

Market Commentary

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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 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.

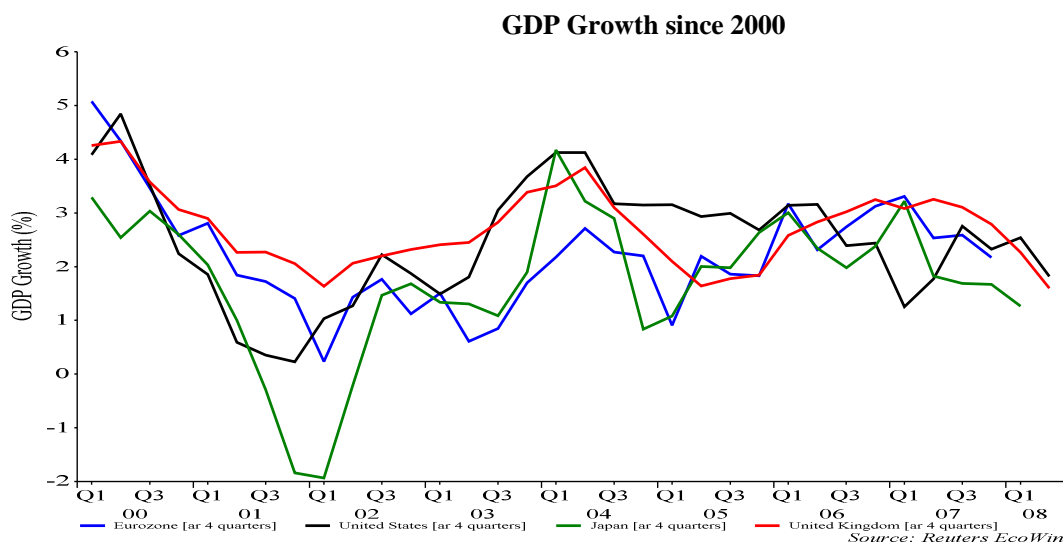
1. Economic and Investment Outlook

The world's major economies are suffering a synchronised slowdown in economic growth for the first time since the early part of this decade. The OECD is forecasting that aggregate growth in the economies of its 30 members will decline to 1.8% this year, from 2.7% in 2007. The IMF, on a broader measure that includes developing markets, forecasts growth slowing to 3.0% in 2008, from 4.8% last year.

Considering individual economies, the US, which still accounts for about one quarter of global GDP, is set to slow even more sharply. The IMF is forecasting US economic growth of 1.3% this year, down from 2.2% in 2007. Growth in the UK is forecast to fall from 3.0% to 1.4%. As the chart below shows, the Eurozone and Japan are being similarly impacted.

The global slowdown is centred on the US, where strong economic growth, driven by expanding credit and rising house prices, has given way to falling house prices and declining credit availability. The weakening of the US housing market has also brought about the so called credit crunch, where the value of new, highly complex, fixed income instruments, backed by mortgage interest payments, has been impaired. This has triggered bank write-offs, concerns regarding liquidity and further restrictions on the availability of credit to households and businesses.

As if these issues were not enough to keep governments and central banks fully occupied, sharply rising commodity prices, most notably oil, have driven up inflation. This has further undermined household finances, threatening to exacerbate the economic slowdown, and also restricted the freedom of central banks to reduce interest rates to ease the impact of the credit crisis. In recent weeks, however, the magnitude of the economic slowdown has become clearer. This has led to an easing in commodity prices, including oil, which in turn has brought some relief to consumers and investors alike.



2. Equities

2.1. UK Equities

UK economic growth is stalling. Consumer spending, so long the bulwark of the economy, is slowing rapidly 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 July survey carried out by market research company GfK NOP, consumer confidence is now at its lowest level since records began.

Credit market problems in the UK are similar to those in the US. Banks are trying to rebuild their reserve ratios by raising additional capital and curtailing loans and improve profitability by increasing lending rates. This means that the Bank of England's (BoE) interest rate reductions, which have taken rates down by 0.75% to 5.00%, are not being fully reflected in interest rates available to borrowers.

While further rate reductions would be helpful for economic growth in general, and the beleaguered housing market in particular, inflation is undermining the BoE's freedom to deliver rate cuts. July's figures showed the Consumer Price Index at 3.8%, compared to the BoE's target rate of 2.0%, while the Retail Price Index, the inflation measure used for index-linked bonds, is higher at 4.6%. However, we expect inflationary pressures to subside later in the year as declining global economic growth acts to slow demand for resources, including labour. This should free the hand of the BoE to reduce interest rates further, as appropriate.

Turning to the stock market, after the recent weakness, UK equities are, on first inspection, more attractively valued than they have been for several years. However, we are mindful that earnings expectations are likely to be pared back and therefore that valuation support may be less solid than it might appear.

Our recommended funds are, in the main, positioned away from the vulnerable consumer-sensitive areas of the market including the much troubled banking sector. We are confident, therefore, that they will prove more defensive than the broader market and we recommend that current allocations to UK equities are maintained.

The FTSE All-Share index has provided a total return of -6.23% over the last six months and -13.28% over the last year.

2.2. European (excluding UK) Equities

Until December's recommended reduction in allocations, Continental Europe had been our favoured destination for investments into international equities. 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 slowdown afflicting the US and UK. Indeed, with the European Central Bank's (ECB) reputation for taking no risks with inflation there was a danger that interest rates would be held too high for too long, driving up the value of the euro and exacerbating the eventual slowdown. The ECB demonstrated their inflation fighting credentials by actually increasing interest rates (to 4.25%) in July.

The core eurozone economies remained fairly resilient for longer than the US or UK, with Germany in particular benefiting from sustained export demand from the Far East. However, the combined impact of the strong euro and weakening global economy is now showing through clearly. Germany's manufacturing orders have now fallen for seven consecutive months, including an unexpectedly sharp decline of 2.9% in June. As the economic news continues to deteriorate, we expect the euro to continue to lose some of its recent gains.

The Continental European economy, however, remains structurally sound and it will continue to be a long term beneficiary both of demand for exports from the Far East, and the continuing development of Eastern Europe. We recommend that allocations to European equities are maintained.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of -8.46% over the last six months (-3.20% sterling adjusted) and -20.94% over the last year (-7.57% sterling adjusted).

2.3. North American Equities

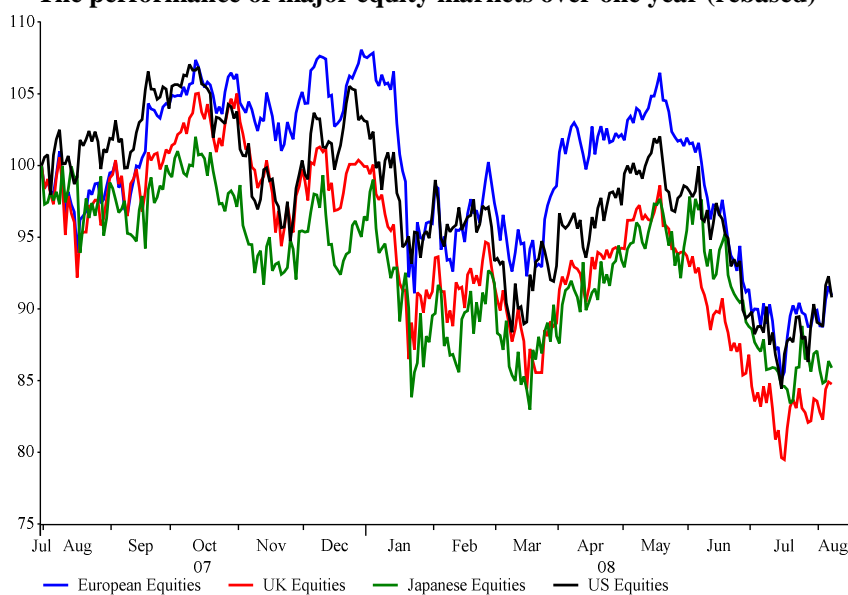
Despite interest rate reductions, totalling a full 3.25% over the last year, and a Federal economic stimulus package worth \$170bn, the US economy is struggling to maintain momentum. Consumer spending is being undermined by falling house prices which, according to the Case-Shiller Home Price index, were 15.8% lower in May compared to the previous year. In the banking sector, the impairment of mortgage-backed securities and related financial assets has damaged the balance sheets of financial institutions, causing a sharp reduction in credit availability to both consumers and businesses.

The Federal Reserve's (the Fed) interest rate reductions have caused the US dollar to weaken markedly, which has helped exporters and triggered the start of the much needed rebalancing of the US economy away from an over-reliance on consumer spending. However, a weak dollar has also increased the price of imported goods, thereby worsening the plight of the consumer.

Considering that the US is at the centre of the current global economic slowdown, the US equity market has proven relatively resilient (see chart). 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 -7.08% over the last six months (-6.75% sterling adjusted) and -11.09% over the last year (-8.80% sterling adjusted).

The performance of major equity markets over one year (rebased)



2.4. Japanese Equities

The Japanese economy, like those of other developed countries, is slowing under the impact of global financial dislocation and rising commodity prices. Japanese consumers are being squeezed between rapidly rising costs and weak wages growth, while Japan's key export sector is suffering from declining global growth.

Japan's equity market performed very poorly in the first quarter of this year, partly due to an acute bout of yen strength but also due to the Japanese economy being very sensitive to global growth. Since the end of the first quarter, however, yen strength has dissipated and investors have begun to reassess Japanese equities on the basis that they could prove defensive relative to other markets.

One positive factor for equity investors is that Japan remains 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.

While Japan, along with other developed economies, is likely to undergo a period of slow growth in the coming months, Japanese equities are now offering better value, both relative to 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 -2.68% over the last six months (-3.92% sterling adjusted) and -22.23% over the last year (-12.12% sterling adjusted).

2.5. Asia Pacific (excluding Japanese) Equities

Equity markets in the Asia Pacific (ex Japan) region have provided excellent returns in recent years. These have been driven by strong regional economic growth, investor enthusiasm for markets linked into the Chinese development story and the expectation that Asian currencies will appreciate over the medium term.

While economies such as South Korea, Hong Kong, Singapore and Taiwan should sustain growth comfortably in excess of the developed Western economies, these markets no longer offer compelling value.

We have, since 2006, recommended only small allocations to Asia Pacific equities in acknowledgement of the strong performance and historic volatility of the region's stock markets. As the global economic downturn has gathered pace, other investors have started to take profits from the region and Asia Pacific equities have begun to underperform those of the developed markets (see chart). However, we continue to believe that investors with longer time horizons will earn good returns as the long term economic fundamentals remain very promising. We recommend that equity weightings to the region are maintained.

The FTSE Asia Pacific (ex Japan) index provided a total return of -5.36% over the last six months and -8.12% over the last year (for sterling based investors).

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



2.6. Emerging Markets Equities

Hopes that strong economic growth in emerging markets (as defined by MSCI – see * below) would continue despite the sharp slowdown in developed economies have been dashed over the last quarter. Upward pressure on inflation from the sustained strength of commodity prices, together with slowing demand for exports, means that these economies 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, and thereby put further upward pressure on inflation. In many emerging markets, however, wages are rising rapidly as competition for workers has enabled employees to claim their share of strong economic growth.

Emerging markets equities provided excellent returns over more than four years to early 2008, however, they are now beginning to underperform developed markets equities. Emerging markets had been trading at valuation premiums to their developed counterparts in acknowledgement of their stronger growth potential. This is now likely to reverse as risk appetite wanes and investors look to book profits. Equity market corrections in China and India, two former favourites of emerging market investors, have been severe. Over the first seven months of the year Chinese shares listed on the Shanghai stock exchange have fallen by 47.27%, while those Indian companies with shares listed in Bombay have seen, on average, a 29.24% 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. We are likely to see the opportunity to increase weightings to emerging markets in the coming months but for the present recommend the maintenance of current holdings.

The FTSE All-World Emerging index provided a total return of -2.33% over the last six months and -1.22% over the last year (for sterling based investors).

* MSCI includes 24 countries in its emerging markets indices: Argentina, Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, 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 stock (gilts) has demonstrated its value as an effective portfolio risk diversifier. 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 served to dampen 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. Rising concerns that inflation would require higher UK interest rates drove gilt yields sharply higher in June, though these inflation concerns did not endure. As the likely extent of the economic slowdown became apparent, gilt yields dropped once more and are now, once again well below 5%.

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 amongst investors. Concerns about credit quality and default risk, together with the unattractive yield premiums available on these, meant that their appeal to investors was much less 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 fixed interest allocations on conventional and index-linked UK government bonds. Index-linked issues have performed particularly well due to ongoing concerns about inflation. As well as offering inflation protection, index-linked bonds are capital gains tax free. This includes the gains from the indexation of capital, and makes index-linked gilts especially attractive when held outside of a tax advantaged wrapper, such as a pension.

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 -0.67% over the last six months and +4.68% over the last year. The ABI UK Pension Index-Linked Gilt sector provided a total return of +2.42% over the last six months and +11.41% over the last year.

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 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 appetites for risk among investors, has served to drive commercial property yields sharply higher and prices sharply 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 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 -4.38% over the last six months and -17.49% over the last year.

5. Cash

Sterling deposits or monies held in AAA-rated liquidity funds earn returns in excess of 5.00% p.a. at present. We regard these as attractive relative to the yields currently available on fixed interest and commercial property.

Our view is that UK interest rates will probably remain close to their current levels for the remainder of 2008, hence we continue to favour allocations to cash. 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 +4.89% over the last year.

6. Note on Hedge Funds

While we continue to research the sector, we remain concerned that hedge funds are riskier than generally perceived. In our view, 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.

Recent news flow has also given us some cause for concern. Carlyle Group closed its hedge fund business in July after poor performance and fund outflows, while a quoted London-based hedge fund manager has two of its flagship funds down by 25.20% and 31.80% over the year to date. We find it very instructive that many hedge funds are experiencing performance issues at this time. According to the FT, in July the hedge fund sector suffered its worst month in eight years as 'popular' bets, such as long positions in energy stocks and shorts in financials, reversed sharply. This leads us to question the value added by many, but not all, hedge funds which appear on the surface to be doing little more than following market trends. Given the level of charges, including performance fees, levied by hedge funds this does not, in our view, constitute an attractive proposition for investors.

For completeness, we have included below the HFRX Global Hedge Fund index figures for hedge fund performance. We are, as might be expected, somewhat sceptical about the integrity of these figures. In our view, the index will almost certainly overstate hedge fund returns. This is because the submission of performance figures to the index compilers is voluntary and it is unlikely that failed or poorly performing hedge funds would submit numbers for inclusion in the index. The effect will cause the index figures to 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 -0.57% over the last six months and -3.34% over the last year.

N. B. The above commentaries reflect our views as at 1 August 2008. Any material changes in economic and market conditions between then and the time of writing would 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 2008 to 31 July 2008 and the twelve month period from 31 July 2007 to 31 July 2008 (source: Lipper Hindsight).