

Market Commentary

December 2010

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Risk Warnings

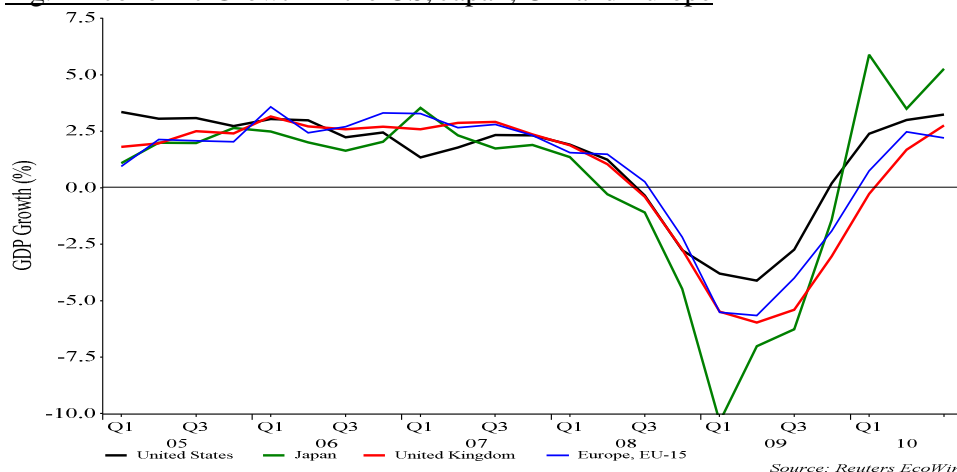
This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 10 December 2010. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments 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 Outlook

The sharp rebuke delivered to President Obama's Democrats in November's midterm elections, together with the confirmation from the Federal Reserve (Fed) of a second dose of quantitative easing (QE), stand testament to the unsatisfactory nature of the economic recovery in the US. While some data points are now indicating a slightly improved picture, employment and housing have continued to disappoint. This is not surprising. High unemployment, which ticked up to 9.8% last month, is, in our view, structural; the result of jobs lost in industries that have permanently relocated to lower cost areas overseas. The housing market is suffering the after-effects of a major bubble, itself the result of monetary policy errors in the early part of the millennium. Thus, despite incentives and tax breaks, house prices have begun to decline once more. They are now 28.6% lower than their mid-2006 peak, according to the Case-Shiller Index.

It has been our view for some time that the strong initial pace of the economic recovery was unlikely to be maintained without further policy support. Reasons for this include the fading effects of both the inventory-rebuilding phase of recovery and the government administered fiscal stimuli. Fig. 1 shows that the initial recovery has been robust. We now expect growth rates to level out as economic fundamentals reassert themselves.

Fig. 1 Economic Growth in the US, Japan, UK and Europe



While we expect economic growth to moderate, we remain optimistic that there will not be a 'double-dip' in global growth or a slide into deflation. Our reasons are twofold. Firstly, while conventional policy levers in developed economies do not leave much scope for further action, central banks can administer further stimulus via QE. Secondly, economic growth remains strong in emerging economies. This is likely to provide a degree of support for growth in developed economies.

The following sections discuss the outlook for selected markets and asset classes.

2. Equities

2.1. UK Equities

UK economic growth for the third quarter showed a 0.8% rise in GDP; slower than the 1.2% growth in the second quarter, but still double economists' consensus forecast. Despite this, the output of the UK economy remains 4% below its pre-recession level and we believe that the pace of the recovery is likely to slow further as the government's fiscal retrenchment weighs on the economy. The Comprehensive Spending Review (CSR), published in October, set out the government's plans to reduce public spending by more than £80bn over the next four years and cut the public sector deficit from 10.1% of GDP to 2.1%. According to estimates from Oriel Securities, this will reduce GDP growth by c0.5% over each of the next four years. With the CSR estimated to cost c490,000 public sector jobs and house prices starting to slide again, UK households are unlikely to feel sufficiently confident to increase consumption spending to provide some offset to the negative contribution to GDP of public sector consolidation. The economy will therefore become more reliant on increasing investment spending from companies and an improvement in export performance.

Our view is that the probability of a double-dip recession in the UK is low. We are encouraged by the Bank of England's stated intent to keep interest rates low and its freedom to restart QE if necessary. Loose monetary policy should help support the household and corporate sectors and allow trade to make a positive contribution to growth by ensuring that sterling stays weak.

Turning to the stock market, in our view, UK equities look attractive. During the economic downturn, many UK corporates cut costs aggressively and raised fresh capital to strengthen their balance sheets. This has left them in fundamentally sound shape and with scope to expand profit margins as the high rate of unemployment acts to depress wage pressures. As a result, any increase in revenues should translate into significantly higher profits. This view has been borne out by recent strong earnings announcements.

Despite this, valuations of UK companies remain relatively low. The UK stock market now offers an attractive dividend yield relative to the yields available on cash, gilts and the highest rated corporate bonds. Historically, this has been a good indicator of future returns, though we are mindful that investor sentiment is a strong driver of the market in the short term. Given the value case for UK equities and our belief that the risk of a double-dip recession is small, our recommendation is that current allocations are maintained.

The FTSE All-Share index has provided a total return of +8.61% over the last six months and +11.52% over the last year.

2.2. European (excluding UK) Equities

The €750bn in support for fiscally troubled eurozone countries, jointly provided by EU member states and the IMF in May, was intended as a “shock and awe” tactic to eliminate concerns about the risk of sovereign default within the region. However, the need for a further €85bn bailout of the Irish government and banking sector in November has demonstrated that this approach has not succeeded. Despite worries over a break up of the eurozone and uncertainty over the future of the single currency, for now, the European Central Bank (ECB) is likely to continue to support the weaker economies by purchasing their government bonds. However, the continued rise in bond yields in the peripheral eurozone economies is likely to increase pressure on the ECB to follow other central banks in resorting to full-blown quantitative easing.

It is therefore perhaps surprising that recent economic data in the region has been encouraging. Both business and consumer sentiment surveys and hard data suggest that the eurozone economy as a whole is still in recovery mode. However, while the eurozone economy managed growth of 0.4% in the third quarter of 2010, this was heavily reliant on the export-led German economy, which grew by 0.7%. The German government expects full-year growth of 3.4% this year, dipping to 1.8% in 2011. In contrast, Greece experienced a contraction of 1.1% in the third quarter.

While we expect the negative implications of the peripheral government bailouts to dominate headlines for the time being, the core eurozone region contains many companies that generate a significant proportion of their revenues in the US, Asia and emerging markets and should therefore be relatively immune from continued weakness in the non-core eurozone economies. German companies, for instance, have spent much of the past two decades establishing strong footholds in emerging Asian and Latin American economies. Meanwhile, the weaker euro will have increased the competitiveness of, and thereby the demand for, European exports. Moreover, valuations remain undemanding relative to history and to other asset classes.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of +7.21% over the last six months and +9.36% over the last year. When translated into sterling, the returns are +6.11% over the last six months and -0.08% over the year.

2.3. North American Equities

After several months of disappointing macroeconomic data releases, the US economy is now beginning to show signs of improvement once again. The economy grew by 2.5% p.a. in the third quarter, which was faster than the preliminary estimate of 2.0% p.a. and the 1.7% p.a. recorded in the second quarter. Consumer spending, meanwhile, grew by 2.8% p.a. in the same period, its fastest increase in four years. With consumption accounting for approximately 70% of economic activity in the US, this development is particularly encouraging.

Other measures of economic strength, however, have failed to show much improvement. The Fed notes that its progress toward cutting unemployment and boosting growth had been ‘disappointingly slow’ and, at the start of November, released details of its much-anticipated second round of QE. It plans to purchase an additional \$600bn of Treasuries through to June 2011, expanding its record stimulus of \$1.7trn in asset purchases, in a bid to lower borrowing costs, boost growth and prevent consumer prices from dropping. President Obama has followed this by announcing an agreement with the Republicans to extend expiring income tax cuts for all Americans, renew jobless benefits for the long-term unemployed, and grant a one-year reduction in Social Security taxes. Whilst it may take some time for these benefits to work through the economy, it shows the government and central bank’s willingness to take action to promote growth.

Against the mixed economic backdrop, company news flow has been encouraging. According to Standard & Poor’s, S&P 500 companies’ earnings growth was 45.7% in the second quarter (annualised) and 32.2% in the third quarter. There has also been positive news from the companies that received bail-outs during the credit crunch. This month, the US Treasury sold its final tranche of shares in Citigroup, realising an overall profit of \$6.85bn on the \$45bn worth of shares it had acquired as part of the rescue in 2008. The insurer AIG is also making progress towards repayment, announcing recently that it has raised \$37bn towards repaying \$180bn.

A buoyant corporate environment looks set to continue for the remainder of this year, with estimates of S&P 500 operating earnings per share rising 47.0% for 2010 as a whole, implying the biggest annual gain in corporate earnings since 1988. Analysts’ forecasts for 2011 show a more modest 13.0% increase. The US equity market looks attractively valued both on current and forward estimates, as well as versus US government bonds. On this basis, we believe the US equity market is well placed to make progress and recommend that current allocations are maintained.

The S&P 500 index provided, in US dollar terms, a total return of +9.50% over the last six months and +9.94% over the last year. In sterling terms, the returns are +2.15% over the last six months and +15.85% over the year.

2.4. Japanese Equities

Macroeconomic indicators released in November were slightly discouraging. Deflation was a larger issue than had been anticipated, as prices fell 2.0% year-on-year. Seasonally adjusted retail sales fell 1.9% month-on-month as private consumption was impacted by growing concerns over wage deflation and job security (yen strength prompted some exporters to squeeze their workers further to eke out cost savings). On the positive side, industrial production grew by 4.5%, faster than many analysts' forecasts, as strong demand from China and Japan's other developing Asian neighbours boosted sales of consumer goods. However, this was set against weaker exports of capital goods as a weaker euro exchange rate put Japanese manufacturers at a relative disadvantage to their German counterparts.

Hopes of political action to aid the economy have also receded; recent opinion polls indicate that Prime Minister Naoto Kan's approval ratings has halved since September. However, the same polls also show frustration and discontent with the main opposition party, indicating that if a general election were called today (as some lawmakers are suggesting), neither party would have outright control of either house. This political deadlock, along with reports of party infighting, increases the probability of another leadership change in 2011 and means that we are unlikely to get much-needed policy reform in the near future.

Positive US macro data in November drove up demand for American assets, helping to halt the yen's advance against the dollar and providing some relief for Japanese exporters. However, heightened concerns about the sovereign credit risk of the peripheral eurozone economies caused the yen to rise 3.5% against the euro over the same period, impacting sales to Japan's third-most important export market.

Japan faces a number of headwinds, but this is to some degree reflected in the low valuations on which Japanese equities trade relative to their international peers. Furthermore, we note that large companies continue to adapt to the strong-yen environment by engaging in aggressive cost cutting. Many companies, world leaders in their own right, continue to trade close to or at a discount to their balance sheet value. On balance, we believe the normalisation of global economic conditions will offer opportunities in due course, but are not, for now, recommending increased allocations.

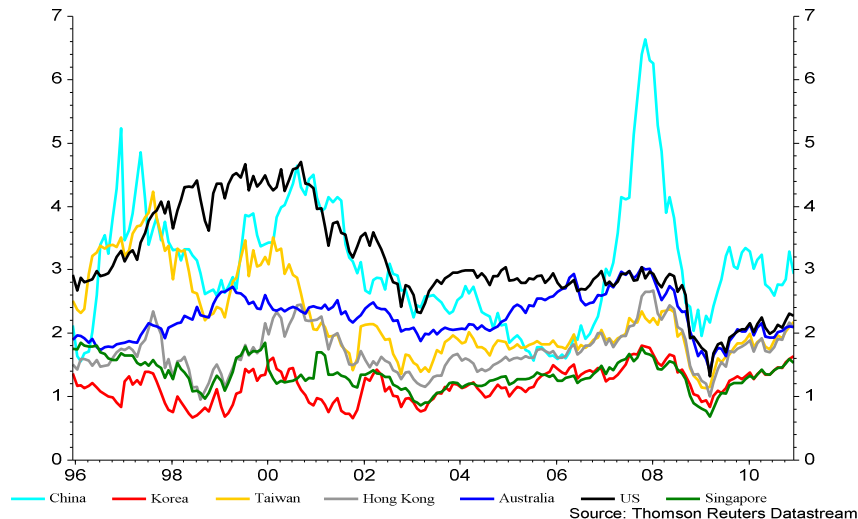
The FTSE Japan index provided, in yen terms, a total return of -1.04% over the last six months and +4.65% over the last year. Yen strength means that, in sterling-adjusted terms, the returns are +0.33% over the last six months and +13.40% over the year.

2.5. Asia Pacific (excluding Japanese) Equities

China continues to be the key driver of growth in the region, as the PMI Manufacturing data (a measure of purchasing managers' intentions and widely regarded as a good forward indicator of economic growth) rose for a fourth straight month in November. This indicates that the country's manufacturing sector continues to flourish despite a string of monetary tightening measures from the People's Bank of China (PBoC). Strong GDP growth, rising inflation, and gradual appreciation of the Chinese yuan, have all been very positive for the Asia Pacific region, as countries like Australia fuel the resource-hungry economy and the financial markets of Hong Kong and Singapore benefit from growth in corporate activity.

In our view, the Asia Pacific ex Japan sector should continue to benefit from the positive economic fundamentals and favourable demographics of the region. The healthier state of public sector balances and lower consumer indebtedness mean that the equity markets of the Asia Pacific nations should be well placed to provide attractive returns when global growth fully recovers. On fundamental measures of value, such as price to book (see Fig. 2), equity valuations in the region trade a touch above their long-term averages, but well below their historical peaks, and in line with the developed world.

Fig. 2 Price to Book Ratio of Asia Pacific and US Stock Markets



We do not think these valuations are expensive given the significantly higher growth potential of these markets. We recommend that current allocations to Asia Pacific are maintained, where appropriate.

The FTSE All-World Asia Pacific ex Japan index provided, in local currency terms, a total return of +14.80% over the last six months and +13.59% over the last year. When translated into sterling, the returns are +12.63% over the last six months and +22.75% over the year.

2.6. Emerging Markets Equities

November proved to be a month of mixed fortunes for the emerging markets (EM). They were buoyed early in the month, after the Fed announced plans for further QE. However, as the debt crisis in peripheral Europe escalated, and tensions between North and South Korea rose, the market volatility appeared to unnerve investors, who took profits, leaving markets broadly flat.

Inflation emerged as a cause for concern in November, after consumer prices jumped by 4.4% yoy in China, in line with rising inflation figures across Brazil (5.2%), India (9.7%) and South Korea (4.1%). Unofficial reports suggested that food prices had risen by more than 10% in major Chinese cities, triggering concerns that escalating costs of living may foster discontent. We believe that monetary tightening is set to continue as liquidity being created in the developed markets flows into the emerging markets, putting upward pressure on inflation.

Stock markets in Brazil and India fell about 3% in November, while China slumped 10%, as these countries' central banks continued to tighten monetary policy to combat high inflation. Brazil and China implemented sharp rises in reserve requirement ratios, while India raised interest rates and compelled state-owned banks to increase deposit rates (by up to 150bps on some fixed-term accounts). Conversely, markets with large weightings toward industrial metals, precious metals and energy benefited from rising commodity prices, due partly to QE-related liquidity; Russia and Qatar advanced c5% as the price of crude oil approached \$90/barrel, while gold and copper made record highs, crossing \$1,400/oz and \$9,000/ton respectively.

The MSCI Emerging Markets index* has rallied c140% from its March 2009 low to date, and while there remain some disparities between the growth prospects of various EM economies and the valuations of their equity markets, the broader market as represented by the MSCI does not look overpriced – trading on c15x forward earnings, which is broadly in line with developed markets. We view this valuation as fair given the high growth potential but more volatile, economically sensitive nature of the emerging markets. We therefore recommend that current allocations are maintained, where appropriate.

The FTSE All-World Emerging index provided, in local currency terms, a total return of +17.48% over the last six months and +15.14% over the last year. In sterling-adjusted terms, the returns are +9.61% over the last six months and +21.34% over the year.

* MSCI includes 21 countries in its emerging markets index: Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey.

3. Fixed Interest

Having fallen for much of the year, 10-year government bond yields in major western economies reached a nadir in the third quarter and have since risen. Despite this recent rise, in the US, UK and Germany (among others), yields remain below their level at the start of the year, meaning that there have been capital gains for bondholders. As much as the easing of the pace of economic recovery took yields down, building optimism about growth in 2011, together with a related pick up in inflation expectations, has driven yields higher once more.

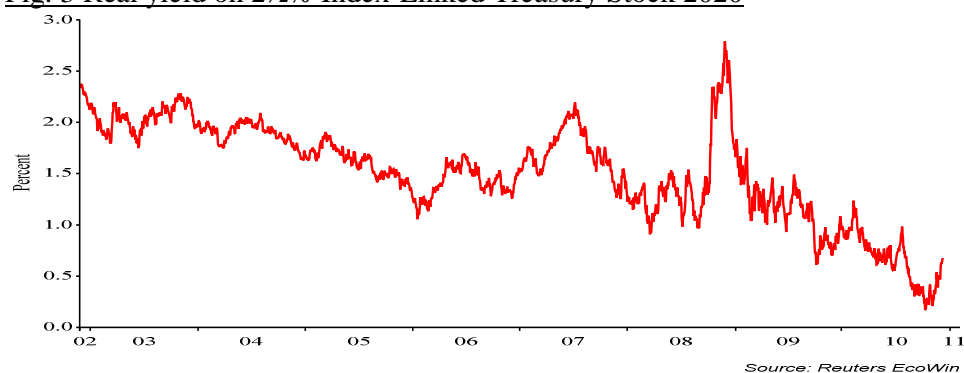
The final burst of strength in US 10-year Treasury bonds, which saw the yield reach a year low of 2.38%, was driven, at least in part, by the expectation of further monetary stimulus from the Fed. In addition to reinvesting c\$250-300bn of cash flows from the mortgage-related debt it bought in the original round of QE, it now also plans to purchase a further \$600bn of US Treasuries by the end of June 2011. As is often the case, when details of the measures were finally announced in early November, much of the expected positive impact was already reflected in market prices; thus yields subsequently rose.

In the UK, the stronger than expected economic growth and persistent above-target inflation has meant that the Bank of England's Monetary Policy Committee (MPC) has not extended its QE programme. However, should the UK economy prove less resilient to the impending fiscal squeeze, more QE is likely to be forthcoming.

While we believe that the diversification value of gilts is attractive, particularly in the event of a Japan-style deflation scenario, the insurance they offer, in our view, comes at too high a price. We therefore continue to recommend zero allocations to conventional gilts, being mindful that they could incur capital losses if the economy grows more strongly than the market is expecting, or if policy errors lead to an inflation shock or a loss of confidence in sovereign credits.

The extraordinary monetary stimulus employed to counter the effects of the financial crisis has, in our view, created a risk that inflation rises meaningfully at some point in the future. As a result, we recommend maintaining existing allocations to inflation-linked bonds. However, we view UK index-linked gilts (ILGs) as fairly fully valued. Fig. 3 shows the real yield on the 2½% Index-Linked Treasury Stock 2020 is low relative to its own history.

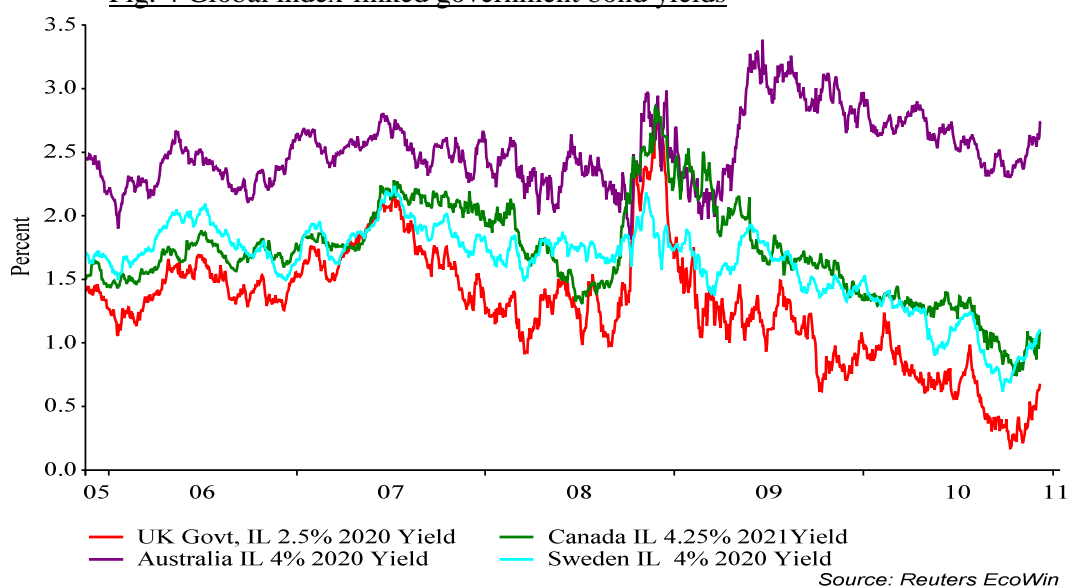
Fig. 3 Real yield on 2½% Index-Linked Treasury Stock 2020



A key driver behind the low yields on ILGs is the need for pension and insurance funds to buy them, almost regardless of price, in order to match the real liabilities of inflation-linked pensions. This structural demand for index-linked bonds is largely UK-specific. As such, Canadian, Swedish and Australian inflation-linked bonds among others offer significantly higher real yields than their UK counterparts (see Fig. 4).

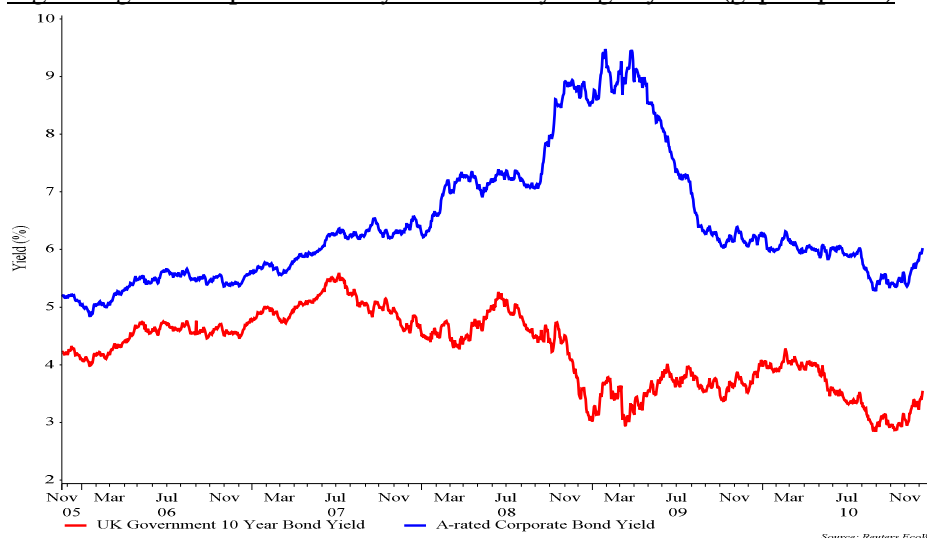
We therefore recommend that, where appropriate, allocations to index-linked bonds are weighted towards sterling-hedged funds of global inflation-linked bonds. As well as obtaining higher real yields, managers of such funds may also exploit duration and relative value opportunities to add further value. Our view is that such funds will offer a degree of protection if real yields on ILGs revert to the levels at which they have traded in the past.

Fig. 4 Global index-linked government bond yields



Turning to our preferred defensive asset class, corporate bonds, we still believe that valuations are attractive despite the compression of absolute yields since early-2009. Spreads over government bonds remain wide relative to recent history (see Fig. 5). Implied default rates are low and, in aggregate, corporates have strong cash balances due, in part, to the outsourcing of labour and component sourcing to cheaper areas overseas. According to the Financial Times, companies now have c9% of their assets in cash. This figure is forecast to rise to 12%, one-third higher than at the peak of the last business cycle. This healthy cash position can be observed by the recent increase in takeover activity including BHP Billiton's (failed) hostile bid for Potash Corp., HP's acquisition of 3Par, HSBC's (aborted) bid for Nedbank and Intel's purchase of both McAfee and Infineon's wireless division.

Fig. 5 A-grade corporate bond yield and 10-year gilt yield (gap = spread)



While continuing to favour corporate bonds we do acknowledge that they may be vulnerable to a further move up in government bond yields, and we certainly do not expect a repeat of the substantial capital gains seen in 2009. We have therefore been recommending that corporate bond allocations are invested in bond funds with more strategic mandates. The managers of these funds invest where they believe the market is rewarding them appropriately for risk, while avoiding areas that look expensive. They can also hedge interest rate risk and exploit arbitrage opportunities between different bond issues to protect and add value. Such funds are also our preferred route for obtaining exposure to non-investment grade corporate debt, which is less sensitive to interest rates but carries greater default risk.

The ABI UK Pension Gilt sector provided a total return of +2.22% over the last six months and +3.09% over the last year. The ABI UK Pension Index-Linked Gilt sector provided a total return of +3.15% over the last six months and +3.32% over the last year. The ABI Pension Sterling Corporate Bond sector provided a total return of +3.89% and +8.16% over the same periods.

4. Property

Over the last 15 months, the UK commercial property market has staged a healthy recovery and is now, in our opinion, fairly valued. Property yields are, on average, c6.4%, broadly where they stood at the beginning of 2004 before the long bull-run which took them down to c4.5%. At current levels, commercial property yields offer a reasonable spread over gilt yields. This is necessary and warranted compensation for depreciation, the illiquidity of commercial property and the risk of default by tenants. However, yields vary across regions and sectors. Central London offices now offer yields as low as 4%, with investors anticipating a strong recovery in rents as the capital's economy recovers and occupiers pay up for limited space – a consequence of a dearth of construction during the credit crisis. In contrast, regional industrial assets can still be purchased on yields above 9%.

Despite the relatively attractive yield on offer, the recovery in commercial property has slowed recently. In our view, this is the result of several factors which are likely to persist over the coming months. Firstly, after strong gains over the last year, some investors will be taking profits. Secondly, we note that there has been a fall in the number and value of purchases, particularly from institutional investors, since the start of the summer. Simultaneously, there has been an increase in sales, particularly by banks.

We believe that, in order for capital values to make significant progress from here, rents need to start rising again. This is likely to depend on the pace of the economic recovery in the UK, as rental growth has historically been closely correlated with GDP growth. As discussed earlier, we do not expect the UK's economic recovery to maintain the pace it achieved in the first nine months of 2010. Therefore, rental growth, except in areas of constrained supply, such as London offices, may still be some way off.

However, that does not mean we are pessimistic on the prospective returns from UK commercial property over the coming year. If prices remain static, an income yield greater than that offered by cash and gilts is still attractive. We also believe that, in a reasonably stable environment, skilled and well-resourced fund managers should be able to add capital value through asset enhancement, lease extensions and re-lettings.

The ABI UK Pension Direct Property index provided a total return of +2.57% over the last six months and +12.44% 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, particularly where better 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 returned +0.25% over the last six months and +0.50% over the last year.

6. Note on Hedge Funds

Our view that hedge funds are riskier than generally perceived gained wider acceptance during the financial crisis of 2008 and early 2009. 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. Despite a partial economic and financial recovery, 240 hedge funds were liquidated in the first quarter of 2010, marking the seventh straight quarter in which closures exceeded new fund launches. A number of high profile hedge fund managers have also decided to close their funds, including Stanley Druckenmiller, who has begun the process of returning capital to investors in Duquesne Capital Management, because he was "dissatisfied" with its performance.

Bloomberg's aggregate hedge fund index fell 1.12% in October, bringing the year to date total return to 3.80%. In our view, the industry's ability to justify high charges and performance fees remains questionable. Nevertheless, the hedge fund industry has emerged from the financial crisis in a very different shape. An increase in hedge fund closures, together with greater consolidation, means that there are now fewer funds, generally employing lower leverage, charging, on average, lower fees and offering better compliance standards, higher levels of communication, greater transparency, more appropriate and independent valuation methods and greater 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 +3.06% over the last six months and +3.32% over the last year.

The above commentaries reflect our views as at 10 December 2010. 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 31 May 2010 to 30 November 2010 and the twelve month period from 30 November 2009 to 30 November 2010 (source: Lipper Hindsight).