

Market Commentary

August 2007

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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 1 August 2007. 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 Commentary

Global equity markets suffered their second notable setback of this calendar year, beginning at the end of July. After climbing steadily through the second half of 2006, markets have become more volatile in 2007 which has been an unwelcome development for investors. The causes of the equity market setbacks are rooted in the financial markets rather than in any change in the macroeconomic outlook.

While the global economy has remained strong in 2007, an environment of rising interest rates and increasing concern about the impact and inherent risks of some new financial products, most notably in the debt markets, are starting to undermine investor confidence in the longevity of the bull market in equities. World equities, as measured by the FTSE World index, fell approximately 6% in each of the two setbacks to the end of July. Both were triggered by concerns that problems in the US housing market and particularly the markets in sub-prime mortgages would have knock on effects for wider financial markets and perhaps even the world economy.

The root of these issues dates from 2005 and 2006 when lax underwriting standards among mortgage issuers allowed loans to be extended at low 'teaser' rates to borrowers with weak credit worthiness. The abundance of funds available for poor credit or 'sub-prime' borrowers was due at least in part to innovation in debt markets, specifically the development of Collateralised Debt Obligations (CDOs). These esoteric products combine debt, such as mortgages, of a variety of qualities and coupons and sell these repackaged units in tranches to yield-hungry investors – particularly pension funds and hedge funds. As interest rates have risen, strains have appeared both in the financials of some of the sub-prime mortgage lenders and also in some of the investors who have bought into these new products without fully understanding the risks involved.

Investor concerns now centre on the extent of the weakness in the US housing market, the extent to which it might be exacerbated by developments in the sub-prime mortgage markets and the likelihood of contagion from the weakness in areas of debt markets to wider financial markets. The willingness of central banks to continue to supply liquidity to the credit markets, if required, will have a significant bearing on these issues.

These developments are clearly unhelpful for investment markets but they must be set against still robust economic growth in most areas of the world and the accompanying strong corporate earnings growth which has underpinned much of the current bull market in equities. Valuation levels also remain supportive with equity markets continuing to trade at price/earnings ratios around their long term averages, though we are aware that market aggregates are skewed by low valuations on large cap. stocks.

On balance, we are maintaining our positive view on equities for the present while monitoring developments closely, particularly in the structured debt markets.

The FTSE World index has provided a total return of +3.12% over the last six months and +12.41% over the last year in sterling terms.

2. Equities

2.1. UK Equities

The UK economy continues to perform strongly. In the year to the end of June, GDP increased at an annualised rate of 3.0%. The combination of strong growth and above target inflation means that at least one further increase in interest rates is likely. This, combined with the action of the five rate rises that have taken place since last summer, should begin to slow the economy later in the year.

While higher interest rates are unhelpful for equity markets, strong economic growth, together with the return of a degree of pricing power for the corporate sector, has resulted in excellent earnings growth for companies. This, coupled with strong dividend growth, continues to support UK equities.

Strong corporate profits growth has meant that UK equities do not look expensive in terms of price/earnings ratios, despite share prices having risen sharply over the past four years. Indeed, following the recent market correction, UK equities are arguably even more reasonably valued as prices have fallen whilst earnings have held up. We are mindful, however, that the backdrop for equities will become less favourable in the coming months as companies reach peak profit margins and rising interest rates act to slow economic growth. We are also aware of the valuation anomalies now apparent within the UK equity market. It is notable that, within the market as a whole, mid and small sized stocks now appear fully valued. This presents an opportunity to take profits from smaller companies and increase allocations to larger ones where the lower valuations and greater defensive qualities are more attractive.

We recently recommended a re-weighting of UK equity portfolios towards funds holding a higher proportion of their assets in larger capitalisation companies. Increasing weightings to larger companies within portfolios should have two additional benefits. Firstly, large cap. companies earn a higher proportion of their profits from overseas than smaller companies. This should prove defensive if higher interest rates slow the UK economy. Secondly, larger companies offer greater liquidity which may prove valuable when the time comes to reduce exposure to equities. Thus far, this move has proved worthwhile with the FTSE 100 index of large companies outperforming both the Mid 250 and Small Cap. indices over the second quarter of the year.

The FTSE All Share index has provided a total return of +4.27% over the last six months and +12.95% over the last year in sterling terms.

2.2. European (excluding UK) Equities

Despite excellent performance in recent years, Continental Europe continues to be our favoured destination for overseas equity investment. Valuations remain reasonable and earnings are supported by economic growth – particularly in Germany which is benefiting from strong export growth and increasing consumer confidence. Growth in Europe is also underpinned by gradual structural improvements being made at the corporate level in areas such as capital efficiency and labour costs. The expansion of the EU is an additional supporting factor, providing both access to well educated and low cost work forces and growing consumer demand for EU-produced goods.

While European equity markets have benefited from improved consumer confidence and stronger growth, the European Central Bank (“ECB”) has been raising rates to head off the threat of rising inflation. Interest rates have now doubled since the ECB began its monetary tightening cycle in December 2005. The ECB remains vigilant on inflation but, taking account of the strength of the euro, may be close to pausing in its rate tightening cycle. Risks to be borne in mind include the impact of higher interest rates on some of the peripheral members of the EU such as Spain and Ireland and the potential impact of a slower US economy on Europe. Nevertheless, we are retaining our current overweight position in European equities.

The FTSE Europe (ex. UK) index provided, in euro terms, a total return of +5.27% over the last six months (+6.82% sterling adjusted) and +23.27% over the last year (+21.49% sterling adjusted).

2.3. North American Equities

Maintained growth in the economy and continued strong corporate earnings growth (the latter aided by the very weak US dollar) have supported rising US equity markets over the last year. However, the weak currency has impacted returns for sterling based investors which, as a result, have been disappointing.

The US economy expanded at an annual rate of 3.4% in the second quarter of 2007, allaying fears that the economic slowdown witnessed in the first quarter would persist. Economic data releases are now indicating that economic growth is likely to remain strong over the balance of the year which should help support the equity market and the dollar. Though financial stocks were undermined by concerns about the sub-prime credit market, high levels of employment should mean that housing market weakness will not become a major issue, although this will require close monitoring. Comfort can be taken in the fact that, with inflation apparently under control, the Fed has room to cut interest rates should weakness in the housing market spread further into the economy.

Given the prolonged underperformance of US equities, which has left them looking attractively valued relative to other markets, we are now recommending portfolios contain small allocations to US equities.

The S&P 500 index provided, in US dollar terms, a total return of +2.10% over the last six months (-1.65% sterling adjusted) and +16.13% over the last year (+6.70% sterling adjusted).

2.4. Japanese Equities

Japan's economy is growing quite strongly due to demand for its exports, but remains troubled by weak domestic consumption and very low inflation. Low interest rates and a weak currency have kept the worst of the deflationary forces at bay but the stronger economy has not, so far, resulted in stronger demand for Japanese assets.

Earlier this year the Bank of Japan ("BoJ") took its second step towards bringing interest rates back into line with international levels with a 0.25% increase. At only 0.50%, however, interest rates are still low by international standards and the caution with which the BoJ is increasing rates has been a factor in keeping the Japanese yen very weak. This weakness has undermined returns to international investors who bought into Japanese equities to participate in the long awaited economic recovery.

We remain of the view that Japan's gradual economic restructuring will eventually bear fruit, resulting in stronger equity market returns and a stronger yen. We are therefore recommending that allocations to Japanese equities are maintained.

The FTSE Japan index provided, in yen terms, a total return of -0.32% over the last six months (-2.46% sterling adjusted) and +10.41% over the last year (-2.50% sterling adjusted).

2.5. Asia Pacific (excluding Japanese) Equities

The economies of the Asia Pacific (excluding Japan) region continue to look very attractive from the perspective of an international investor. Decreasing reliance on western export markets and sizeable foreign currency reserves mean that the periodic crises of the past are unlikely to be repeated. Additionally, strong economic growth and current account surpluses make it likely that Asian currencies will appreciate over the medium term.

Large speculative capital flows make the Asia Pacific equity markets among the most volatile in the world, though they held up well in the recent global sell-off. We believe that investors with a longer time horizon will earn excellent returns providing that the economic fundamentals remain sound. We recommend that equity weightings to the region are maintained.

The FTSE Asia Pacific ex. Japan index provided a total return of +19.12% over the last six months and +34.31% over the last year (for sterling based investors).

2.6. Emerging Markets Equities

Emerging markets equities have risen strongly over a four year period. Corrections, such as the ones experienced at the end of February and in mid-March, have been sharp but short lived while the correction in late July was no greater in the emerging markets than in the developed. The economic drivers of emerging markets have remained intact throughout this period. Strong growth has driven up employment and income, thereby creating a virtuous circle of consumer demand and further strong growth. These factors remain in place and, while the equity markets no longer offer the bargain valuations of 2003, we believe allocations to equities within the region should be maintained.

The FTSE All-World Emerging index provided a total return of +21.33% over the last six months and +40.00% over the last year (for sterling based investors).

3. Fixed Interest

Fixed interest investments have not fared particularly well over the past year as stronger economic growth has driven interest rates higher. Although yields are now more attractive we remain of the view that with growth remaining strong, yields may yet have further to rise.

Within the various classes of fixed interest instruments the additional yield available on corporate and non-investment grade bonds relative to their government counterparts, known as the yield spread, remains very low by historical standards despite a noticeable increase during the market turbulence at the end of July. This is due at least in part, to the innovation in financial products, particularly the repackaging of portfolios of bonds and mortgage-backed securities as mentioned earlier. Our view is that these products are too new to be fully understood or fully tested by the stresses of the economic cycle. We are therefore very cautious in our bond allocations preferring shorter dated conventional and index-linked gilts to corporate and non-investment grade bonds.

The ABI UK Pension Fixed Interest sector provided a total return of -0.22% over the last six months and +0.86% over the last year (for sterling based investors).

4. Property

Investments in commercial property in the UK have provided very strong returns in recent years. Recently, however, the strong cash flows into the asset class which have driven capital values higher have slowed considerably as investors have grown concerned that higher interest rates will begin to slow the economy and impact on demand, removing the support for the current inflated prices of commercial properties. Indeed, UK commercial property, as measured by the ABI Pension Property index, recorded a loss in the second quarter of 2007 – its first quarterly loss since 2001.

We continue to recommend reduced allocations to this asset class as it becomes clearer that valuations have lost touch with fundamentals. This is best illustrated by the yields available on commercial properties. These have continued to fall, despite the recent capital losses, while those on other asset classes, such as fixed interest and cash deposits, have increased.

The ABI UK Pension Property index provided a total return of -3.73% over the last six months and +4.59% over the last year (for sterling based investors).

5. Cash

With the likelihood of at least one further base rate increase in 2007, cash deposits earning approximately 5.75% p.a. at present with no (nominal) capital risk are attractive from a defensive perspective. We view cash as an important component of portfolio construction, offering some protection from the negative impact that rising interest rates could have on other assets. Where appropriate, advantage should be taken of ‘cash plus’ products that offer an enhancement through tax shelters.

N.B. Unless otherwise noted, all performance figures are total returns (including income re-invested) for the six month period from 31 January 2007 to 31 July 2007 and the twelve month period from 31 July 2006 to 31 July 2007 (source: Lipper Hindsight).