Market Commentary

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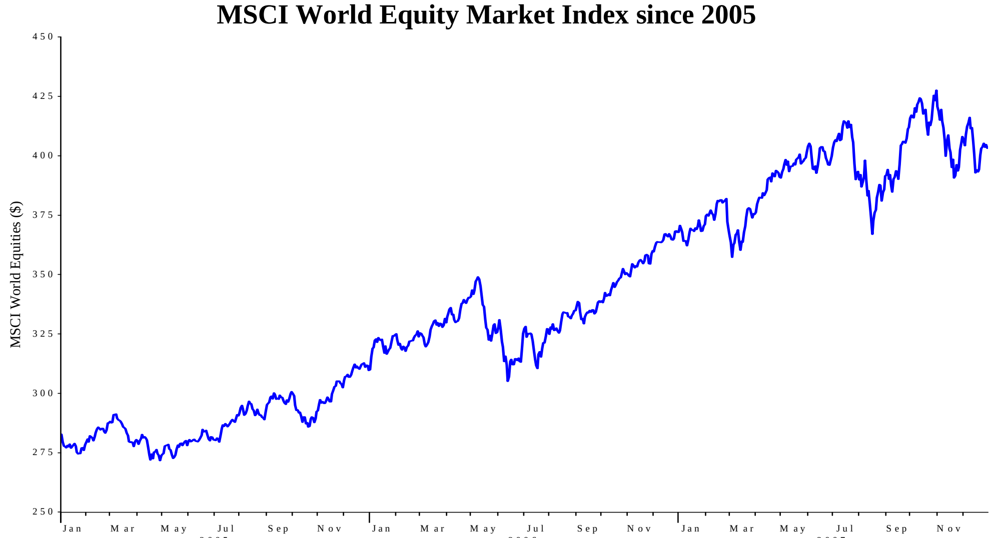
1. Economic Commentary

The second half of 2007 saw the return of volatility to equity markets as the four-year bull market ground to a halt in the wake of a sharp slowdown in the US housing market and a crisis in credit markets.

After an initial, sharp sell-off in August, equity markets rallied strongly, more than recovering their losses by the end of October. November, however, brought renewed concerns about the health of the banking sector, causing widespread selling of equities and other risky assets. Optimism that the summer’s weakness would be short-lived quickly evaporated as it became clear that the problems in the credit markets were more deep-seated than initially thought. As financial institutions announced further provisions against the value of sub-prime mortgage related assets, investors became increasingly concerned about the wider implications of a weakened banking sector. Chief among these concerns is that banks, labouring under the burden of impaired assets on their balance sheets, would become less willing to lend money. Reduced access to credit combined with weakening asset prices is clearly an unhelpful mix for economic growth. The risks may be compounded by lower consumer spending as falling house prices undermine the appetite for borrowing and spending.

The potential for these factors to drive the US economy into recession has not been lost on investors or policy makers. In response to the threat of much slower US economic growth, the Federal Reserve (the Fed) reduced interest rates by 1% between September and the year end.

MSCI World Equity Market Index since 2005



With the outlook for economic growth deteriorating, we adopted a more cautious stance in November by cutting weightings to Continental European equities. We have held overweight positions here since 2004 and have captured very strong returns. With the reduction in Europe, equity weightings within our recommended portfolios are now underweight compared to our long term strategic models.

As 2008 unfolds we will be focusing our attention closely on developments in credit markets and leading indicators of economic activity to ascertain whether a further reduction in equity weightings is appropriate.

The FTSE World index has provided a total return of +2.22% over the last six months and +9.70% over the last year.

2. Equities

2.1. UK Equities

After a prolonged period of steady expansion, the pace of economic growth in the UK is set to ease in 2008. Evidence of slowing activity, including falling house prices, declining consumer confidence and weaker retail sales, prompted the Bank of England to cut interest rates in December for the first time in more than two years.

With the full impact of the sub-prime crisis on credit availability not yet fully evident, it is likely that interest rates will be reduced further during the course of the year. However, the scope for the Bank to implement further rate cuts will depend, at least in part, on the path of inflation. Data for November showed the Consumer Price Index at 2.1%, marginally above the Bank's target rate of 2.0%. RPI, the measure used for inflation linked bonds, is much higher at 4.3%. This pressure on price stability stems from higher energy and food prices, which have been driven by international factors such as rapid growth in emerging economies.

We expect the inflationary pressures from rising energy and food prices to ease over the course of the year as the effects of lower global growth cause demand to slow. This should free the hand of the Bank of England to deliver more rate cuts as necessary. Meanwhile, sterling is weakening against other major currencies, which should cushion the impact of slower growth on the corporate sector.

Strong returns from UK equities over the past four years have been driven by the supportive economic growth conditions described above, together with a return of a degree of pricing power to companies. These factors have helped companies report excellent earnings growth and enabled them to deliver healthy dividend increases. This strong corporate profits growth has meant that, despite share prices having risen over the past four years, UK equities have not become 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 levels of recent years. We are monitoring developments closely, particularly those in credit markets and US economic data releases, but are recommending the maintenance of current allocations to UK equities for the present.

The FTSE All Share index has provided a total return of -2.11% over the last six months and +5.32% over the last year.

2.2. European (excluding UK) Equities

Continental Europe has 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 have recommended 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 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 UK, delays in rate cuts in Europe risk driving the euro higher still, making any slowdown in the European economy more acute.

The FTSE Europe (ex. UK) index provided, in euro terms, a total return of -4.80% over the last six months (+3.87% sterling adjusted) and +6.15% over the last year (+15.72% sterling adjusted).

2.3. North American Equities

The US is at the epicentre of the current economic turmoil. After years of strongly rising prices, the US housing market is now weakening rapidly as the easy access to mortgage finance, which fuelled much of the boom, is withdrawn. The economy was already slowing in response to the monetary tightening that took interest rates from 1.00% to 5.25% in the two years to mid-2006, and declining house prices and reduced access to credit will exacerbate this slowdown.

Interest rates have already been pared back by a full 1% since September, demonstrating that the Federal Reserve is ready to take aggressive action 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 remained quite resilient in 2007. This was due, in part, to the weakness of the US dollar, which helped support the earnings of the US's many international businesses. As 2008 progresses, we expect the impact of the economic slowdown to broaden to other sectors of the economy. However, the US market is trading on its lowest price to earnings ratio since 1995, which should cushion the impact of earnings downgrades. We therefore recommend that portfolios maintain small allocations to US equities.

The S&P 500 index provided, in US dollar terms, a total return of -1.37% over the last six months (-0.59% sterling adjusted) and +5.49% over the last year (+3.72% sterling adjusted).

2.4. Japanese Equities

The performance of both the Japanese economy and stock market continues to disappoint. While overall growth has been fairly steady, domestic consumption remains weak, and stubbornly low inflation continues to frustrate the Bank of Japan's policy aim of gradually increasing interest rates. However, the crisis in credit markets has brought about a sea-change in currency markets. Previously, the yen had been a source of cheap funding for carry traders who borrowed in yen to fund investments in higher yielding currencies. The reduced availability of speculative capital, together with a greatly reduced appetite for risk, has seen this carry trade start to unwind, driving the yen higher against both the dollar and sterling. The yen has appreciated by 9.6% against the dollar and by 10.7% against sterling in the last six months.

While an appreciating yen is helpful for sterling based holders of Japanese assets, it is not helpful to Japan's export sector. Slowing world growth is also an unwelcome development for the export-orientated Japanese economy. These factors mean that, while Japanese equities continue to have attractions from a defensive perspective, it is difficult to foresee very strong returns in the short term. As a result, we have moved our recommended allocation to Japanese equities back to neutral.

The FTSE Japan index provided, in yen terms, a total return of -15.96% over the last six months (-6.36% sterling adjusted) and -10.72% over the last year (-6.37% 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 estimated to have grown by more than 5% in 2007 while Singapore is expanding even faster, with a growth rate of almost 8%. 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 the Asia Pacific region an attractive destination for long term equity investors. Large speculative capital flows, however, mean that the Asia Pacific equity markets remain among the most volatile in the world. In addition, after strong upward moves, these markets are no longer cheap.

We believe, however, that investors with a longer time horizon will earn good returns as the long-term economic fundamentals remain very promising. We recommend that equity weightings to the region are maintained.

The FTSE Asia Pacific ex. Japan index provided a total return of +12.14% over the last six months and +29.39% over the last year (for sterling based investors).

2.6. Emerging Markets Equities

Emerging markets equities have risen very strongly through the four-year global equity bull market, driven, at least in part, by strong economic growth and rising domestic consumption. These improving fundamentals remain in place; expanding economies have 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 exceptionally 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. Elsewhere within emerging markets, we are maintaining current allocations, while remaining mindful that the current pace of appreciation in equity prices is unlikely to be sustainable.

The FTSE All-World Emerging index provided a total return of +18.75% over the last six months and +37.38% over the last year (for sterling based investors).

3. Fixed Interest

Fixed interest investments did not fare particularly well in the early part of 2007 as strong economic growth drove interest rates higher. By contrast, the second half saw government bond yields falling back in anticipation of slowing economic growth, and therefore lower interest rates. Government bonds 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 rapidly. 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 +7.76% over the last six months and +3.62% over the last year (for sterling based investors). The ABI UK Pension Index Linked Bonds sector provided a total return of +9.90% over the last six months and 7.21% over the last year (for sterling based investors).

4. Property

After several years of strong returns, investors in UK commercial property suffered a major setback in 2007. In recent years, bank borrowing has been increasingly used to fund property purchases. However, the availability, at low cost, of abundant debt financing had driven prices up to levels where yield-based valuations looked extremely stretched. Mid-2007 saw an abrupt reduction in the willingness of banks to lend at low rates against property purchases, which, together with reduced appetites for risk among investors, has served to undermine commercial property valuations.

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 began in the second half of 2007. UK commercial property returns, including rental income, were negative over the last year as measured by the ABI UK Pension Property index. This is the first time commercial property prices have fallen since 2001.

In our view, 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 -13.07% over the last six months and -13.20% over the last year (for sterling based investors).

5. Cash

Sterling cash deposits, earning approximately 5.50% p.a. at present, are attractive relative to the yield currently available on fixed interest or commercial property. While UK interest rates will fall in 2008, 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 are concerned that hedge funds are riskier than generally perceived. In our view, the transparency of many hedge funds' investment processes is not sufficient for us to be comfortable about recommending their inclusion in portfolios. Liquidity, valuation of assets and the level of charges are also areas where we believe investors should demand more clarity.

With regard to performance, we remain cautious 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 +0.98% over the six months to the end of November and +9.08% over the year to the same date. For euro based investors the corresponding return figures are +0.16% and +7.15% respectively.

N.B. Unless otherwise noted, all performance figures are total returns (including income re-invested) for the six month period from 29 June 2007 to 31 December 2007 and the twelve month period from 29 December 2006 to 31 December 2007 (source: Lipper Hindsight).