

Market Commentary

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**Saunderson House Limited
1 Long Lane
London EC1A 9HF**

**020 7315 6500 (Switchboard)
020 7315 6550 (Fax)**

Authorised and Regulated by the Financial Services Authority

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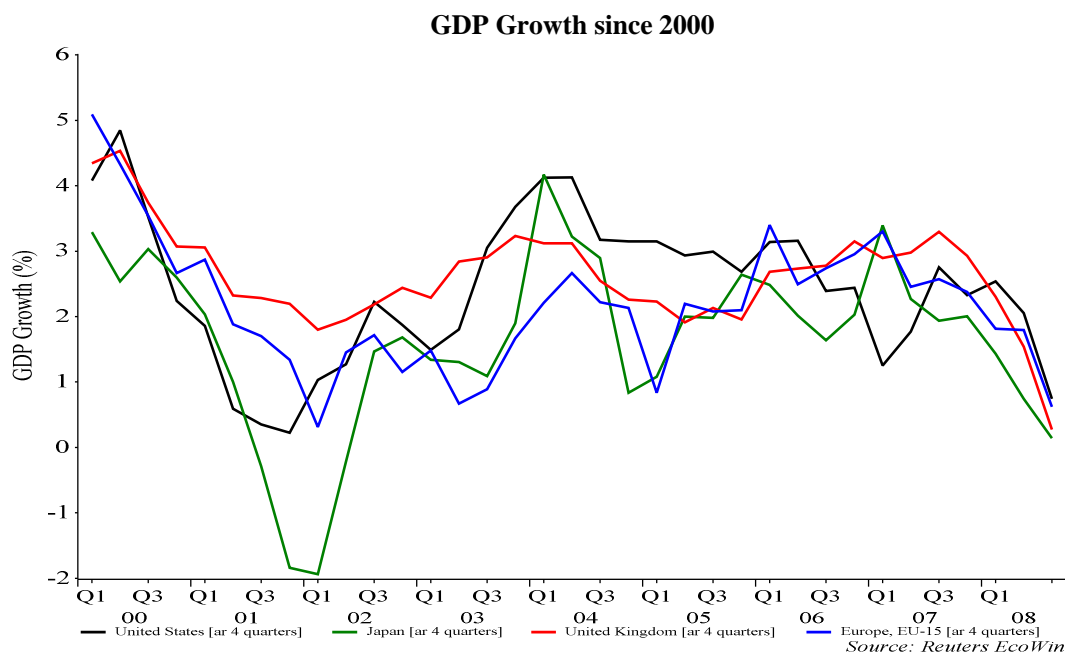
Risk Warnings

This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 8 December 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

Action taken by governments in September and October to stabilise the financial system and avert widespread bank failures appears to have succeeded. The use of public funds to recapitalise banks and guarantee future bank debt issues has re-established confidence among depositors and the extreme risk aversion witnessed in mid-October is gradually subsiding.

Meanwhile, central banks have delivered very aggressive interest rate cuts and made available huge quantities of liquidity in an attempt to unfreeze money markets. These actions are aimed at averting the second phase of the economic crisis – a deep global recession or, worse still, a prolonged slump caused by credit starvation and deleveraging by investors, businesses and consumers. Economic data remain unremittingly weak and, while a complete collapse in the banking sector looks to have been averted, the impact of such seismic events on business and consumer confidence is only now beginning to be felt. Residual concerns about the financial system will reverberate through the real economy for months to come and it is not clear that the injections of capital into banks will improve credit availability for companies or consumers. As the chart below shows, the major economies of the world have entered into a sharp, synchronised slowdown. Key factors in determining how long and how deep the recession will be include the extent of further falls in house prices, particularly in the US, and how far unemployment rises with the attendant secondary effects on asset prices and confidence.



During the last 12 months, we have seen the impact on investment markets of the withdrawal of cheap short term funding. Many businesses built on the assumption that almost limitless credit was a permanent feature of the financial landscape have failed. Northern Rock in the UK and Washington Mutual in the US are two high profile examples. There are also many others, from investment banks such as Lehman Brothers to hedge funds that were borrowing short term money and investing in higher yielding assets (the now infamous carry traders). The problems among the car manufacturers are also closely related to credit availability, as they were heavily reliant on granting easy finance terms to allow consumers to purchase new vehicles.

Within the mainstream asset classes, equities have suffered greatly as expectations of lower profitability are priced in. Arguably, stock markets have also become victims of their own liquidity. As markets for other assets such as high yield bonds, property and structured debt instruments have seized up, investors needing to raise cash have sold their more liquid assets; equities. Moreover, because so many investors have used leverage to gear market returns, the number of forced sellers (those who need to sell regardless of price) appears to be greater than in previous market downturns. That equity markets never enjoyed high ratings in the current business cycle has provided no protection. Equities have suffered as growth expectations have deteriorated and as forced sellers have taken advantage of the relative availability of liquidity.

Turning to other asset classes, commercial property had been a major beneficiary of cheap credit, and has suffered from its withdrawal. In fixed interest markets risk aversion has become acute. This has resulted in conventional government bonds performing very strongly relative to corporate bonds, particularly non-investment grade issues. Corporate bonds are now trading on some of the widest spreads over government bonds ever recorded, while non-investment grade bond markets are effectively closed.

Considering our recommended asset allocations, reductions in equity weightings late last year have helped to protect portfolios from the worst of the market falls but, with perfect foresight, we would have gone much further. However, after the sharp falls this year, equities now appear reasonably attractive on a five to ten year timeframe. Even making generous allowance for earnings downgrades and dividend cuts, the yields on many blue chip equities look appealing when compared to those available on other asset classes.

The MSCI World Equity Market index has provided a total return of -23.67% in sterling over the last six months and -23.55% over the last year.

2. Equities

2.1. UK Equities

After recording zero growth in the second quarter of 2008, the UK economy actually shrank in the third quarter. This was the first quarterly decline in output since 1992. The weakening economy is also apparent in the labour market. Unemployment is now moving gradually upwards and reached 5.8% in the third quarter, 0.3% higher over the quarter. Inflation, not long ago a major policy concern, is now in decline. The latest figures show a 0.7% fall in the Consumer Price Index (CPI), taking the annual rate of increase down from 5.2% in September to 4.5% in October.

Falling inflation has freed the hand of the Bank of England (BoE) to embark on a policy of aggressive interest rate reductions including a 1.50% reduction on 6 November and a further 1.00% on 4 December. This has taken the Bank Rate down to 2.00%, equal to its lowest level since the creation of the BoE in 1694. Rapidly falling interest rates, together with the realisation that the recession in the UK may be quite severe, has caused sterling to weaken. This should be helpful in providing a further boost to the economy.

The Chancellor's Pre-Budget Report in late November was used by the government to announce a fiscal stimulus of up to £30bn, including a cut of 2.5% in the rate of VAT and the bringing forward of capital projects. In addition to the fiscal measures, the government has been using its newly acquired power over the banking sector to urge banks to pass on the BoE's rate cut to borrowers.

In taking such bold policy measures, the UK authorities are acknowledging that the prospects for the UK economy are worse than they have been since the early 1990s. Consumers are under pressure from a deteriorating jobs market, falling house prices and cost pressures from rising utility and fuel bills. The latter are likely to subside in the coming months as they reflect the recent fall in the oil price. However, reduced access to credit as the banking sector retrenches means that consumer confidence is likely to remain weak.

Turning to the stock market, the path of UK equities from here will depend crucially on the depth of the economic slowdown to come and the extent to which earnings downgrades are already reflected in share prices. Our view is that the sizeable correction in equities seen so far means that shares offer value on all but the very worst outcomes for corporate earnings. We are, therefore, recommending that current allocations to UK equities are retained where appropriate.

The FTSE All-Share index has provided a total return of -29.30% over the last six months and -32.24% over the last year.

2.2. European (excluding UK) Equities

Until our recommendation to reduce allocations to European equities in late 2007, the Continent had been our favoured destination for investments into overseas markets. 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 credit crisis or the accompanying economic slowdown that was already impacting the US and UK. This has proven to be the case, although the core eurozone economies did remain resilient for longer than the US or UK, thanks to their status as net exporters which allowed them to benefit from sustained demand from the Far East and the less indebted position of their consumers. However, with exports falling under the impact of the weakening global economy and European banks affected by the credit freeze, economic activity has now begun to falter. Eurozone GDP fell 0.2% in the third quarter. The European Central Bank, which was increasing interest rates as late as July in response to the threat of inflation, joined other major central banks in delivering co-ordinated rate cuts in early October and, in early December, reduced rates by a further 0.75% to 2.50%.

The core countries of continental Western Europe, including Germany, France and the Benelux nations, remain less dependent on consumer spending than the US and UK. They are also set to be long term beneficiaries both of Far Eastern demand for exports and the continuing development of Eastern Europe. After the recent weakness, we therefore recommend that current allocations to European equities are retained where appropriate.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of -36.77% over the last six months (-33.51% sterling adjusted) and -42.67% over the last year (-33.59% sterling adjusted).

2.3. North American Equities

A 0.50% reduction in the Federal funds rate on 29 October took US interest rates back down to 1.00%, the level they reached in 2003 in the wake of the technology bubble collapse. This represents monetary easing on a grand scale; a little over one year ago, rates were 5.25%. In an attempt to avert a deep recession, interest rate cuts have been accompanied by a Federal economic stimulus package, the passage into law of the \$700bn Troubled Asset Relief Program ("TARP") and an injection of capital into US banks similar to that used in the UK rescue. President-elect Barack Obama is already proposing a major fiscal expansion via public infrastructure works to take effect after his inauguration as President in January.

US retail sales, so long the mainstay of the US economy, are now being undermined by falling house prices and rising unemployment. US house prices, according to the Case-Shiller Home Price index, were 17.4% lower in September (the latest data available), compared to the previous year. November saw the US economy suffer its worst month of job losses in 34 years, shedding 533,000 workers and driving unemployment up to 6.7%. The virtuous circle of easy credit availability driving house prices ever upwards has turned into a vicious circle. The banking sector, paralysed by losses already incurred on structured mortgage assets, has retrenched, reducing the availability of credit to consumers, thereby exacerbating house price falls and further undermining consumer confidence. However, falling government bond yields may offer some relief to homeowners. In contrast to the UK, US mortgages are predominantly determined by reference to the 10 year government bond yield. As this falls, mortgagors have the chance to refinance at lower rates thereby reducing their monthly outgoings.

After the recent weakness, US equities look inexpensive relative to their history. However, we are aware that the US economy and the US corporate sector have yet to experience the full consequences of recession.

We believe 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 -35.20% over the last six months and -38.09% over the last year. The recent strengthening on the dollar, driven up by optimism about the effectiveness of the US's policy actions, means that, when translated into sterling, the returns are -16.54% over the last six months and -17.05% over the last year.

2.4. Japanese Equities

Japan, as a major exporter of manufactured goods, is extremely sensitive to the strength of global growth. As such, Japan's economy has suffered as demand for its exports has waned. The impact of declining global growth has been exacerbated by a resurgent currency. The yen has been boosted by the narrowing of interest rate differentials as rates have been cut aggressively around the world. It has also strengthened as a result of the reversal of the carry trade, where borrowers sold yen to invest in higher yielding currencies. Currency strength has further undermined demand for export goods and Japan's economy has dropped into recession, shrinking by 0.1% in the third quarter with falling industrial output being the major contributing factor.

Japan is one step removed from the global financial crisis. Japanese banks have much less 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. In fact, the health of Japanese financial institutions is allowing them to make strategic acquisitions overseas. In recent months, Mitsubishi UFJ Group has purchased a stake in Morgan Stanley and Nomura has acquired the non-US businesses of Lehman Brothers.

Japan's already very low interest rates were cut further, to just 0.30% at the end of October. The interest rate reduction was accompanied by a ¥5,000bn (\$52bn) fiscal stimulus.

Over the year to 28 November the yen appreciated by some 34.28% against sterling, mitigating, to some degree, the very weak performance of the Japanese equity market. Nevertheless, Japanese equities remain deeply out of favour with international investors, despite now appearing very cheap both versus their own history and by comparison with international counterparts. We therefore recommend current allocations to Japanese equities are maintained where appropriate.

The FTSE Japan index provided, in yen terms, a total return of -41.43% over the last six months (-16.39% sterling adjusted) and -45.58% over the last year (-15.08% sterling adjusted).

2.5. Asia Pacific (excluding Japanese) Equities

For several years up until this year, equity markets in the Asia Pacific (ex Japan) region had provided excellent returns. Rising markets were driven by strong regional economic growth, investor enthusiasm for markets linked into the Chinese development story and the expectation that Asian currencies would appreciate over the medium term. However, as the global economic outlook has deteriorated this year and investor risk aversion has increased, Asian equities have begun to underperform their western counterparts (see chart).

We have, since 2006, recommended only very small allocations to Asia Pacific equities in acknowledgement that the strong performance was driving markets to relatively high valuations. We do, however, continue to believe that investors with longer time horizons should earn good returns as the long term economic fundamentals remain very promising. Although, after the recent sell-off, valuations have become significantly more attractive, we continue to recommend that clients maintain their current low tactical equity weightings to the region where appropriate.

The FTSE Asia Pacific (ex Japan) index provided a total return of -38.65% over the last six months and -39.83% over the last year (for sterling based investors).

Asia Pacific (ex Japan) equities have underperformed developed markets over the first 11 months of 2008 (rebased)



Source: Reuters EcoWin

2.6. Emerging Markets Equities

Hopes that emerging markets (as defined by MSCI *) could continue to grow rapidly despite the sharp slowdown in developed economies have been dashed in 2008. Upward pressure on inflation as economies have begun to encounter capacity constraints, together with slowing demand for exports as the developed world economies slow rapidly, means that many emerging markets are now slowing from the impressive rates of growth seen in recent years.

Assisted by robust economic growth, emerging markets equities had provided excellent returns over more than four years to early 2008. As the outlook for the global economy has deteriorated, however, emerging markets equities have started to underperform. Having risen very strongly, to the point that many were trading on significant valuation premiums to their developed counterparts, emerging equity markets were vulnerable to sharp reversals. These have been occurring. Equity market corrections in China and India, two former favourites of emerging market investors, have been severe. Over the 11 months to 28 November, in sterling terms, Chinese shares listed on the Shanghai stock exchange fell by 64.44% while those Indian companies with shares listed in Bombay have seen, on average, a 55.18% decline.

Along with equities in the Asia Pacific region, 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. As in the developed markets, we are likely to see opportunities to increase weightings to emerging markets in due course. For now we recommend maintaining current holdings as appropriate.

The FTSE All-World Emerging index provided a total return of -40.05% over the last six months and -40.99% over the last year (for sterling based investors).

* MSCI includes 25 countries in its emerging markets indices: Argentina, Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, 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 stocks (gilts) have demonstrated their value as effective portfolio risk diversifiers. From a peak of over 5.50% in mid-2007, the yield on the 10-year UK government bond has retreated by 175bps to 3.76% by the end of November 2008. This has generated capital gains which have helped to offset some of the losses on equity holdings. Gilts are benefiting from lower growth expectations, lower inflation expectations and, importantly, their 'safe haven' status amid the turbulence in credit markets and falling equity prices. Index-linked gilts benefited from rising inflation concerns up until mid-year but have since underperformed conventional gilts as the threat of higher inflation, driven by soaring commodities prices, eased.

While gilts have proven 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. Concerns about credit quality and default risk, together with the, until recently, unattractive yield premiums available on non-government debt, meant that their appeal to investors was limited and they have, accordingly, underperformed their government counterparts.

Our long-held belief that non-government fixed interest securities offered little value has meant that our recommended allocations to fixed interest in total have not been heavy. However, within the asset class we have advised clients to focus on conventional and index-linked UK government bonds. We expect conventional gilt yields to remain fairly low over the next year as interest rates remain low and the economy works its way through the downturn. Following this period it is likely that higher inflation expectations, together with heavy gilt issuance, will see yields move higher once more. We are therefore continuing to recommend that government bond allocations are divided evenly between conventional and index-linked issues. In addition, 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 +7.98% over the last six months and +7.02% over the last year.

The ABI UK Pension Index-Linked Gilt sector provided a total return of -7.21% over the last six months and -4.40% over the last year. Shorter dated index-linked stock has fared considerably better than this. For example, index-linked gilts with less than 5 years to maturity (as measured by the FTSE Index-Linked British Government under 5 years index) have provided returns of -4.65% over the last six months and -1.46% over one year.

4. Property

After several years of strong returns, investors in UK commercial property have suffered a major setback with property values receding substantially. Until 2007, the sector had been a major beneficiary of the vast quantities of low cost debt finance that characterised the credit bubble. Increasing levels of gearing were used to leverage the steady but otherwise unexciting returns from commercial property, spurring development and, eventually, oversupply. 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 appetite for risk among investors, and the implications of the slowing economy for property demand, has served to drive commercial property yields sharply higher and prices correspondingly 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 has been under way since early 2007. UK commercial property returns, including rental income, were negative in 2007 as measured by the ABI UK Pension Property index and are highly likely to be so again in 2008.

Given the degree of oversupply, commercial property valuations are likely to remain under pressure for some time. We are monitoring developments closely with a view to taking a more positive stance on this asset class in due course.

The ABI UK Pension Direct Property index provided a total return of -12.16% over the last six months and -20.07% over the last year.

5. Cash

Due to the elevated level of money market interest rates, sterling deposits or monies held in AAA-rated liquidity funds can presently earn returns in excess of the BoE Bank Rate of 2.00% p.a. due to the premium at which the inter-bank rate trades. However, we expect the interest rates available on both bank deposits and liquidity funds to trend down towards the Bank Rate in the coming months.

Despite lower rates, cash still has its attractions and we continue to favour heavy weightings, particularly where attractive fixed rates from good quality institutions can be secured. 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.

Cash invested at the BoE Bank Rate would have provided a total return of +2.33% over the last six months and +4.95 over the last year.

6. Note on Hedge Funds

Our view that hedge funds are riskier than generally perceived is gaining wider acceptance. 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.

According to Hedge Fund Research, hedge funds are this year on course to suffer their worst performance since records began in 1990. Among the casualties are some high profile names; Citadel Investment's flagship fund, which at \$18bn is one of the industry's largest, lost 13% in November and is 47% lower over the year while similar performance from Atticus European took year-to-date losses to more than 43%. Others employing high levels of gearing have found themselves even more severely impacted. As credit availability has decreased, geared hedge funds have had little choice but to sell their underlying assets at whatever prices are available in the market. This forced selling looks set to intensify in the fourth quarter as hedge fund investors continue to file significant redemption requests.

For completeness, we include the HFRX Global Hedge Fund index figures for hedge fund performance below. We remain, as might be expected, somewhat sceptical about the integrity 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 would 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 -21.99% over the last six months and -21.49% over the last year.

N. B. The above commentaries reflect our views as at 8 December 2008. 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 2008 to 28 November 2008 and the twelve month period from 30 November 2007 to 28 November 2008 (source: Lipper Hindsight).