

Market Commentary

August 2010

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Risk Warnings

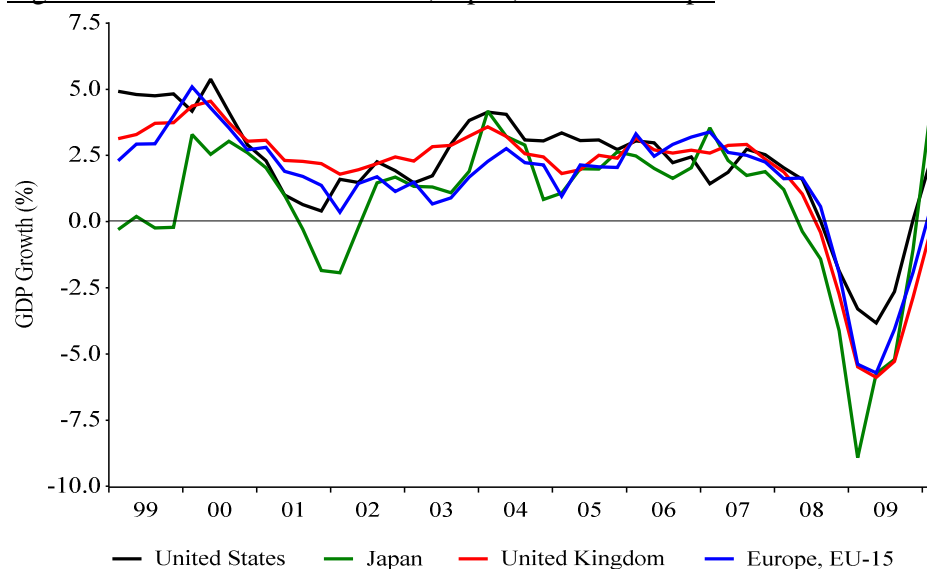
This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 16 August 2010. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments 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

Surveys and data releases suggest that the pace of the global economic recovery is easing. In recent weeks for example, retail sales, consumer confidence and business outlook surveys have all failed to match expectations in the US. In addition, US unemployment remains stubborn, having receded by just 0.5% from its peak of 10% a year ago. High unemployment continues to weigh on consumers' willingness to spend, as does reduced access to credit finance and the continuing weakness of the US housing market.

Sentiment has been impacted by renewed concern about global financial stability as a result of the European debt crisis and mixed US macro data. It has been our view that the pace of the economic recovery, which is now a little over a year old, was always likely to moderate. Reasons for this include the inevitable fading of the positive effects of both the restocking phase of the recovery and the government administered fiscal stimuli. In addition, the ending of exceptionally loose monetary policy was naturally going to have a dampening effect on the rate of economic growth. Fig. 1 shows that the initial recovery has been robust. We now expect this to level out as the imperative for consumers and governments to address their debt levels reasserts itself.

Fig. 1 Economic Growth in the US, Japan, UK and Europe

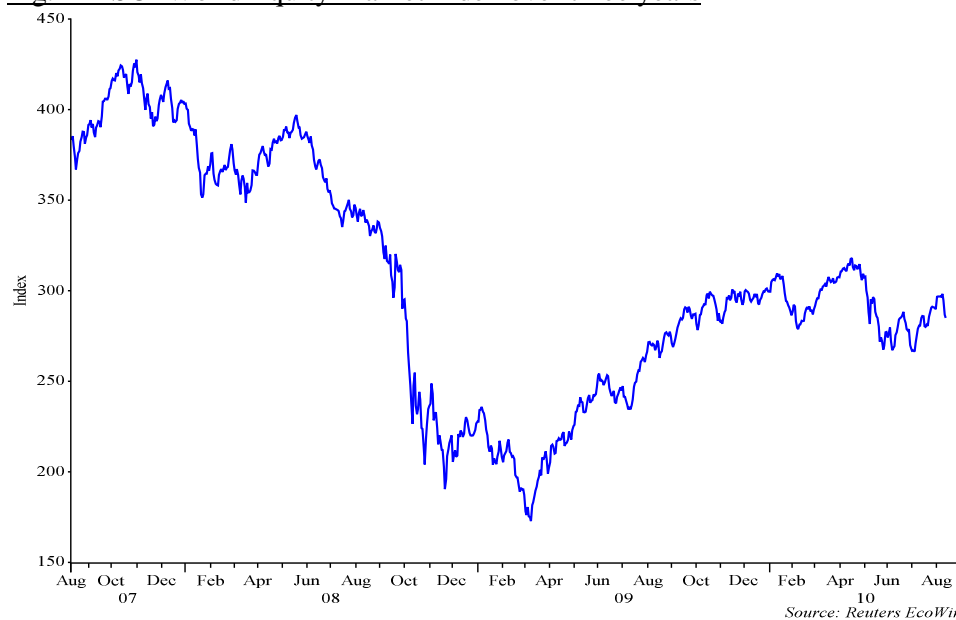


While we expect economic growth to moderate, we remain optimistic that we will not see a 'double-dip' in global growth, or a return of concerns about a possible deflationary slump. Our reasons are twofold. Firstly, while conventional policy levers in developed economies do not leave much scope for further action, central banks stand ready to administer further stimulus measures if needed. Although the Federal Reserve's recent decision to reinvest the proceeds of its maturing holdings of agency debt and agency mortgage-backed securities into longer-term Treasuries does not strictly constitute quantitative easing, it shows their willingness to dispense further "medicine" as and when necessary.

Secondly, economic growth is strong in emerging economies. As the threat of inflation in emerging nations wanes, as is likely in the face of weaker developed markets growth, emerging markets policymakers will have the freedom to allow growth to accelerate once more. This should provide a degree of support for growth in developed economies.

Understandably, the threat of renewed economic weakness and the lingering possibility of sovereign debt default has undermined investor confidence and increased risk aversion. However, markets bounced back sharply in July (see Fig. 2) as corporate earnings continued to beat consensus estimates on the back of productivity gains and inventory restocking.

Fig. 2 MSCI World Equity Market Index over three years



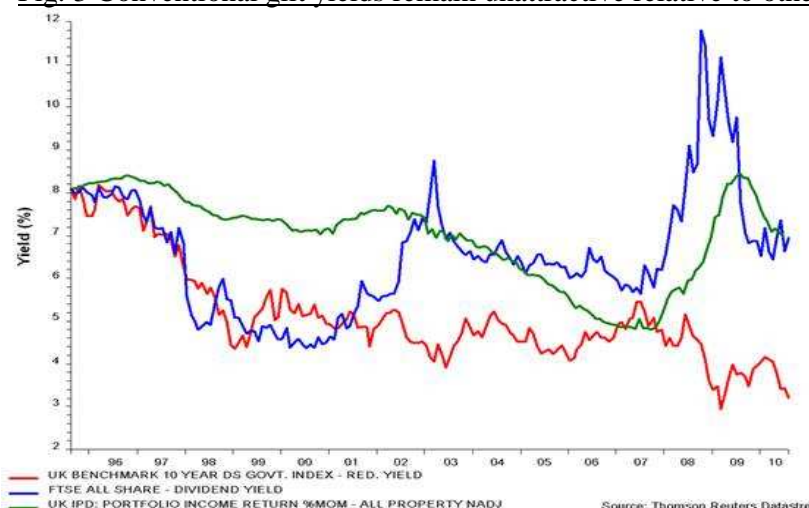
We remain positive on equities for the medium term. Equity markets in developed economies continue to trade on attractive valuations, both in absolute terms and in relation to other asset classes, most notably government bonds and cash. This means that, unless earnings and dividend growth fall materially short of current expectations, equities, particularly those of high-quality defensive businesses, remain well supported.

Should economic growth threaten to disappoint meaningfully, thereby raising the spectre of the material further falls in earnings and dividends mentioned above, we expect further non-conventional monetary policy, in the form of quantitative easing, from central banks. This would have the effect of raising liquidity, thereby supporting asset prices. In such circumstances, financial assets such as equities should be favoured over nominal ones, such as government bonds and cash deposits.

The MSCI World Equity Market index has provided a total return of +4.36% in sterling terms over the last six months and +16.87% over the last year.

Turning to other major asset classes, government bonds, which were the asset class of choice for investors in late 2008 and early 2009, were largely out of favour until the latest bout of risk aversion when investors have, once again, sought out safe havens. Considering UK government bonds, downward pressure on prices, from the high levels of issuance and the possible return of inflation, has been offset by the expectation of an extension to the period of very low interest rates and concerns that economic growth may disappoint. However, with the UK benchmark 10-year issue yielding just 3.11%, our view remains that conventional gilts continue to be unattractive when viewed in relation to the other major asset classes (see Fig. 3).

Fig. 3 Conventional gilt yields remain unattractive relative to other assets



In contrast to government bonds, corporate bond prices were driven sharply lower through the financial crisis, owing both to forced selling by leveraged investors caught out by the ferocity of the crisis and concerns about falling corporate earnings. The increase in yields on corporate bonds was even more pronounced when compared to the strength in government bonds, as investor enthusiasm for the defensive attributes of government bonds forced yields lower. This situation began to correct in the first quarter of 2009 and, since then, corporate bond prices have made a rapid recovery and yields have continued to fall steadily. In our view, corporate bonds remain attractive, both in absolute terms and relative to government bonds and cash on deposit.

Considering commercial property, a five-year bull market came to an end in mid-2007 when prices eventually began to weaken under the pressure of credit market dislocation. Property values continued to decline until mid-2009, as tighter credit market conditions removed an important source of funding for commercial property buyers and the deteriorating economy undermined tenant demand. Commercial property values have now begun to recover and with the asset class yielding around 6.5%, we believe it is now attractive, both in absolute terms and relative to other assets. We have therefore been recommending additional allocations where appropriate.

The following sections consider our monitored asset classes, including hedge funds and cash, in more detail.

2. Equities

2.1. UK Equities

The first estimate for UK GDP growth over the second quarter of 2010 came in at 1.1% – its fastest rate for more than four years and almost twice economists' consensus forecast. While encouraging, we are doubtful that growth can continue at this pace in the second half of the year. The new government's austerity Budget introduced tax increases and sharp cuts in public sector spending that together aim to eliminate the UK's structural budget deficit over the life of this parliament. Although back-end loaded, we expect higher taxes and public sector job cuts to weigh on consumers' ability to spend and lead to higher unemployment, unless the private sector takes up the slack. However, we are not yet convinced of the corporate sector's willingness or ability to do so, as purchasing managers' surveys indicate slower than expected expansion by companies in the service sector, while recent Bank of England data show that lending to UK corporates contracted in May.

That said, our view is that the probability of a double-dip recession in the UK is fairly low. We are encouraged by the Bank of England's stated intent to keep interest rates lower for longer and its ability to restart quantitative easing if necessary. Loose monetary policy should help support growth in the household and corporate sectors, as the government's contribution to GDP shrinks, and allow trade to make a positive contribution to growth by ensuring that sterling stays weak.

Turning to the stock market, we believe that UK equities look attractive on a number of measures. During the economic downturn, many UK corporates aggressively cut costs and raised fresh capital to strengthen their balance sheets. This has left them in fundamentally sound shape and with expanded profit margins. As a result, any increase in revenues should translate into significantly higher profits. This has been borne out by the strong second quarter earnings season, with many companies' profits beating expectations.

Despite this, valuations of UK companies remain relatively low. Following the recent market weakness, the UK stock market now offers a high dividend yield relative to yields available on cash, gilts and the highest rated corporate bonds. Historically, this has been a good indication of future returns, though we are mindful that investor sentiment is a strong driver of the market in the short term. As we continue to believe that the risk of a double-dip recession is unlikely, our recommendation is that current allocations to UK equities are maintained.

The FTSE All-Share index has provided a total return of +4.04% over the last six months and +19.35% over the last year.

2.2. European (excluding UK) Equities

European equity markets have remained volatile over the last year with investors concerned over the potential for sovereign debt default in Greece and the possibility of contagion to other troubled eurozone economies. However, the provision jointly by EU member states and the IMF of €110bn of loans to the Greek government, together with an ECB facility for €750bn in loans and guarantees for fiscally troubled eurozone countries, appears to have, for now, eased the risk of financial market crisis in the region.

Together with this loan package, equivalent to c24% of the combined GDP of Portugal, Italy, Ireland, Greece and Spain, the ECB continues to provide emergency liquidity for commercial banks holding the debt of the weaker peripheral member nations. While the central bank is no longer lending to banks for 12-month terms, as it was through 2009, it recently offered unlimited three-month funds at a rate of 1% at least until September and did not rule out further provision.

In return for the rescue package, painful fiscal adjustment and structural reforms have been demanded. We are therefore likely to see a prolonged period of economic weakness in the embattled peripheral countries. While the eurozone economy as a whole managed growth of 1.0% in the second quarter of 2010, there is a clear divergence between the economies of Germany, which grew by 2.2% over the quarter, and Greece, which experienced a 1.5% contraction. The continued strength in the German economy, with industrial production up 10.9% year on year in June and factory orders running at +28.4% year on year, suggests that the negative effects from the fiscal crisis in the peripheral eurozone countries is being offset by the rebound in the global economy and a weaker euro. Both of these should increase the competitiveness of, and thereby the demand for, the eurozone's exports from overseas markets. With the core countries of Germany, France and Italy making up 65% of eurozone GDP (compared to 18% for Portugal, Ireland, Greece and Spain), this may provide more stability to the eurozone economy than many analysts are expecting.

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

The FTSE Europe (ex UK) index provided, in euro terms, a total return of +5.00% over the last six months and +15.00% over the last year. The weakness of the euro since mid-October means that, in sterling-adjusted terms, the returns are +0.70% over the last six months and +11.87% over the year.

2.3. North American Equities

Recent economic data releases in the US have disappointed, with consumer spending, pending home sales and factory orders all weaker than forecast in June, raising concerns that the world's largest economy may lapse back into recession. The economy has recorded growth in each of the last four quarters, including an annualised expansion of 2.4% in the second quarter of 2010. However, the rate of growth has been declining as the impacts of the government's fiscal stimulus packages have faded. This was acknowledged at the Federal Reserve's (Fed's) August meeting, at which officials downgraded their economic outlook and noted the "pace of recovery in output and employment had slowed in recent months" and was likely to be "more modest" than anticipated in the near term. Officials also agreed to begin reinvesting proceeds from expiring mortgage-backed securities into Treasury bonds, signalling that the bias of monetary policy has decisively shifted away from tightening towards easing. One may therefore continue to expect exceptionally low levels of interest rates for an extended period.

Signs of weakness in forward looking indicators put a halt to the rally in US equities at the end of the first quarter, and triggered a bout of dollar weakness. Strong corporate earnings for the second quarter, however, have lifted sentiment once more, though the market remains precariously balanced between corporate and economic newsflow. Despite the economic uncertainty, monetary and fiscal policy is set to remain supportive; the Fed's decision to use proceeds from its investments in mortgage-backed securities to buy longer-term government debt demonstrates their willingness to extend quantitative easing further if required, while dollar weakness should stimulate further export growth. Our view therefore is that, while the US economy may slow after a strong initial recovery, it will not lapse back into recession.

On this basis, we believe the US equity market is well placed to make progress. We have been recommending allocations to US equities are selectively increased, where appropriate.

The S&P 500 index provided, in US dollar terms, a total return of +3.61% over the last six months and +13.84% over the last year. The strength of the dollar over the seven months to the end of May means that, when translated into sterling, the returns are +6.01% over the last six months and +20.51% over the year.

2.4. Japanese Equities

Despite recent signs of improvement, concerns remain about the vitality of Japan's economic recovery. The quarterly Tankan survey revealed that confidence among large manufacturers rose to a two-year high, with the central bank reiterating its cautiously optimistic outlook for the economy, while acknowledging its reliance on exports for GDP growth. Since assuming the role of Prime Minister in June 2010, Naoto Kan has been vocal about his ambitions of generating economic growth of more than 2% per annum by 2020. He has also historically been a firm advocate of quantitative easing to address deflationary pressures. However, his main priority will be to address the country's huge public debt, amounting to c200% of forecast 2010 GDP. This is the result of nearly two decades of fiscal spending programmes aimed at boosting the economy. While the Democratic Party-led coalition enjoys a comfortable majority in the lower house, its recent loss of the upper house will likely halt reforms on spending, since both houses must approve legislation.

While we acknowledge the severity of Japan's structural economic issues, we believe the corporate outlook is brighter. Aggressive cost cutting measures have been undertaken and Japan's companies, and therefore its equity market, should now be well placed to benefit from the global recovery. Indeed, the equity markets were lifted by better than expected Q2 results from the main exporting sectors – consumer electronics and automobiles – led by key names such as Panasonic and Toyota. However, the persistent strength of the yen since the onset of the credit crisis continues to disadvantage Japan's exporters. In his previous role as finance minister, Kan was vocal in his support for policies to weaken the yen. However, foreign exchange markets have continued to prize the 'safe haven' status of the Japanese currency in a volatile market, and this, together with the ongoing deferral of monetary policy normalisation in the developed economies of the west, has supported the currency. We suspect that a sustained improvement in risk appetite, or the monetisation of the country's spiralling public debt, might be accompanied by a weakening yen – a development that would be welcomed by Japan's export sector.

As a result of the significant structural issues facing Japan, the equity market has been a long-term laggard among the developed markets. However, Japanese equities now appear inexpensive on a range of measures, both in historical terms and relative to other markets. We believe that the normalisation of global monetary policy may offer opportunities in due course, but we are not for the present recommending increased allocations.

The FTSE Japan index provided, in yen terms, a total return of -5.29% over the last six months and -9.20% over the last year. Yen strength means that, in sterling-adjusted terms, the returns are +1.37% over the last six months and +5.58% over the year.

2.5. Asia Pacific (excluding Japanese) Equities

Boosted by government stimuli, rising Chinese domestic consumption and the strong rebound in international trade, Asian economies have enjoyed rapid growth in recent months. Singapore and Taiwan grew at annualised rates of more than 10% in the first quarter of 2010, while South Korea and Hong Kong recorded growth of over 8%. Rather than too little growth, as is the issue in the developed economies, rapid growth in the Asia Pacific region brings with it the threat of rising inflation and thus the need for tighter monetary policy in due course.

The nature of the export-driven Asian economic model means that most countries (with the exception of China) will find that tweaking interest rates and money supply do surprisingly little to regulate GDP or inflation. Hence, the policy lever of choice is likely foreign exchange rates. Indeed, the Singapore dollar has risen appreciably against the major currencies, and China has already begun its rebalancing process. Looking ahead, we expect this trend to continue playing out in the medium term, and see these currency gains as accretive to investors' total returns.

While equity markets in the region were not immune to the sell-off triggered by European sovereign debt concerns, they recovered well in July to end near this year's highs. We think the region should continue to outperform global equity markets over the longer term due to the better economic fundamentals, including favourable demographics, more soundly financed public sectors and lower consumer indebtedness.

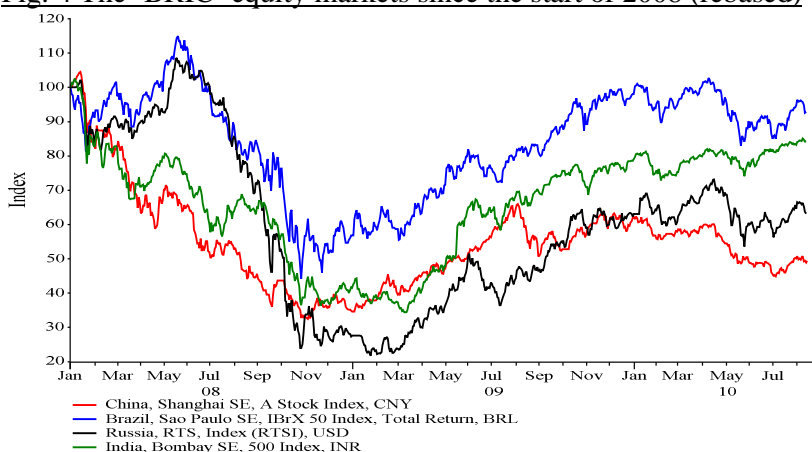
On measures such as price to book value, equity valuations in the region are broadly in line with their long-term averages. The MSCI Asia Pacific ex Japan Index, for example, trades on a P/E ratio of 12.4x and on a dividend yield of 3.4%, which are attractive levels relative to history and their western counterparts. In the context of the attractive growth prospects, such valuations appear undemanding. Issues of corporate governance have shown signs of steady improvement, as governments and oligarchs loosen their grip on these large corporations, making them more investable to minority stakeholders. We have recently therefore been recommending increased allocations to Asia Pacific, where appropriate.

The FTSE All-World Asia Pacific ex Japan index provided, in local currency terms, a total return of +6.71% over the last six months and +12.10% over the last year. When translated into sterling, the returns are +9.86% over the last six months and +23.72% over the year.

2.6. Emerging Markets Equities

The equity markets of the emerging economies* enjoyed a strong 2009, as the international response to the financial crisis kick-started economic growth and international trade rebounded strongly. Attracted by the rapid return to growth and the now relatively stronger economic fundamentals of the emerging nations, investors directed record sums towards emerging markets equity funds over the course of 2009. As shown in Fig. 4 however, emerging equity markets have not been able to side step renewed concerns about the health of the global financial system and the threat this poses to growth. Investors have also become wary of the likely impact on equity markets of steps taken by policymakers to slow the very rapid rates of economic growth in order to head off the threat of inflation.

Fig. 4 The 'BRIC' equity markets since the start of 2008 (rebased)



China provides a good example of investors' new found caution. By the third quarter of 2009, the Shanghai 'A' Index had doubled from its October 2008 low. It then traded sideways for the remainder of the year and has since fallen back by more than 25%. This fall has been driven by government policies aimed at cooling residential property markets to ensure that inflation does not take hold.

As a result of these corrections, the valuations of emerging market equities now look reasonable and, in our view, present an attractive entry point to access the excellent growth potential of the emerging economies. We have therefore been recommending increased allocations to the region, where appropriate.

The FTSE All-World Emerging index provided, in local currency terms, a total return of +8.34% over the last six months and +22.08% over the last year. In sterling-adjusted terms, the returns are +10.85% over the last six months and +29.24% 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

Despite recent political uncertainty and a forecast budget deficit that, at 12.0% of GDP, exceeds the 9.3% deficit expected for Greece in 2010, UK gilts have performed well since late February. Unlike Greece's gross sovereign debt, which stands at 125% of GDP, the UK's equates to a more manageable 79% of annual output. Furthermore, the UK is less reliant on overseas buyers of its debt, with just 30% of government debt in foreign hands compared to 70% for Greece. Finally, the average maturity of outstanding UK debt is 13.5 years, significantly higher than Greece's 7.9 years. As a result, there is less concern about the UK's ability to refinance maturing debt.

Nonetheless, conventional gilts look expensive, even as 'insurance' against economic shocks, and we continue to recommend zero allocations. This view has been unhelpful over the past six months, with gilts rallying as investors sought havens amid the European sovereign debt crisis and signs of slowing global growth. However, given the high level of issuance expected over the coming years and the vulnerability of conventional gilts to rising inflation, we believe yields must rise to offer adequate compensation for these risks. We consider inflation, as a result of the extraordinary monetary stimulus employed to mitigate the effects of the financial crisis, to be a meaningful medium term risk. The impact of higher inflation on conventional government bonds would be to drive yields higher with a corresponding fall in prices. Our concerns regarding inflation lead us to retain our positive stance on index-linked bonds. These have their capital and coupon values linked to a measure of inflation (such as the retail prices index in the UK), helping them to preserve their purchasing power in an environment of rising prices. Although real yields, particularly on UK index-linked gilts, look low in absolute terms, we see such bonds as useful insurance against the risk of significantly higher inflation.

We also continue to favour funds of corporate bonds, despite strong returns over 2009 and 2010 to date. In many cases, these have proven to be relative safe havens during the sell-off in risk assets since late-April. Gross redemption yields on these funds in the region of 4-7% p.a. look attractive relative to gilts and cash, while their volatility is much lower than that of equity funds. However, we do not expect a repeat of the substantial capital gains seen in 2009. Corporate bonds are probably now close to fair value and are potentially vulnerable to rising gilt yields. Mindful of this, we have been recommending that allocations are invested in bond funds with more strategic mandates. The managers of these funds invest where they believe the market is paying them to take risk, while avoiding areas that look expensive. They can also hedge out interest rate risk and exploit relative value opportunities between different bonds 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 +3.73% over the last six months and +7.54% over the last year. The ABI UK Pension Index-Linked Gilt sector provided a total return of +1.63% over the last six months and +7.67% over the last year. The ABI Pension Sterling Corporate Bond sector provided a total return of +4.17% and +17.35% over the same periods.

4. Property

The UK commercial property market reached its low point in the summer of 2009, approximately three months later than equity and corporate bond markets. The initial property rally was muted, with investors still cautious on the asset class due in part to its dependence on a still-weak domestic economy and concern that there would be a wave of sales from banks, as a result of leveraged property investors either defaulting or being unable to refinance loans.

Attractive yields relative to cash and gilts and, where available, low borrowing rates, have overcome investors' concerns and UK commercial property consequently performed strongly through the second half of 2009 and first half of 2010. The vast majority of recent purchases have been made by UK institutional and overseas investors, with the latter attracted in part by the weakness of sterling. Supply, meanwhile, has been tight, with a limited number of prime properties (high specification buildings in good locations and on long leases to financially sound tenants) coming to market. As a result, initial yields on the IPD index have been pushed down from nearly 8% at the market's low point to 6.5% as at the end of June. Lagging the investment market is the occupier market, though this is now showing signs of stabilising. Though rental values are still falling, the rate of decline has slowed in most areas. One exception is City of London offices, where competition for limited grade-A space is resulting in rental growth. This steadying of the rental market is supported by a general fall in vacancy rates from their peak in October 2009.

Given this stabilisation in commercial property market fundamentals, we are optimistic that the asset class can deliver attractive returns relative to cash and gilts. Prime assets, in our view, are to be preferred, despite lower yields. This is where institutional demand is focused and where banks are becoming more willing to lend. Near-prime or 'core-plus' properties are also attractive. These are of less interest to international or income dependent institutional investors, but offer the scope for fund managers to add capital value through asset enhancement, lease extensions and re-lettings.

The ABI UK Pension Direct Property index provided a total return of +6.04% over the last six months and +19.55% 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 attractive 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 provided a return of +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.

Almost one in ten hedge funds closed in 2008, according to Chicago-based research group Hedge Fund Research. Despite a partial economic and financial recovery, 240 hedge funds were liquidated in the first quarter of 2010, marking the seventh straight quarter in which closures exceeded new fund launches. We note with interest that the managers of several of the funds which closed in 2008 and 2009 have opened new operations. We believe that many may have done so in order to reset the 'high water marks' above which performance fees can be levied, having fallen some way below them while managing their previous funds. Investor expectations of positive, uncorrelated returns from hedge funds have clearly been disappointed and, in our view, the industry's ability to justify high charges and performance fees remains questionable.

Hedge Fund Research reported the average hedge fund gained 1.52% in the first seven months of the year. The sector has also been unnerved by German chancellor Angela Merkel's call for a total European ban on naked short-selling of government bonds and ongoing uncertainty regarding the EU's controversial directive for further regulation of hedge funds.

Nevertheless, the hedge fund industry has emerged from the financial crisis in a very different shape. There are now fewer funds, generally employing lower leverage, charging, on average, lower fees and offering better reporting, transparency and liquidity. These, in our view, are all welcome developments.

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 validity 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 will 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 -0.14% over the last six months and +5.73% over the last year.

The above commentaries reflect our views as at 16 August 2010. 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 January 2010 to 31 July 2010 and the twelve month period from 31 July 2009 to 31 July 2010 (source: Lipper Hindsight).