when translated into sterling, the returns are -34.17% over the last six months and -35.15% 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, such as quantitative easing; buying long-dated treasury and corporate bonds to force liquidity into the financial system. Furthermore, President Barack Obama is proposing a major fiscal expansion worth hundreds of billions of dollars.

US retail sales, so long the mainstay of the US economy, are now being undermined by falling house prices and rising unemployment. US house prices, according to the Case-Shiller Home Price index, were 19.2% lower in December (the latest available data), compared to the previous year. After recording more than a half-a-million job losses in each of the last four months, the US unemployment rate is now 8.1%, its highest level since 1992.

The virtuous circle of easy credit availability driving house prices ever upwards has turned into a vicious circle. The banking sector, paralysed by losses already incurred on structured mortgage assets, has retrenched, reducing the availability of credit to consumers, thereby exacerbating house price falls and further undermining consumer confidence. However, falling government bond yields may offer some relief to homeowners. In contrast to the UK, US mortgages are predominantly determined by reference to the 10-year government bond yield. As this falls, mortgagors have the chance to refinance at lower rates, thereby reducing their monthly outgoings.

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 -41.82% over the last six months and -43.32% over the last year. The strengthening of the dollar, means that, when translated into sterling, returns are -25.56% over the last six months and -20.90% over the year.

2.4. Japanese Equities

Japan, as a major exporter of manufactured goods, is extremely sensitive to the growth of the global economy. As such, Japan's economy has suffered as demand for its exports has waned. The impact of the global downturn has been exacerbated by a resurgent currency. The yen has been boosted by the narrowing of interest rate differentials against other major currencies as rates have been cut aggressively around the world. It has also strengthened as a result of the reversal of the carry trade, where borrowers sold yen to invest in higher yielding assets denominated in other currencies. Currency strength has undermined demand for export goods, leading Japan to its first trade deficit in thirteen years in January and tipping the economy into recession, with output shrinking by 0.5% in the third quarter and 3.2% in the fourth quarter.

Japan is slightly removed from the centre of the global 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. However, with weak domestic consumption, the Japanese economy is reliant on overseas demand, and therefore continues to suffer along with the major Western economies. In January, month on month industrial output fell by 10.2%, the steepest fall on record.

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 ($500bn) to be spent on supporting new industries and infrastructure projects in an attempt to stimulate the economy.

In the 12 months to 28 February, the yen appreciated by 32.65% 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.

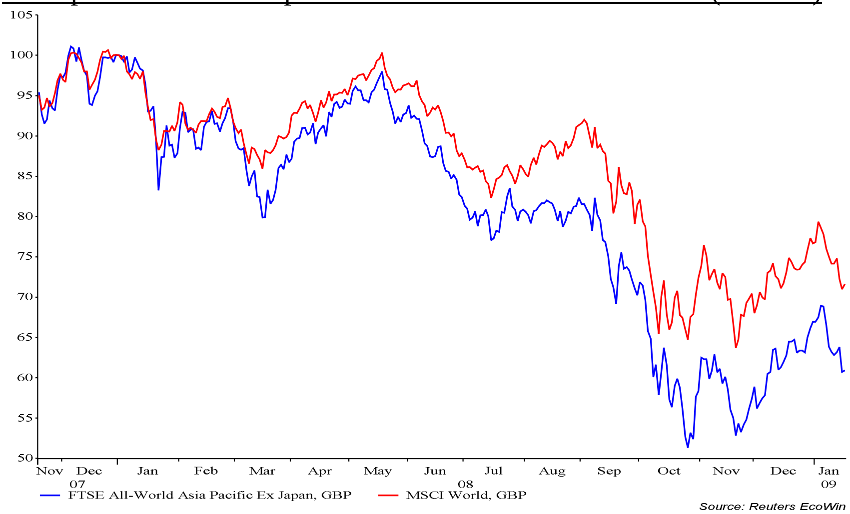
The FTSE Japan index provided, in yen terms, a total return of -40.34% over the last six months and -43.09% over the last year. In sterling-adjusted terms, the returns are -15.32% over the last six months and -15.49% over the year.

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 intraregional 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 sharply 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 underperformed their western counterparts as a result (see Fig. 4).

Fig. 4 FTSE All-World Asia Pacific ex Japan equities have underperformed developed markets since the start of 2008 (rebased)



We have, since 2006, recommended only very small allocations to Asia Pacific equities in acknowledgement of the relatively high valuations. However, we continue to believe they offer good long term prospects as the economic fundamentals remain promising. Though valuations have become significantly more attractive after the recent sell-off, we believe earnings estimates remain too optimistic and we therefore continue to recommend that clients maintain their current low tactical equity weightings to the region, where appropriate.

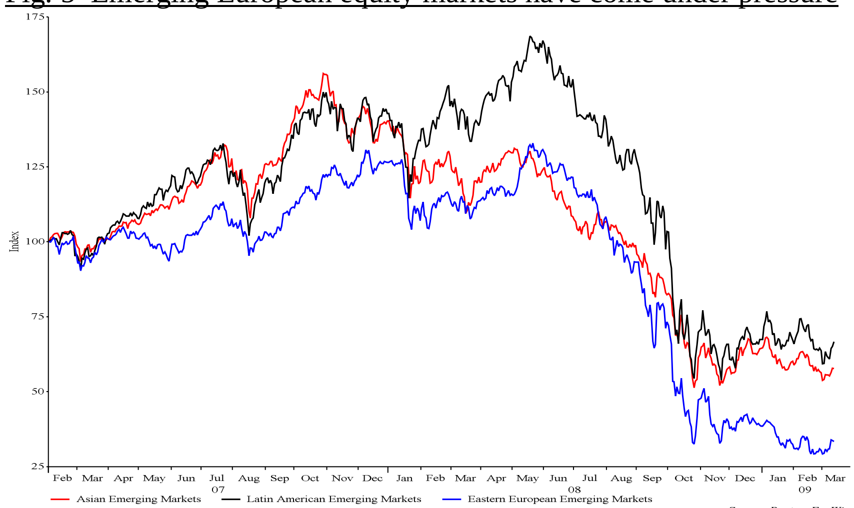
The FTSE All-World Asia Pacific ex Japan index provided, in local terms, a total return of -44.89% over the last six months and -53.81% over the last year. In sterling-adjusted terms, the returns are -29.48% over the last six months and -35.54% over the year.

2.6. Emerging Markets Equities

Alongside the economies and equity markets of the Asia Pacific region, those of the emerging markets* have suffered sharp set backs. Slowing 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 in sterling terms (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 terms, a total return of -47.69% over the last six months and -56.09% over the last year. In sterling-adjusted terms, the returns are -33.06% over the last six months and -38.72% 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 was demonstrated over the course of 2008. From a peak of more than 5.50% in mid-2007, the yield on the 10-year conventional gilt retreated by nearly 2.00 percentage points to 3.61% by the end of February 2009. This generated capital gains within portfolios that went some way to offsetting the 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 their 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 would 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 may drive yields higher and prices lower.

Exposure to index-linked gilts also proved beneficial early in 2008 due to concerns over inflation. However, as these concerns faded and investors focused instead on the possibility of deflation, yields on index-linked gilts rose sharply in the third quarter of 2008 before falling back once again.

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 relatively low and may be vulnerable to rising inflation expectations. We are therefore 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 +5.43% over the last six months and +7.51% over the last year. The ABI Sterling Corporate Bond sector provided a total return of -14.31% and -13.93% over the same periods.

The ABI UK Pension Index-Linked Gilt sector provided a total return of -8.93% over the last six months and -2.47% over the last year. Shorter dated index-linked stock has performed considerably 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 -0.15% over the last six months and +2.86% 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, they still look expensive relative to other assets and given the level of oversupply and the continued deterioration of the economic backdrop, commercial property valuations 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 -17.50% over the last six months and -21.55% over the last year.

5. Cash

Due to the elevated level of money market interest rates, sterling deposits or 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 +1.47% over the last six months and +4.00% 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 -19.25% over the last six months and -22.12% over the last year.

The above commentaries reflect our views as at 13 March 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 31 August 2008 to 27 February 2009 and the twelve month period from 29 February 2008 to 27 February 2009 (source: Lipper Hindsight).