

Market Commentary

October 2008

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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 13 October 2008. 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.

Over the last 12 months we have seen the full impact on investment markets of the withdrawal of cheap short term funding. Those businesses built on the assumption that abundant credit was a permanent feature of the financial landscape have imploded rapidly. Northern Rock and Bradford & Bingley are two familiar examples, but there are literally thousands of others - from hedge funds who were borrowing short term money and investing in higher yielding assets (the now-infamous carry traders), to property companies borrowing to develop holiday complexes in Eastern Europe on the assumption that property prices would continue to rise indefinitely.

Within the mainstream asset classes, equities have suffered greatly as risk aversion has increased. This culminated in out-and-out panic in the second week of October, causing equity markets in the UK, Europe, the US and Asia to fall c20%. This was followed by a sizeable recovery based on optimism that the policy response would have the desired effect, however, the relief has proven short lived and the downtrend in markets has resumed. Elsewhere, commercial property, which had been a major beneficiary of cheap credit, has suffered acutely from its withdrawal. In fixed interest markets, after several years of strong performance from lower quality non-investment grade bonds, investors have, rightly, now become extremely concerned about credit risk. This has resulted in government bonds performing very strongly relative to corporate and particularly non-investment grade bonds.

Considering our recommended asset allocations, reductions in equity weightings late last year have helped, but with perfect foresight we would have gone further. Sharp falls in equity markets have left shares looking, on first inspection, highly attractive, especially to investors with a long time horizon. However, we are aware that the impending economic slowdown has not yet been fully reflected in corporate earnings forecasts. Elsewhere, portfolios have had healthy weightings to cash and short and medium-dated gilts. Both have offered capital security and liquidity.

The MSCI World Equity Market index has provided a total return of -6.74% in sterling over the last six months and -14.98% over the last year. Rolling these figures forward two weeks to 13 October, to incorporate recent volatility, gives -19.47% and -26.58% respectively.

2. Equities

2.1. UK Equities

Growth in the UK has stalled with economic output no greater in the second quarter than the first. It is likely to fall in the third quarter. Consumer spending, so long a strong feature of the UK economy, is slowing as falling house prices, a deteriorating jobs market and cost pressures from rising utility and fuel bills have served to undermine consumer confidence. According to a survey carried out by market research company GfK NOP in September, consumer confidence is close to its lowest level since records began in 1974.

Impaired assets on the balance sheets of UK banks are having the same impact on credit markets as their US counterparts. Banks are trying to rebuild their capital ratios by raising additional capital (from the UK government in the case of Royal Bank of Scotland, HBOS and Lloyds TSB), scrapping dividends and curtailing loans. At present, banks remain distrustful of their peers and interbank lending is very limited. The sterling interbank rate for 3 months currently stands some 1.75% above the Bank of England's (BoE) policy rate of 4.50%.

Inflation, which proved a major concern earlier in the year, now appears to have been a red herring. With oil and commodities prices falling sharply, unemployment rising and restricted credit availability, inflation is likely to fall very sharply in the coming months. Ironically, the Monetary Policy Committee of the BoE may become more concerned about too little inflation, rather than too much, over the next two years as the deflationary impact of falling asset prices works its way to all corners of the economy. This has freed its hand to cut interest rates by 0.50% in an attempt to alleviate the pressures on the financial system. We expect further rate reductions in the coming months.

Turning to the stock market, the recent sharp fall in the UK equity market leaves shares looking very inexpensive versus cash and government bonds. However, earnings forecasts will almost certainly be downgraded as attention turns to the economic slowdown.

Our recommended funds are, in the main, positioned away from the vulnerable consumer-sensitive areas of the market, including the much troubled banking sector. They have also given the speculation driven mining stocks a wide berth. We are confident they will fare well relative to the wider indices in the months ahead.

The FTSE All-Share index has provided a total return of -13.45% over the last six months and -22.25% over the last year. Incorporating returns for the two weeks to 13 October gives -24.52% and -32.20% respectively.

2.2. European (excluding UK) Equities

Until we recommended a reduction in allocations to European equities in late 2007, the Continent had been our favoured destination for investments into overseas markets. This proved profitable 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 the recommended reduction in allocations was our view that the eurozone would not prove immune to the financial storm or the accompanying economic slowdown afflicting the US and UK. Indeed, with the European Central Bank's (ECB) reputation for giving greater weight to inflation risks than growth risks, there was, in our view, a danger that interest rates would be held too high for too long, driving up the value of the euro and exacerbating the eventual economic slowdown. The ECB subsequently demonstrated their inflation fighting credentials by actually increasing interest rates (to 4.25%) in July.

The core eurozone economies did remain resilient for longer than the US or UK, with the exporters of manufactured goods in particular benefiting from sustained demand from the Far East. However, the combined impact of the strong euro and weakening global economy is now showing through clearly. Germany's IFO survey of the business climate has fallen at an unprecedented rate from a high of 104.6 in March to 92.9 in September. Evidence of a rapidly declining business environment, together with the financial market turmoil, allowed the ECB to participate in the co-ordinated interest rate reduction of 8 October. In response to this and the economic slowdown, the euro has begun to lose some of its recent gains against the dollar and sterling.

The core countries of continental Western Europe, including Germany, France and the Benelux nations, remain structurally sound and they will continue to be long term beneficiaries both of demand for exports from the Far East and the continuing development of Eastern Europe. Also, over the longer term we expect the euro to gain in value against sterling. Therefore, 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 -14.83% over the last six months (-15.81% sterling adjusted) and -28.88% over the last year (-19.71% sterling adjusted). Returns rolled through to 13 October give -25.10% (-26.71% sterling adjusted) and -37.46% (-30.10% sterling adjusted) respectively.

2.3. North American Equities

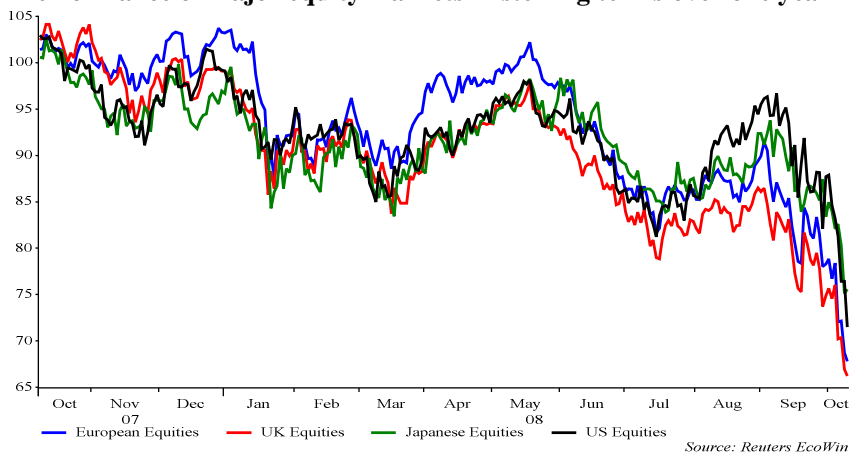
Despite interest rate reductions totalling a full 3.75% over the last year, a Federal economic stimulus package worth \$170bn, the passage into law of the \$700bn Troubled Asset Relief Program and an injection of capital into its banks similar to the UK rescue package, the US economy is sliding towards recession.

Consumer spending, so long bolstered by rising property values, is now being undermined by falling house prices which, according to the Case-Shiller Home Price index, were 16.30% lower in July compared to the previous year. Massive exposure to real estate via mortgage-backed securities (many containing tranches which are now valueless) has paralysed the banking sector. Two major lenders, Washington Mutual and Wachovia, have had to be rescued in the last month alone. The accompanying sharp reduction in credit availability to both consumers and businesses is exacerbating house price falls and further undermining consumer confidence.

Considering that the US is at the centre of the current global economic slowdown, its equity market had, until the end of September, performed surprisingly well relative to other major markets (see chart). The recent sell-off has, however, seen this disparity reduce. Though valuations appear supportive, we are aware that the US economy and its companies have yet to experience the full consequences of recession. We believe that allocations to US equities should be maintained for the present.

The S&P 500 index provided, in US dollar terms, a total return of -10.87% over the last six months (-0.61% sterling adjusted) and -21.98% over the last year (-10.82% sterling adjusted). Returns inclusive of events to 13 October are -23.25% (-12.41% sterling adjusted) and -32.81% (-21.41% sterling adjusted) respectively.

Performance of major equity markets in sterling terms over one year



2.4. Japanese Equities

The Japanese economy, like those of other developed countries, is slowing under the impact of global financial dislocation. As a major exporter, Japan is more sensitive to global economic growth than other major nations. Its equity market has, accordingly, suffered most.

One factor in Japan's favour is that it stands one step removed from the global financial crisis. Japanese banks have little exposure to the sub-prime assets that have damaged their US and European counterparts and the economy has not suffered from excessive house price increases. In fact, the health of Japanese financial institutions is allowing them to make strategic acquisitions overseas. Recent deals include Mitsubishi UFJ Group's purchase of a stake in Morgan Stanley and Nomura's acquisition of the non-US businesses of Lehman Brothers.

Japan's lack of exposure to the financial crisis together with its already very low interest rates, has meant that the yen has appreciated very markedly against other major currencies. This has worsened the plight of Japan's exporters but has provided some consolation for overseas investors in Japanese financial assets. Over the year to 13 October the yen appreciated by some 21.06% against sterling, mitigating to some degree the very weak performance of the equity market.

Japanese equities remain deeply out of favour with international investors, but they are now very cheap both versus their own history and by comparison with international counterparts. We therefore recommend current allocations to Japanese equities are maintained.

The FTSE Japan index provided, in yen terms, a total return of -9.74% over the last six months (-5.64% sterling adjusted) and -31.66% over the last year (-15.37% sterling adjusted). Rolling these forward two weeks to 13 October the figures become -30.02% (-21.14% sterling adjusted) and -47.01% (-29.26% sterling adjusted) respectively.

2.5. Asia Pacific (excluding Japanese) Equities

Until this year, equity markets in the Asia Pacific (ex Japan) region had provided excellent returns. Rising markets were driven by strong regional economic growth, investor enthusiasm for markets linked into the Chinese development story and the expectation that Asian currencies would appreciate over the medium term. However, as the global economic outlook has deteriorated this year, investor enthusiasm has waned and Asian equities have begun to sharply underperform their western counterparts (see chart).

We have, since 2006, recommended only very small allocations to Asia Pacific equities in acknowledgement of their strong performance, their increasingly high valuations and the historic volatility of the region's stock markets. We do, however, continue to believe that investors with longer time horizons will earn good returns as the long term economic fundamentals remain very promising. Though, after the recent sell-off, valuations are significantly more tenable, at present we continue to recommend that clients maintain their current tactical equity weightings to the region.

The FTSE Asia Pacific (ex Japan) index provided a total return of -18.78% over the last six months and -27.08% over the last year (for sterling based investors). The figures incorporating market movements in the two weeks to 13 October are -30.35% and -37.47% respectively.

Asia Pacific (ex Japan) equities have underperformed developed markets over 2008 to date (rebased)



2.6. Emerging Markets Equities

Hopes that emerging markets (as defined by MSCI – see * below) could continue to grow rapidly, despite the sharp slowdown in developed economies, were dashed in the first three quarters of 2008. Upward pressure on inflation as economies have begun to encounter capacity constraints, together with slowing demand for exports, means that many emerging markets are likely to slow from the rapid rates of growth seen in recent years. While inflation may prove a transitory issue for developed economies, it appears more entrenched in some emerging markets and may require an aggressive policy response to bring it back to acceptable levels. The key point of differentiation is that wage inflation in developed markets does not look likely to rise, thereby putting further upward pressure on inflation. In many emerging markets, however, wages are rising rapidly as increasing job mobility and competition for workers has enabled employees to claim their share of the strong economic growth.

Assisted by robust economic growth, emerging markets equities provided excellent returns over more than four years to early 2008. As the outlook for the global economy has deteriorated, however, emerging markets have started to retrench. Having risen very strongly, to the point that many were trading on significant valuation premiums to their developed counterparts, emerging equity markets were vulnerable to sharp reversals. These have been occurring. Equity market corrections in China and India, two former favourites of emerging market investors, have been severe. Over the year to 13 October, Chinese shares listed on the Shanghai stock exchange fell by 60.59% while those Indian companies with shares listed in Bombay have seen, on average, a 44.25% decline.

We have been recommending only small allocations to emerging markets equities for the last two years. This has caused client portfolios to miss out on some upside but, driven by strong speculative inflows, these markets have been looking increasingly expensive for some time. As in the developed markets, we are likely to see opportunities to increase weightings to emerging markets in the coming months but for now recommend maintaining current holdings.

The FTSE All-World Emerging index provided a total return of -18.47% over the last six months and -21.91% over the last year (for sterling based investors). Rolling these figures forward to 13 October gives -32.69% and -35.54% respectively.

* MSCI includes 25 countries in its emerging markets indices: Argentina, Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey.

3. Fixed Interest

Over the last year UK government fixed interest stocks (gilts) have demonstrated their value as effective portfolio risk diversifiers. From a peak of over 5.50% in mid-2007, the yield on the 10-year UK government bond retreated by over 125bps to a 4.25% low in mid-March, generating capital gains which have helped to offset some of the losses in equity holdings. Gilts benefited from lower growth expectations (and therefore lower interest rate hopes), and also from their 'safe haven' status amid the turbulence in credit markets and falling equity prices. Yields subsequently rose somewhat amid concerns that rising inflation would require higher UK interest rates but, as the extent of the economic slowdown and worsening financial crisis became apparent, they have fallen back once more and now stand at close to 4.50%.

While gilts proved highly attractive to investors, lower quality classes of fixed income securities, such as corporate and non-investment grade bonds, have suffered from increasing risk aversion. Concerns about credit quality and default risk, together with the unattractive yield premiums available on non-government debt, meant that their appeal to investors was much lower and they have, accordingly, underperformed their government counterparts.

Our belief that non-government fixed interest securities offered little value has meant that our recommended allocations to fixed interest in total have been fairly light. However, within the asset class we have advised clients to focus on conventional and index-linked UK government bonds. Index-linked issues performed particularly well in the first half of the year due to concerns about inflation. However, yields have recently risen somewhat as fears over economic growth have replaced those over inflation. We expect conventional bond yields to remain fairly low over the next year as the economy works its way through the downturn. Following this period it is likely that higher inflation expectations, together with heavy gilt issuance, will see yields move higher once more. We are therefore recommending that government bond allocations are split evenly between conventional and index linked issues. In addition, we are closely monitoring the now much more realistically valued non-government bond sectors and are selectively increasing allocations.

The ABI UK Pension Gilt sector provided a total return of +0.48% over the last six months and +5.75% over the last year. Rolling these figures through to incorporate the two weeks to 13 October gives returns of -0.97% and +4.22% respectively.

The ABI UK Pension Index-Linked Gilt sector provided a total return of +0.65% over the last six months and +9.78% over the last year. However, including market events over the two weeks to 13 October gives returns of -6.36% and +2.13% respectively.

4. Property

After several years of strong returns, investors in UK commercial property have endured a major setback with property values receding substantially. Until 2007, the sector had been a major beneficiary of the abundance of low cost debt finance that characterised the credit bubble; higher and higher quantities of debt were used to gear the steady but otherwise unexciting returns from commercial property. 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 reduced appetite for risk among investors, has served to drive commercial property yields sharply higher and prices correspondingly lower.

Our Investment Bulletin of October 2006 set out our view that commercial property investments could suffer as prices were forced down to levels more attractive to investors. This consolidation is now well under way. UK commercial property returns, including rental income, were negative in 2007 as measured by the ABI UK Pension Property index and are highly likely to be so again in 2008.

For now, it remains our view that the risk-adjusted returns available on cash deposits are more attractive than those on commercial property. However, value is beginning to return to the asset class and we are monitoring this closely with a view to taking a more positive stance on commercial property in due course.

The ABI UK Pension Direct Property index provided a total return of -5.44% over the last six months and -19.71% over the last year. Rolling these figures through to 13 October gives -6.16% and -19.78% respectively.

5. Cash

Sterling deposits or monies held in AAA-rated liquidity funds earn returns in excess of 4.50% p.a. at present.

With the economic outlook deteriorating, our view is that UK interest rates are set to fall sharply. The Monetary Policy Committee of the Bank of England, perhaps belatedly, has now recognised that inflation is set to decline quite sharply in the months ahead. Despite this, cash still has its attractions and we continue to favour heavy weightings. 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.

The ABI UK Pension Money Market index provided a total return of +2.29% over the last six months and +4.76% 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.

According to Hedge Funds Research, hedge funds are this year on course to suffer their worst performance since records began in 1990. Among the casualties are some high profile names; Citadel Investment's flagship fund, which at \$18bn is one of the industry's largest, lost 15% in September alone whilst similar performance from Atticus European took year-to-date losses to more than 43%. 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 set to intensify in the fourth quarter as hedge fund investors continue to file significant redemption requests.

For completeness, we include the HFRX Global Hedge Fund index figures for hedge fund performance below. We are, 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 -8.09% over the last six months and -9.93% over the last year. Returns rolled through to 13 October are -13.24% and -14.98% respectively.

N. B. The above commentaries reflect our views as at 13 October 2008. 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 March 2008 to 30 September 2008 and the twelve month period from 28 September 2007 to 30 September 2008 (source: Lipper Hindsight).