

Market Commentary

December 2009

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Risk Warnings

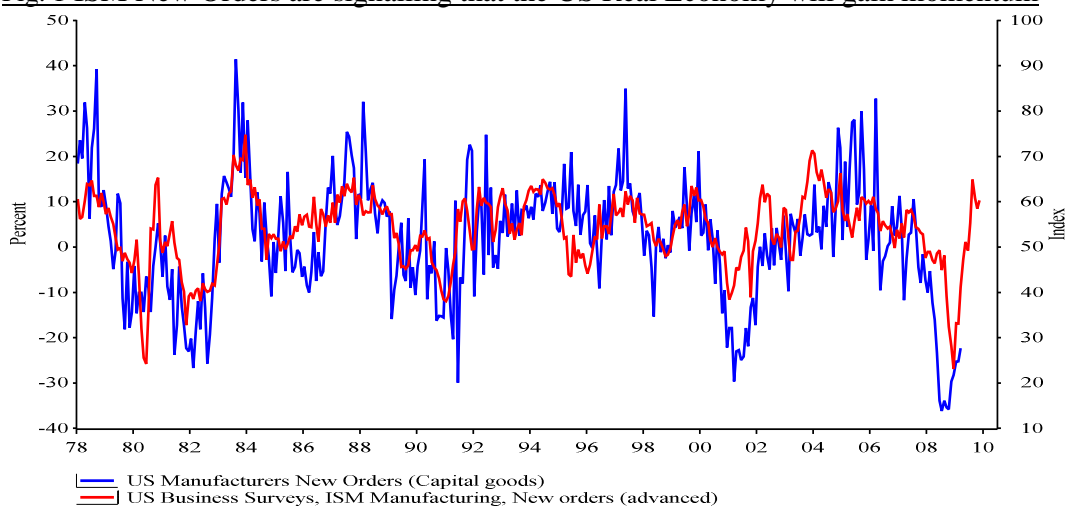
This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 16 December 2009. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments and any income therefrom can go down as well as up and you may not get back the full amount you invested. Levels and bases of, and reliefs from, taxation are those currently applying but are subject to change and their value depends on the individual circumstances of the investor.

1. Economic and Investment Outlook

Recently released data, together with forward-looking surveys of business and consumer sentiment, are indicating that the global economy is expanding once more. Financial stabilisation and a return to growth have come earlier than many observers dared hope only a few months ago. Concerns that the world economy might suffer a multi-year depression, not unlike the Great Depression of the 1930s, or would remain mired in recession for a prolonged period have all but disappeared, and the discussion among policymakers and economists is now centred on the shape and durability of the recovery. After many months of downgrades, forecasts for economic growth are now being revised higher. For example, the International Monetary Fund, in its October World Economic Outlook paper entitled 'Sustaining the Recovery', upgraded its expectation for economic output growth from the developed nations in 2010 to 1.3% from a forecast of 0.6% made in July.

Recognition for the rapid improvement in the economic outlook, as exemplified by the ISM New Orders Survey in the US (see Fig. 1), is, in large part, attributable to the speedy and aggressive response to the credit crisis from both monetary authorities and governments. Ignoring warnings about the longer-term costs or inflationary consequences of their actions, central banks have moved decisively to take official interest rates down to the lowest levels ever recorded. Governments, meanwhile, have launched fiscal packages to support demand in their economies. A wide array of other policy measures are now in place to ease credit market conditions, support mortgage holders and extend loans to key businesses, such as car manufacturing and container shipping. As a result, financial markets have stabilised, consumer sentiment has steadied, and businesses have begun to rebuild inventories.

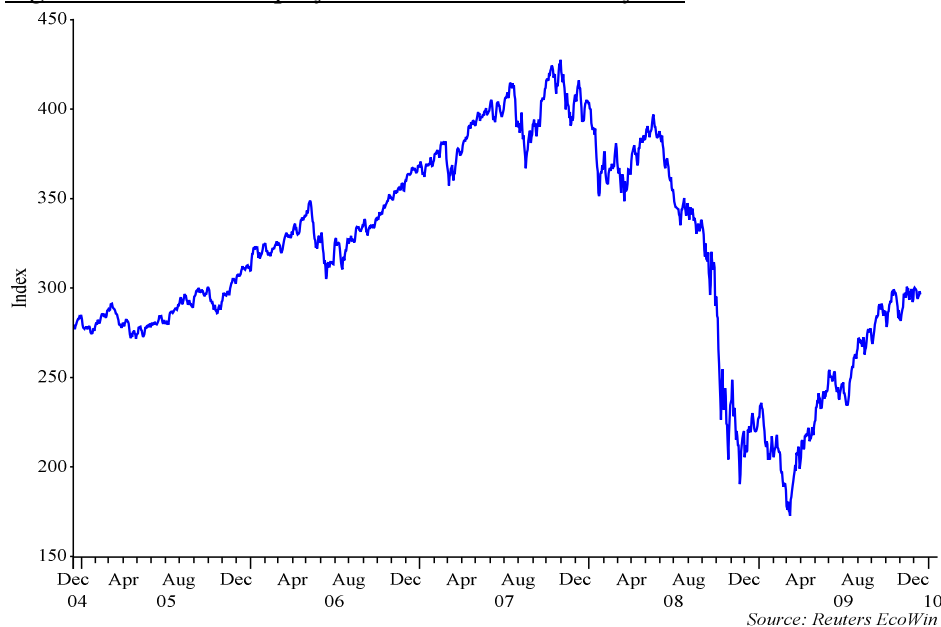
Fig. 1 ISM New Orders are signalling that the US Real Economy will gain momentum



Looking forward to 2010, we believe that the key debates will centre on the extent to which recovery becomes self-sustaining and the degree to which policy support can be withdrawn without a relapse in growth.

As might be expected, the improved economic outlook has resulted in a bounce in equity markets from the extremely depressed levels of March (see Fig. 2). The recovery in share prices has been supported by company earnings statements which have, in the main, met or exceeded analysts' forecasts over the past few months. The drivers of better corporate earnings include the inventory rebuild mentioned above, as well as benefits to costs as companies have reaped the rewards of the aggressive overhead reductions made in late 2008 and the early part of this year. Cost pressures have also been alleviated by lower interest rates and reduced raw materials prices compared to last year.

Fig. 2 MSCI World Equity Market Index over five years



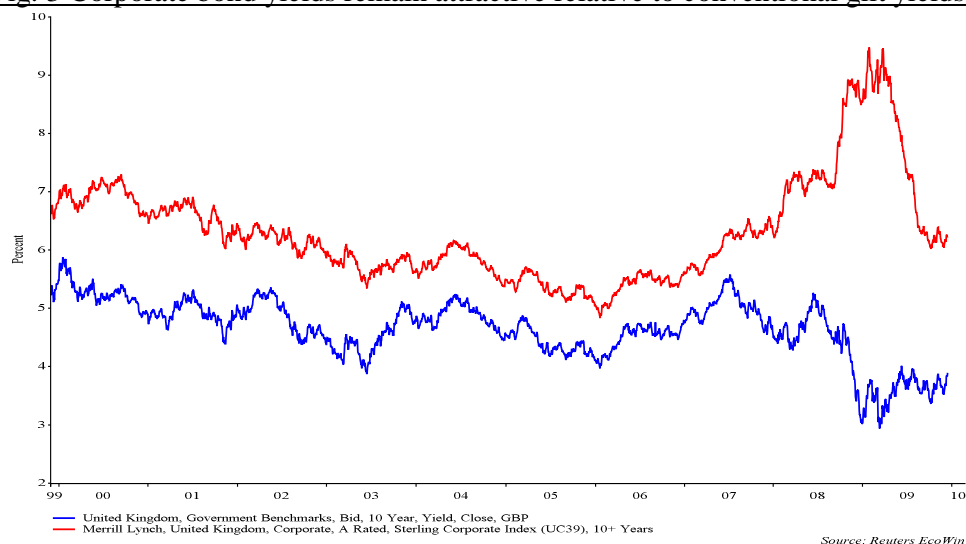
The path of economic growth, and therefore corporate profits and dividends, will be the key determinant of equity market returns in 2010. Considering valuation, the extreme weakness in equity markets in late 2008 and early 2009 saw dividend yields in most major equity markets move above their respective government bond yields. This was a clear indication of investors' extremely bearish expectations for both the sustainability of existing dividends and the prospects for future dividend growth. The rally over the past six months has brought equity yields down once more but, unless earnings and dividend growth remain very subdued for a prolonged period, equities remain attractively valued relative to both government bonds and cash deposits.

The MSCI World Equity Market index has provided a total return of +17.70% in sterling terms over the last six months and +24.01% over the last year.

Turning to other major asset classes, government bonds, which were the asset class of choice for investors in the final quarter of 2008, have struggled to make further progress. The downward pressure on sovereign bond prices resulting from the high levels of issuance appears, for now at least, to have been balanced by government policies designed to expand money supplies, including the direct purchases of government bonds. Commercial banks, which have access to low cost short-term funds, are also purchasers of government bonds at present.

In stark contrast to government bonds, corporate bond prices were driven to exceptionally low levels in late 2008 both by concerns about falling corporate earnings and forced selling by leveraged investors caught out by the ferocity of the liquidity squeeze. The increase in the yields on corporate bonds relative to their government counterparts was even more pronounced (see Fig. 3). This was due to investor enthusiasm for the defensive attributes of government bonds forcing prices higher and yields down. This situation began to correct in the first quarter of 2009 in response to the policy initiatives outlined above, since when corporate bond prices have made a rapid recovery. In our view, however, corporate bonds still present opportunities for investors given the attractive yields available in comparison to both government bonds and cash on deposit.

Fig. 3 Corporate bond yields remain attractive relative to conventional gilt yields



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 the middle of this year as tighter credit market conditions removed an important source of funding for commercial property buyers and the deteriorating economy undermined tenant demand. While commercial property values have now begun to stabilise, rents may yet have further to fall. However, yields are at appealing levels, both in absolute terms and relative to other assets. We have therefore been recommending additional allocations to this asset class.

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

2. Equities

2.1. UK Equities

While the UK economy remains the only G7 economy yet to officially emerge from recession, the rate of decline in output is slowing. In the third quarter, UK GDP declined by 0.3% compared to a drop of 0.6% in the prior quarter and 2.5% in the first quarter of the year. A key driver of this improvement has been the adoption of highly accommodative monetary policy by the Bank of England. In March, the Bank rate was reduced to an all time low of 0.50% and a £125bn program of quantitative easing was introduced. This was subsequently extended to £200bn. The impact of low interest rates can be seen in the housing market, where, according to figures produced by Nationwide, house prices are now close to 10% above their February lows. The impact is also evident in retail sales which showed year-on-year growth of 3.4% in October, the fastest pace of expansion since May 2008.

Despite the aggressive policy response, the upturn in the UK may not prove as robust as in other economies. Regardless of who wins next year's general election, the new government will have to address the country's budget deficit through a combination of tax increases and spending cuts. In this respect, the recent Pre-Budget Report in our view represents a missed opportunity to set out a clear path back towards a sustainable fiscal policy. Considering the private sector, consumption is unlikely to drive strong economic growth as household balance sheets are over-extended and need a period of higher savings and reduced spending. In addition, the financial services sector, which in the previous economic cycle was a major contributor to growth (contributing £500bn to the economy in 2007, according to the British Bankers' Association), looks likely to be hamstrung by increased regulation to reduce the risk of a repeat of the financial crisis.

While the UK's economic recovery may not be the strongest in the developed world, we are recommending that current weightings to UK equities are maintained at present. UK equities have attractions on valuation grounds and sterling's depreciation since the onset of the credit crisis should help UK-based businesses to increase exports and displace imports with domestically produced goods. It is noteworthy that, in aggregate, major UK-listed companies generate a substantial proportion of their revenues from overseas (c60% according to HSBC). These companies should be able to grow their profits at a faster rate than the domestic economy and also benefit from enhanced profits growth as foreign earnings are translated to sterling.

The FTSE All-Share index has provided a total return of +19.74% over the last six months and +29.28% over the last year.

2.2. European (excluding UK) Equities

The eurozone economy grew 0.4% in the third quarter of 2009, the first quarter-on-quarter expansion in a year-and-a half, following a 0.2% fall in the second quarter. Inflation in the 16-country region returned to positive territory in November, with consumer prices rising 0.6% year-on-year. The European Central Bank (ECB) has been less willing than its Anglo-Saxon counterparts to reduce interest rates and its official rate has been kept at 1.00% since June – noticeably higher than base rates in the UK, US and Japan. Although this has prompted criticism that the ECB has not been sufficiently aggressive, the central bank's injection of €442bn of one-year funds into the eurozone banking system in June, at an interest rate of just 1.00%, shows that it has taken supportive action. European banks now have access to effectively unlimited low cost liquidity, at least until the summer of 2010. As a consequence, the ECB's balance sheet is now bigger as a proportion of eurozone GDP than that of the Federal Reserve relative to US GDP.

Unemployment in the eurozone remained steady at 9.8% in October, the highest rate in ten years. However, the data mask a considerable divergence within the region, with unemployment ranging from just 3.7% in the Netherlands to 19.3% in Spain. The generous welfare systems in the eurozone, together with higher savings rates than the US and UK, should mean that European consumers can cope with higher levels of unemployment and continue to spend. However, retail sales also stagnated in October, suggesting domestic consumer spending remains weak, leaving prospects for the region heavily dependent on demand for exports. Though economic data and surveys have indicated a degree of recovery, this has been largely due to government stimulus packages and temporary inventory effects. Any recovery, therefore, is likely to be fragile and it may take some time before export-orientated European companies see any significant growth in demand. Having advised a reduction in weightings to European equities at the end of 2007, we recommend that remaining allocations are retained, where appropriate.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of +16.56% over the last six months and +23.35% over the last year. The strength of the euro in the six months to 30 May means that, when translated into sterling, the returns are +21.48% over the last six months and +36.47% over the year.

2.3. North American Equities

The response of the US authorities to the credit crisis and subsequent economic downturn has been impressive. Under the chairmanship of Ben Bernanke, an expert on depression-era economics, the Federal Reserve (the Fed) reduced interest rates sharply. From 5.25% in September 2007, policy rates had been lowered to a target rate of “between zero and 0.25%” by December 2008, where they remain. The Fed also introduced a policy to purchase up to \$300bn in US Treasury bonds, which has now been completed, as well as buying c\$1,450bn of mortgage backed securities from the two government-sponsored housing enterprises, Freddie Mac and Fannie Mae. The aims are similar to the UK’s quantitative easing: to force additional liquidity into the economy and drive market interest rates down towards the official interest rates. These monetary measures have been accompanied by a Keynesian-style \$700bn fiscal stimulus package, the Troubled Asset Relief Program.

These measures appear to be having their desired effect; after four quarters of negative growth (the longest stretch of declines since quarterly records began in 1947), economic output in the third quarter grew by a revised 2.8%. This is due in part to stabilising order books which are prompting companies to rebuild inventories, thereby triggering growth in production.

Underlying consumer demand, however, remains fragile. Headline retail sales data have been buoyed by the impact of the ‘cash-for-clunkers’ scheme and though unemployment fell last month, it remains high at 10.0% – almost twice its rate just 18 months ago. A return to the credit-fuelled consumption patterns of the pre-crisis years is therefore doubtful and the need for US consumers to rebuild their savings is likely to create a meaningful headwind for demand. Furthermore, price competition resulting from significant spare capacity has begun to appear and, if sustained, such price declines could prove detrimental to corporate profits.

Turning to the stock market, nine months ago US equities had fallen to levels that could be considered inexpensive relative to historical valuations. However, aided by the loose monetary and fiscal conditions, the recent rally has taken them back, in our view, to broadly fair value. We therefore recommend that allocations to US equities should be maintained for the present, where appropriate.

The S&P 500 index provided, in US dollar terms, a total return of +25.39% over the last six months and +17.24% over the last year. The weakening of the dollar in the second quarter of this year means that, when translated into sterling, the returns are +18.41% over the last six months and +7.63% over the year.

2.4. Japanese Equities

With GDP having contracted at an annualised rate of 14.2% in the first quarter of 2009, Japan's recession was its most severe in the post-war period. It was also sharper and deeper than those seen in the other major developed economies. Though acute, the contraction proved relatively short-lived as the economy returned to growth in the second quarter of the year, thanks largely to a recovery in international trade.

Despite signs of improvement, concerns remain about the vitality of Japan's economy. These concerns were recently highlighted by the downgrading of third quarter GDP growth from an annualised 4.8% to a much more pedestrian 1.3%. At the heart of Japan's problems lie unfavourable demographic trends and an absence of immigration. Expectations of deflation appear embedded and therefore, to a degree, self-fulfilling. Furthermore, personal savings ratios have fallen sharply suggesting that demand for future government debt issues may be limited. With little scope to effect further monetary or fiscal stimuli, the Democratic Party of Japan (DPJ), elected in an historic landslide victory on 30 August, faces significant obstacles in its attempts to encourage consumer spending in a population that has, with good reason, developed a profoundly cautious attitude.

In addition to structural domestic issues, Japan's economy has also faced a significant external headwind in the form of currency appreciation. The yen has strengthened by 10.48% relative to the dollar over the twelve months to the end of November, and by 38.27% since the first signs of investor risk aversion appeared in the summer of 2007. This has disadvantaged Japan's all-important export sector, particularly when compared to South Korean competitors who have, until recently, benefited from a weaker currency. Recent policy initiatives from the Japanese central bank have acted to weaken the yen somewhat, a development that will be welcomed by exporters.

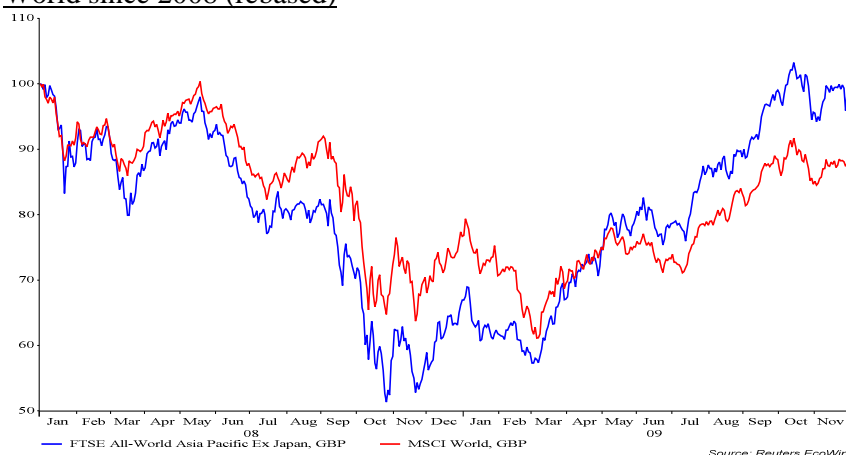
In response to Japan's economic difficulties, international investors have largely shunned its equity market. Consequently, Japanese equities appear inexpensive both in historical terms and relative to other equity markets. While we acknowledge the severity of Japan's structural economic issues, we believe the corporate outlook is brighter. Aggressive cost cutting measures have been undertaken and, aided by lower raw materials input costs, Japanese companies, and the Japanese equity market, should now be in a relatively strong position to benefit from a recovery in global demand. We recommend current allocations are maintained, where appropriate.

The FTSE Japan index provided, in yen terms, a total return of -5.89% over the last six months and +2.82% over the last year. The fluctuations of the yen in the six months to 30 May mean that, when translated into sterling, the returns are +2.47% over the last six months and +6.29% over the year.

2.5. Asia Pacific (excluding Japanese) Equities

The global crisis impacted the Asia Pacific region not through banking or finance channels, but through the sharp contraction in international trade that resulted from the collapse in trade finance and the steep falls in consumer demand in the west. As export volumes declined, industrial production fell, economic growth estimates were revised lower and unemployment increased. The failure of the Asia Pacific economies to ‘decouple’ and thereby avoid the problems of the developed world, together with much higher risk aversion among investors, caused the region’s equity markets to underperform in 2008. However, as policy measures have delivered a better economic outlook and risk appetite has improved, Asia Pacific equities have recovered strongly (see Fig. 4).

Fig. 4 FTSE All-World Asia Pacific ex Japan compared to MSCI World since 2008 (rebased)



With high savings ratios, cheap labour and strong public sector finances, many Asia Pacific economies have the potential to achieve rapid economic growth. Having benefited from strong export-led growth over the past decades, Asian policy makers are now making a concerted effort to stimulate domestic demand which, with increasing levels of prosperity, should stimulate further economic growth over the medium term. However, more immediately, Asian growth is likely to remain closely linked to the health of the global economy.

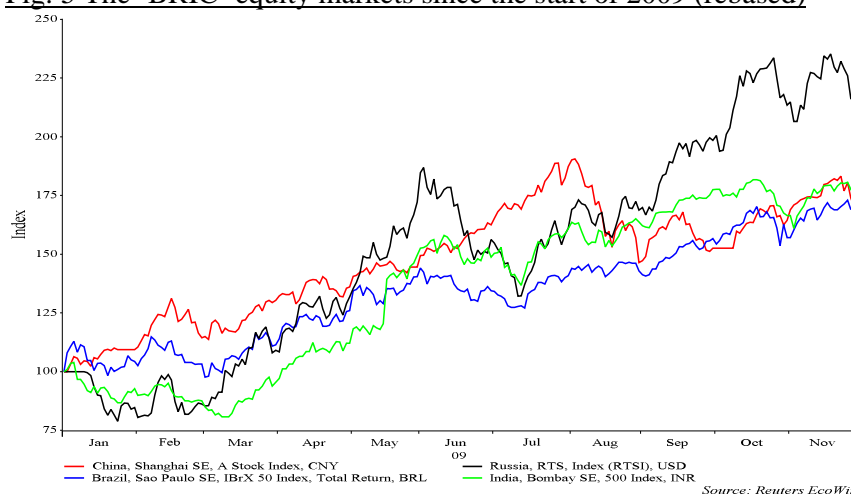
Such has been the strength of the equity market rally in Asia that valuation measures are now above their long-term averages and appear to reflect expectations of a full global economic recovery, an outcome that is, as yet, by no means certain. Though we recognise the region’s long-term potential, we do not currently recommend increasing allocations.

The FTSE All-World Asia Pacific ex Japan index provided, in local currency terms, a total return of +20.22% over the last six months and +60.25% over the last year. In sterling-adjusted terms, the returns are +24.46% over the last six months and +72.23% over the year.

2.6. Emerging Markets Equities

After the steep losses recorded in 2008, emerging equity markets* have enjoyed a strong 2009 (see Fig. 5). Though many emerging economies (with the notable exclusion of those in Eastern Europe) were largely free of the debt issues that plagued their western counterparts, investors judged, correctly, that the prospect of a protracted decline in western consumption would undermine, at least temporarily, the export driven growth models of the emerging economies. Improvements in global economic data have encouraged a renewed optimism to which emerging markets equities have responded strongly.

Fig. 5 The 'BRIC' equity markets since the start of 2009 (rebased)



While the rebound in equity markets is, to some extent, justified by the improving economic background, there are suggestions that loose global monetary conditions are having a disproportionate effect on the emerging markets. With developed world interest rates at historic lows, the strong growth potential of the emerging markets is proving attractive to investors. The resulting capital inflows risk destabilising the emerging market growth story, a fact that has not gone unnoticed in Brazil, where a tax has been introduced in an attempt to curb speculative capital inflows.

Though we believe the long-term outlook is positive, emerging equity markets valuations appear full. We therefore do not recommend adding to allocations for the present.

The FTSE All-World Emerging index provided, in local currency terms, a total return of +26.51% over the last six months and +90.73% over the last year. In sterling-adjusted terms, the returns are +24.31% over the last six months and +78.33% over the year.

* MSCI includes 22 countries in its emerging markets index: Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey.

3. Fixed Interest

The UK Debt Management Office, on behalf of HM Treasury, is set to issue £241bn of UK debt securities in the current fiscal year. This is almost £100bn more than the 2008/9 issuance, which was itself far higher than earlier years. Meanwhile, the Bank of England recently extended its quantitative easing policy of purchasing gilts from non-public holders by £25bn to £200bn. The aims of these seemingly conflicting policies are clear: to fund government borrowing requirements and force additional liquidity into the financial system. In the US, debt issuance will be approximately \$2,000bn, though American repurchases are being focused on the debt of the mortgage agencies as well as on US treasury bonds.

The presence of the authorities as both the issuer of government bonds and buyer of substantial portion thereof is almost certain to result in price distortion. In the UK, the 10-year conventional gilt yielded 3.52% at the end of November. This, in our view is unattractive given the medium term threat of higher inflation and the fact that repurchases, which are clearly supporting prices, will end long before issuance levels fall back to pre-crisis levels.

In contrast to conventional government bonds, index-linked gilts in our view remain an attractive asset class. Returns have been strong over the past year, reflecting concerns over inflation risks in the medium term and the asset class' undervaluation at the tail end of 2008. While the current economic weakness makes near term inflation unlikely, the monetary policies being employed by the BoE significantly raise the risk of higher inflation over the next decade and, consequently, the inflation protection qualities of index-linked gilts remain appealing.

We continue to favour funds of corporate bonds. Since late January, when we recommended increasing allocations to investment grade bonds, this sector has rallied strongly. With all but distressed bonds trading close to their par values, we expect that returns will now come increasingly from income rather than capital appreciation. However, yields remain attractive both in absolute terms and relative to those available from conventional government bonds. Mindful that official interest rates must rise in the medium term, we have latterly been recommending that allocations are invested in strategic bond funds, where managers can hedge out interest rate risk and allocate assets to wherever they see value within the asset class.

The ABI UK Pension Gilt sector provided a total return of +6.10% over the last six months and +7.10% over the last year. The ABI Pension Sterling Corporate Bond sector provided a total return of +19.43% and +19.87% over the same periods. The ABI UK Pension Index-Linked Gilt sector provided a total return of +8.99% over the last six months and +17.62% over the last year.

4. Property

According to figures compiled by Investment Property Databank (IPD), UK commercial property prices fell by c44% between June 2007 and July 2009. This correction far exceeds the previous sharpest fall recorded, which was 27% in the three years to mid-1992. In the bull market that ran until mid-2007, property was a major beneficiary of the easy monetary environment that induced price bubbles in several risk asset classes. Property deals were often structured with high levels of low cost debt financing, which disappeared at the onset of the credit crisis. With it went a key prop for commercial property prices. This effect was exacerbated by the deteriorating economy, which further undermined property values by putting downward pressure on rents.

The extent to which prices have fallen over the past two and a half years, together with the accompanying rise in yields, means that commercial property once again appears attractive to value-focused investors. Risks remain, particularly the threat of ongoing, downward pressure on rental values and occupancy rates arising from the weak economic environment and additional supply from developments now approaching completion. A further factor complicating the outlook for the sector is the c£225bn of outstanding loans backing UK commercial properties held by banks. Much of this will need to be either refinanced or repaid over the next five years. So far, banks appear to have been willing to extend or refinance loans in return for higher coupons and injections of additional capital into financial structures. However, there remains a risk that lenders will be less flexible in future and force the sale of properties, thereby increasing supply and depressing prices further.

According to the IPD UK Monthly Index, commercial property now yields c7.3%. This looks attractive, both on an absolute basis and in relation to other asset classes and offers, in our view, sufficient compensation for the risks outlined above. We have therefore been recommending, where appropriate, increases to commercial property allocations. To mitigate risk, we are recommending that increased allocations are focused on established funds, holding predominantly prime and ungeared, or lowly geared, property portfolios, though these carry correspondingly lower yields.

The ABI UK Pension Direct Property index provided a total return of +8.15% over the last six months and -6.57% 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 and we continue to favour small overweight positions in the asset class, 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 +0.79% over the last year.

6. Note on Hedge Funds

Our view that hedge funds are riskier than generally perceived has 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. Losses for the calendar year, as measured by the group's HFRX Global Hedge fund index (in sterling) were almost 23%, the biggest annual decline since data tracking began in 1990. Investor expectations of positive, uncorrelated returns from hedge funds have clearly been disappointed. Despite a partial recovery over 2009 to date, the industry's ability to justify high charges and performance fees remains, in our view, questionable.

The fallout from Bernard Madoff's fraudulent investment scheme has persisted through 2009 as the estimate of the true extent of the scheme's losses has grown to \$21.2bn, far higher than earlier estimates. Allegations of insider trading and fraud at hedge funds Galleon Group and K1 respectively go some way to justifying our view that the transparency of many funds, and funds of hedge funds, are not up to the requisite standard for us to recommend investing.

We expect the hedge fund industry to emerge from the financial crisis in a very different shape. There will certainly be fewer funds, 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 +7.01% over the last six months and +11.27% over the last year.

The above commentaries reflect our views as at 16 December 2009. Any material changes in economic and market conditions between then and the time of writing your report will be reflected in our recommendations.

Unless otherwise noted, all performance figures are total returns (including income re-invested) for the six month period from 30 May 2009 to 30 November 2009 and the twelve month period from 30 November 2008 to 30 November 2009 (source: Lipper Hindsight).