

Market Commentary

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Risk Warnings

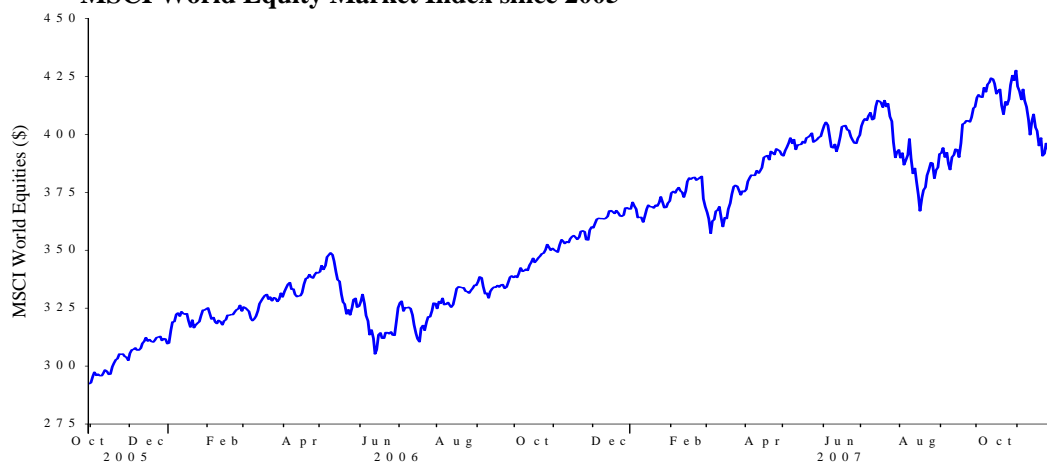
This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 3 December 2007. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments 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

Having more than recovered the losses sustained in the August setback, equity markets suffered another abrupt wave of profit taking and risk aversion in November. Despite a further 0.25% cut in US interest rates on 31 October, concerns about the health of credit markets came to the fore once more, causing widespread selling of equities and other risky assets. Optimism that the volatility of the summer months would be short lived quickly evaporated as it became clear that banks would need to take further provisions against sub-prime mortgage related assets on their balance sheets. A key issue for investors is the lack of clarity in the financial position of the banks. This has arisen because of the complexity of the assets involved, their treatment in accounts and the inability of analysts, investors and perhaps even the banks themselves, to accurately quantify and value them. The result has been a widespread reluctance among banks to lend to each other, which has caused short term credit markets to stop functioning effectively. This has left interbank interest rates trading at levels far above the policy rates set by central banks.

The outlook for equity markets now depends crucially on the extent to which these financial market issues intensify and their impact on the wider economy. The US housing market, which was driven up to unsustainable levels by cheap and easy credit, is central to these considerations. While US house prices are now falling, the extent of the weakness and the knock-on impact on the US consumer is, as yet, unknown. The Federal Reserve, the US central bank, is attempting to mitigate the worst of the impact by cutting interest rates. However, with interbank rates trading above official rates, the extent to which this monetary easing benefits the consumer remains a concern.

MSCI World Equity Market Index since 2005



Until recently, we have been recommending maintained allocations to equities within client portfolios. With the outlook for economic growth in 2008 deteriorating, we now believe that it is appropriate to adopt a more cautious stance by reducing equity holdings.

Our positive view on equities has been based on valuation support. As measured by price to earnings ratios, many equity markets are still trading at levels close to their long term averages. However, there is now a risk that slower economic growth, or even a recession, drives down corporate earnings. This, clearly, would undermine the valuation support.

Within equity allocations, we are recommending a reduction in clients' Continental European holdings. We have held overweight positions here since 2004 and have captured very strong returns. With the reduction to neutral in Europe, our recommended portfolios are now neutral or underweight in all equity markets except Japan. Our overweight allocation to Japanese equities is based on the relatively low valuations in that market and the defensive characteristics of the yen. These factors, taken together, persuade us to maintain the current position for the present.

The FTSE World index has provided a total return of -1.91% over the last six months and +10.32% over the last year.

2. Equities

2.1. UK Equities

The UK economy, for now, continues its remarkably strong and stable expansion. Figures for the third quarter of 2007 show that the economy grew at an annualised rate of 3.2%. However, given the potential impact of the credit crisis, together with the three increases in the bank rate earlier this calendar year, it is likely that the pace of economic growth will weaken, perhaps substantially, in 2008. The scope for the Bank of England to reduce interest rates next year to ease the impact of slower growth will depend on the path of inflation. Data for October showed the Consumer Price Index at 2.1%, marginally above the Bank's target rate of 2.0%. Our view is that inflationary pressures from higher energy and food prices will ease, leaving the way clear for interest rate reductions early next year.

Considering equity markets, strong returns from UK equities over the past four years have been the result of the supportive economic conditions described above and the return of some pricing power to the corporate sector. These factors have driven excellent earnings growth for companies, thereby enabling healthy dividend increases. Strong corporate profits growth has meant that, despite share prices having risen over the past four years, UK equities do not look expensive in terms of price to earnings ratios.

Nevertheless, we are mindful that, with growth likely to slow and credit conditions deteriorating, the outlook for equities is becoming less favourable and returns may struggle to match the excellent levels of recent years. Although, as mentioned above, valuations are supportive, corporate profit margins are close to record levels and may begin to decline in the coming months. Also, high commodity prices are boosting the profits of resource companies that have a large weighting in the UK indices. A fall in commodity prices prompted by a deteriorating growth outlook would, therefore, undermine the earnings of several large index constituents. We are monitoring developments closely, particularly those in credit markets and US economic data releases, but recommending the maintenance of current allocations to UK equities for the present.

The FTSE All Share index has provided a total return of -3.10% over the last six months and +8.54% over the last year.

2.2. European (excluding UK) Equities

Continental European equities have been our favoured destination for international equity allocations since 2004. This has proved very profitable, with European (ex. UK) equities outperforming those of the US, UK and Japan over the last three years.

Many of the factors that have driven strong returns from European equities, such as corporate restructuring and the opening up of the former communist states in Eastern Europe, remain in place. However, we believe there are now grounds for a more cautious approach and we are recommending a reduction in allocations to European equities within client portfolios.

One of the main reasons for this change in view is the recent strength of the euro. While this has boosted returns for sterling based holders of European equities, it presents a significant handicap for Continental Europe's exporters and, therefore, for the wider European economy. One cause of the euro's strength is the European Central Bank's (ECB's) reputation for taking no risks with inflation by holding interest rates higher than might otherwise be the case. With rates falling in the US, and likely to fall in the UK as well, delays in rate cuts in Europe risk not only driving the euro higher still, but also making any slowdown in the European economy more acute.

The FTSE Europe (ex. UK) index provided, in euro terms, a total return of -4.72% over the last six months (-0.01% sterling adjusted) and +11.56% over the last year (+18.18% sterling adjusted).

2.3. North American Equities

The US is at the epicentre of the current economic debate. After years of strongly rising prices, the US housing market is now weakening as the easy credit, which fuelled much of the boom, is withdrawn. Whether this will drag the US economy into recession remains to be seen. The housing market woes will certainly have a material impact, but the economy was already slowing in response to monetary tightening that took interest rates from 1.00% to 5.25% in the two years to mid-2006.

The 0.75% reduction in interest rates implemented in September and October demonstrates that the Federal Reserve is ready to take aggressive action in an attempt to avert a recession. Whether it succeeds or not will depend on several factors including: how deeply rooted the sub-prime related issues are, the resilience of the job market and the impact of falling house prices on consumer behaviour.

In the corporate sector, aside from those areas directly impacted by the credit crisis and housing market troubles, profits growth has remained fairly resilient. Profits growth from the many US international businesses has been boosted by the very weak US dollar, which has declined by 10.9% against the euro over the year to date and by 5.0% against sterling. However, the weak currency has, of course, impacted investment returns for sterling based investors, which have consequently been relatively disappointing.

Given the prolonged underperformance of the US stock market, which has left it looking more reasonably valued, we continue to recommend that portfolios maintain small allocations to US equities.

The S&P 500 index provided, in US dollar terms, a total return of -2.33% over the last six months (-6.04% sterling adjusted) and +7.22% over the last year (+3.05% sterling adjusted).

2.4. Japanese Equities

The Japanese economy and stock market performance continue to disappoint. Economic growth has been fairly steady and employment conditions continue to exert upward pressure on inflation. However, domestic consumption remains weak, and stubbornly low inflation continues to undermine the Bank of Japan's policy aim of gradually increasing interest rates. With interest rates at only 0.50%, the yen has been vulnerable to carry traders, who raise yen funds and switch them into other currencies, and to domestic investors who transfer assets overseas to take advantage of higher yields available elsewhere. This currency weakness has undermined returns to international investors who bought into Japanese equities to participate in the long-awaited economic recovery. However, the days of credit-fuelled speculation, such as the carry trade, appear to be numbered. The reduced availability of speculative capital, together with a greatly reduced appetite for risk, has seen the carry trade start to unwind. The yen has appreciated by 4.5% against the dollar and by 3.7% against sterling in the last three months.

We remain of the view that Japan's steady progress on restructuring its economy will eventually bear fruit. In the meantime, Japanese equities look defensive, with valuation levels low compared to both historic levels and other markets. Meanwhile, economic fundamentals suggest that the yen is very undervalued at current levels. We are therefore recommending that, despite the disappointing performance thus far, allocations to Japanese equities are maintained.

The FTSE Japan index provided, in yen terms, a total return of -12.03 over the last six months (-7.06% sterling adjusted) and -2.68% over the last year (-2.93% sterling adjusted).

2.5. Asia Pacific (excluding Japanese) Equities

The economic performance of the Asia Pacific (ex. Japan) region remains impressive. The economies of South Korea, Hong Kong and Taiwan are all growing at over 5% year on year while Singapore is expanding even faster, with a growth rate of over 9% per annum. Decreasing reliance on Western export markets and sizeable foreign currency reserves mean that the periodic crises of the past are much less likely to be repeated. Additionally, strong economic growth and current account surpluses make it likely that Asian currencies will appreciate over the medium term. These factors make Asia Pacific equities attractive to international investors.

Large speculative capital flows mean that the Asia Pacific equity markets remain among the most volatile in the world. In addition, these markets are no longer cheap. We believe, however, that investors with a longer time horizon will earn good returns as the 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 +13.50% over the last six months and +32.18% over the last year (for sterling based investors).

2.6. Emerging Markets Equities

Emerging markets equities have risen very strongly over the four year global equity bull market, driven, at least in part, by strengthening economic fundamentals. These improving fundamentals remain in place; strong growth has driven up employment and income, thereby creating a virtuous circle of consumer demand and further strong growth.

Investors are currently favouring the markets of the 'BRIC' economies: Brazil, Russia, India and China. While the economies in these regions are exhibiting very strong growth, we are concerned that investor appetite, particularly for Indian and Chinese shares, is taking on speculative proportions. Valuations look stretched and we are cautious about recommending further allocations to BRIC funds at present.

The FTSE All-World Emerging index provided a total return of +17.13% over the last six months and +39.16% over the last year (for sterling based investors).

3. Fixed Interest

Fixed interest investments did not fare particularly well in the early part of the year as strong economic growth drove interest rates higher. More recently, government bond yields have fallen back in anticipation of slower growth, and therefore lower interest rates, in 2008. They have also benefited from safe haven status amid the turbulence in credit markets and have fully demonstrated their value to investors as the most effective portfolio risk diversifier. By contrast, corporate and non-investment grade bonds have suffered from decreasing risk appetite amongst fixed interest investors.

Within the various classes of fixed interest instruments, we have long held the view that the additional yield available on corporate and non-investment grade bonds relative to their government counterparts, known as the yield spread, has been inadequate. We have therefore advised clients to focus fixed interest allocations on UK government bonds. This view has been fully vindicated by recent developments, which have seen spreads widen very sharply. We are closely monitoring corporate and non-investment grade bond yields relative to those available on government bonds, with the view to increasing allocations to the non-government sector when valuations become compelling.

The ABI UK Pension Gilt sector provided a total return of +5.30% over the last six months and +1.16% over the last year (for sterling based investors).

4. Property

Investments in commercial property in the UK had provided very strong returns up until the beginning of this year. However, years of rising capital values were not fully underpinned by increases in rent, leaving yield based valuations looking stretched. Our Investment Bulletin of October 2006 set out our view that commercial property prices could suffer a period of consolidation as yields were forced back up to levels more attractive to investors. This consolidation is now taking place. UK commercial property returns, including rental income, were negative over the last year as measured by the ABI UK Pension Property index. This was the first time commercial property prices have fallen since 2001.

Despite the threat of higher interest rates now receding, the risk-adjusted returns available on cash deposits remain more attractive than those on commercial property and we continue to recommend reduced allocations to this asset class.

The ABI UK Pension Property index provided a total return of -11.63% over the last six months and -7.95% over the last year (for sterling based investors).

5. Cash

Sterling cash deposits, earning approximately 5.75% p.a. at present, are attractive relative to the yield currently available on fixed interest or commercial property. While UK interest rates may fall next year, we continue to favour allocations to this asset class. From an asset allocation perspective, cash deposits offer strong defensive qualities (provided the appropriate credit risk due diligence has been undertaken). They also bring flexibility to portfolios, enabling investors to take advantage of opportunities in other asset classes as and when they arise.

6. Note on Hedge Funds

While we continue to research the sector, we remain somewhat sceptical about the ability of most hedge funds to generate consistently positive total returns in all market conditions.

The Credit Suisse/Tremont Investable Hedge fund index provided a total return in dollars of +5.80% over the six months to the end of August and +11.47% over the year to the same date. For euro based investors the corresponding return figures are +4.69% and +9.32% respectively.

N.B. Unless otherwise noted, all performance figures are total returns (including income re-invested) for the six month period from 31 May 2007 to 30 November 2007 and the twelve month period from 30 November 2006 to 30 November 2007 (source: Lipper Hindsight).