

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 9 March 2011. 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.

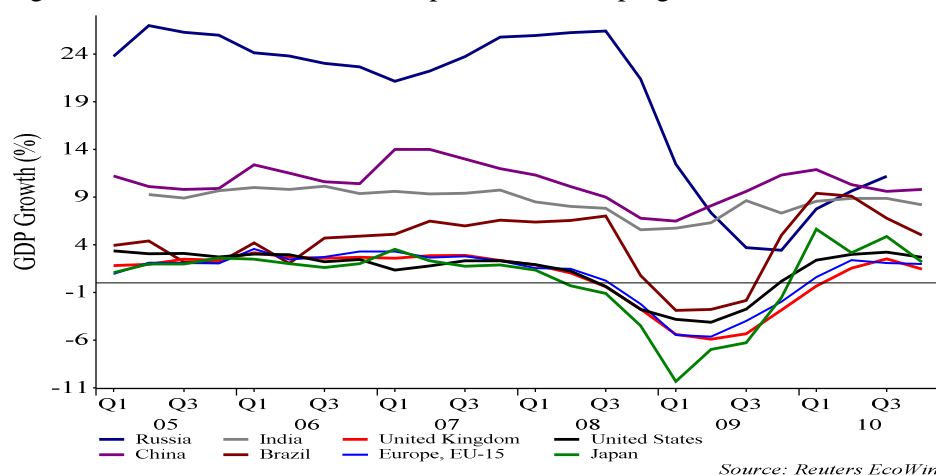
1. Economic Outlook

After shrinking in 2009, the global economy grew by 5.0% in 2010 according to figures from the IMF. While this is a healthy rate of expansion, growth has been very much skewed in favour of developing, rather than developed, economies (see Fig. 1 below). More importantly, what growth there has been in developed markets has been achieved only with the support of ultra-accommodative monetary policies, including low interest rates and quantitative easing (QE).

December's tax-focused US fiscal stimulus, accompanying the second draught of QE from the US central bank, the Federal Reserve (Fed), stands testament to the unsatisfactory nature of the economic recovery in the United States. In the eurozone, crises in Greece and Ireland have required EU and IMF intervention to head off sovereign default, while in Japan, the authorities have resorted to currency intervention to try to regain competitiveness in their export sector. Many emerging markets, notably those of the Far East and South America, have achieved strong economic growth without government support.

Looking ahead, in our view, 2011 is likely to see the global economy continuing to 'muddle through', much as it did in 2010. Governments and central banks in the developed world will be keen to begin the process of policy normalisation, but will need to remain mindful of the risk of choking off growth and sending their economies back into recession. In emerging economies, inflation is the principal threat and monetary tightening is already taking place to ensure this does not become entrenched. Other threats to the continuation of the recovery that can be easily identified include: (i) a major disruption in oil supplies, caused by an escalation of conflict in Middle Eastern oil producing nations, (ii) a recurrence of crisis in the eurozone, this time perhaps engulfing major economies such as Spain and Italy, (iii) a sharp slow down in China's economy, and (iv) a US bond market crisis triggered by the parlous state of the economy's public finances.

Fig. 1 Economic Growth in Developed and Developing Economies



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

2. Equities

2.1. UK Equities

Revised data for UK GDP showed that the economy contracted by 0.6% in the fourth quarter of 2010. This surprised investors who were anticipating an upwards revision from January's preliminary reading of -0.5%. While we have thought for some time that the pace of the recovery would moderate, a drop in output was unexpected and may give the Bank of England's Monetary Policy Committee (MPC) further leeway to postpone increases in interest rates. Stalling growth and stubborn inflation, with prices in January 4.0% higher over one year on the CPI measure (5.1% on the RPI measure), have prompted discussion in the media about the prospect of stagflation – persistent inflation with little or no economic growth.

While factory gate prices rose 4.8% annually in January, as some companies have managed to combat higher raw materials costs by raising their prices, we believe that high inflation is likely to prove temporary and the UK economy is not heading for stagflation. In our view, inflation is unlikely to become entrenched given the deflationary impact of the government's austerity measures and the fact that recent tax increases and commodity price rises will drop out of the annual inflation numbers later this year. Stripping these effects out, domestically generated inflation is below the MPC's CPI target of 2%, due to low wage growth. The pace of economic growth, meanwhile, should pick up in 2011. The Office of National Statistics estimated that the drop in output in the fourth quarter was largely attributable to weather conditions. This view is supported by the robustness of recent business confidence and manufacturing orders surveys that indicate that the cold weather has not undermined the economic recovery in the private sector. This suggests that first quarter may see GDP growth bounce back quite strongly.

We remain of the view that UK equities are attractive. During the economic downturn, many UK businesses cut costs aggressively and raised fresh capital to strengthen their balance sheets. This has left them in good financial shape, with scope to expand profit margins as sales recover. As a result, any increase in revenues should translate into significantly higher profits. This has been borne out by the strength of the earnings recovery to date. Valuations in the UK remain reasonable and the stock market 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, our recommendation is that current allocations are maintained.

The FTSE All-Share index has provided a total return of +16.52% over the last six months and +17.02% over the last year.

2.2. European (excluding UK) Equities

January's debut bond offering by the European Financial Stability Facility (EFSF) saw strong demand, attracting orders from more than five hundred investors and totalling €44.5bn, almost nine times the €5bn of paper on offer. Demand for the AAA-rated issue, priced at a 40bp yield premium over equivalent German government bonds, was particularly robust from sovereign wealth funds and Asian investors, with the Japanese government buying over 20% of the issue. The subsequent fall in bond yields of the peripheral eurozone nations has raised hopes that, following the bailouts of Greece and Ireland in 2010, a further full-blown eurozone crisis can be avoided. The increase of the lending capacity of the EFSF in March from €250bn to €440bn, together with the approval to buy bonds issued by countries with bailout programs in the primary market, has increased the chances of a benign outcome to the eurozone sovereign crisis.

Given peripheral eurozone debt concerns, it is perhaps surprising that recent economic data in the region has been encouraging – the region's economy managed growth of 0.3% in the fourth quarter of 2010. However, this was heavily reliant on the core eurozone nations, particularly Germany, where industrial production grew 10.0% year-on-year in December, with factory orders growing at an annual pace of 16.0%. While the strength in the German economy was initially led by exports (boosted by a weaker euro), recent data, such as solid retail sales in January, has shown signs that the fall in unemployment, to 7.3% in February, its lowest since 1991, is beginning to feed through into domestic consumer price growth.

Risks still remain in the eurozone economies. The negative implications of the peripheral government bailouts are likely to dominate headlines for some time yet, while recent comments from ECB President Trichet suggest that concerns over the inflation outlook may lead to interest rate increases as soon as April. However, the core eurozone region hosts many companies that generate a significant proportion of their revenues in the US, Asia and emerging markets and therefore should 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 +16.19% over the last six months and +20.00% over the last year. When translated into sterling, the returns are +19.32% over the last six months and +13.67% over the year.

2.3. North American Equities

Having rallied to levels last seen before the collapse of Lehman Brothers in September 2008, US equities have marked time in recent weeks as political unrest in North Africa and the Middle East has caused investors to shun risky assets. The economic environment in the US, however, has continued to improve, with a raft of positive economic data releases providing cause for optimism on the recovery. The rate of economic growth picked up in the fourth quarter to record 2.8% expansion for 2010, its strongest year since 2005. Growth was driven by a pick-up in consumer spending, which recorded a 4.4% annualised increase in the fourth quarter, its fastest pace in four years. The manufacturing sector, meanwhile, continues to show strength, expanding for the 19th successive month in February. The Fed recognised the improving economic climate in its January policy meeting by upgrading its forecast for 2011 GDP growth to a range of 3.4%-3.9% from its previous forecast of 3.0%-3.6%.

Encouragingly, labour markets are now also showing a modest improvement; the unemployment rate has fallen from 9.8% to 8.9% in the last three months and payrolls showed a healthy gain in February. Fed Chairman Ben Bernanke, however, notes that the decline in the unemployment rate is likely to be slow, adding that 'it could take four to five more years for the job market to normalise fully'. The Fed has taken action to help accelerate progress here, announcing in November that it would proceed with a second round of QE. President Obama followed this by extending the Bush-era income tax cuts, renewing jobless benefits for the long-term unemployed, and granting a one-year reduction in Social Security taxes. While these measures should help to boost economic growth, they exacerbate the country's fiscal deficit, which has grown tenfold since 2001 to \$1,230bn, equivalent to 8.0% of GDP. An expanding economy will help America's fiscal position, though fiscal retrenchment will be required to fully address the debt burden. This is the next major challenge for US policymakers, while the Fed will be keenly watching building inflationary pressures from the recent steep rise in oil prices.

Looking at the corporate environment, US companies continue to show strength. More than 70% of the 372 companies in the S&P 500 that have reported fourth quarter results have beaten earnings-per-share projections, with revenue gains up 8% year-on-year. A buoyant corporate environment looks set to continue in 2011 and, in our opinion, US equities are attractively valued both against history and versus US government bonds. 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 +27.73% over the last six months and +22.57% over the last year. In sterling terms, the returns are +20.69% over the last six months and +14.73% over the year.

2.4. Japanese Equities

Japanese macroeconomic indicators released in February continued to send mixed signals to investors. While industry-related figures were generally pessimistic, this was partly offset by consumer data, which were less negative-than-expected. Japan's GDP contracted 0.3% in the last quarter of 2010, and third quarter growth was revised down to 0.8% (from 1.1% originally). The country's export-driven economy unexpectedly recorded a ¥470 billion trade deficit, versus estimates for a ¥50 billion surplus, as export growth was weak and energy import costs rose significantly as a result of high prices, driven by political unrest in the Middle East. January household spending fell 1.0% year-on-year (against consensus estimates of a fall of 1.5%) as the employment situation improved slightly: the job-to-applicant ratio rose to 0.61 from 0.57. However, wages were stagnant over the period.

The Japanese political landscape deteriorated again in February, as the government continued to struggle to pass a budget for fiscal 2011/12. At the time of writing, the budget plan has cleared the lower house after much wrangling, but still faces strong opposition in parliament's upper house. News reports indicate that the current Prime Minister, Naoto Kan, has an approval rating of less than 20%, making it likely that he will be replaced before the next general election. However, the situation is complicated by the recent resignation of Seiji Maehara, who was the leading candidate to succeed Kan, after it was revealed he received illegal political donations.

The yen was broadly unchanged against the US dollar over the month of February, holding at about the ¥82.0 level. Continuing unrest in the Middle East region, particularly in oil-rich Libya, gave nervous investors a reason to remain in the "safe haven" Japanese currency. The current market level is significantly stronger than the average rate of ¥86.5 budgeted for by Japanese manufacturers (according to the Tankan survey), and if the yen continues to trade at these levels, it is likely that export-reliant companies will have to revise down their earnings estimates for Q1 2011.

Japan continues to face 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 – many industry-leading multinationals continue to trade close to or at a discount to their book value. The opportunities created by a global economic recovery should be balanced against the seriousness of the structural issues facing Japan. We are not, therefore, recommending increased allocations.

The FTSE Japan index provided, in yen terms, a total return of +19.57% over the last six months and +8.00% over the last year. In sterling terms, the returns are +15.79% over the last six months and +9.65% over the year.

2.5. Asia Pacific (excluding Japanese) Equities

February was a volatile month for stock markets in the region, as the benchmark MSCI AC Asia Pacific ex. Japan index ended the month c2% lower, having been as much as 4% lower during the period. Political unrest in the Middle East has caused the price of crude oil to move above \$100/barrel again. Such high energy prices threaten to slow the strong economic growth in the Asian region going forward.

Consumer price inflation (CPI) continues to be a key concern in the region, as CPI growth remained at elevated levels: China, 4.9%; Hong Kong, 3.6%; Singapore, 5.5%; South Korea, 4.5%; Indonesia, 6.8%. The outlook for inflation remains skewed to the upside, as prices of energy, basic materials and consumer staples are being affected by natural disasters and political turmoil around the world. Mining operations in Australia are still recovering from severe flooding at the start of the year, while New Zealand's economy, a major exporter of agricultural produce, was disrupted by a 6.3 magnitude earthquake in Christchurch. Oil and gas prices remained at elevated levels as protests continue to spread throughout oil-rich nations such as Bahrain and Oman, while Libya moved closer to a full-blown civil war as Muammar Gaddafi proved determined to hold on to power despite domestic resistance and international calls for the leader to step down.

The Chinese government was kept busy last month as it moved to stifle early signs of a Middle East-inspired civil disobedience movement, dubbed the "Jasmine Revolution". China's Premier Wen Jiabao was quoted as saying he would seek to curb the country's high rate of GDP growth to contain inflationary pressures, lowering the economic growth target for the most recent 5-year plan from 8% to 7%. CPI in China reached 4.9% in January, which, although higher than December's 4.6% reading, was significantly lower than consensus estimates of c5.5%. This is a sign that the central bank's aggressive monetary tightening policies may be beginning to take effect, and decreases the likelihood of further measures in the short run to restrict growth in property prices and overall money supply. Despite the possible macroeconomic headwinds described, we believe the Asia Pacific ex. Japan sector should continue to benefit from the region's strong economic fundamentals and favourable demographics.

On fundamental measures of value, such as price to book, valuations in the region trade a touch above their long-term averages, but well below their historical peaks, and broadly in line with the developed world. We do not think these valuations are overly demanding given the higher growth potential of these markets. We recommend that current allocations to the sector are maintained where appropriate.

The FTSE All-World Asia Pacific ex Japan index provided, in local currency terms, a total return of +10.04% over the last six months and +15.50% over the last year. When translated into sterling, the returns are +10.19% over the last six months and +14.27% over the year.

2.6. Emerging Markets Equities

Emerging market equities, as represented by the MSCI Emerging Markets index^{*}, have fallen c7% (in sterling terms) over the first two months of the year, compared with a 1.5% gain in developed market equities. The underperformance is a result of continued inflationary pressures following rising food prices and, more recently, the civil unrest in the Middle East and North Africa. As a direct consequence, the price of Brent crude oil hit a two and a half year high in February. Stock markets of oil dependent economies, notably China and India, both fell c3% over the month, while equity markets across the Middle East remained under pressure. Although oil export economies, such as Russia and Brazil, defied the downward trend of most other emerging markets to record gains of c5% and c2%, respectively, this did not offset the underperformance of the broader market.

Emerging market economies continue to grow at a rapid pace (China, for example, recorded GDP growth of 10.3% in 2010, while India grew at a rate of 8.5%). However, policy-makers are faced with a number of headwinds, the most notable being inflation, particularly in food and energy prices. Food prices in emerging markets are c12% higher than at the end of 2009 and, given adverse weather conditions and structural increases in demand, prices appear unlikely to soften in the short term. In order to combat mounting inflationary pressures, many emerging market governments are raising interest rates. China has increased interest rates four times in the last three months, while India, Brazil, South Korea, Taiwan and Vietnam have all raised rates at least once in 2011. Rising emerging market currencies, driven in part by investor inflows, has also proved challenging, resulting in some central banks imposing taxes on foreign investment in an attempt to cool speculative inflows. During 2011, emerging market policy-makers will face the difficult task of controlling inflation, without damaging growth too much, while trying to mitigate the effects of increased liquidity created by Western monetary policies.

While disparities between the growth expectations of emerging market economies and the valuations of their equity markets are becoming evident, the broader MSCI Emerging Markets Index does not look overly expensive – trading on c15x historic earnings. This is broadly in line with developed markets. We view this valuation as fair given the higher growth potential but more volatile and 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 +14.95% over the last six months and +21.87% over the last year. In sterling-adjusted terms, the returns are +8.62% over the last six months and +14.07% 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.

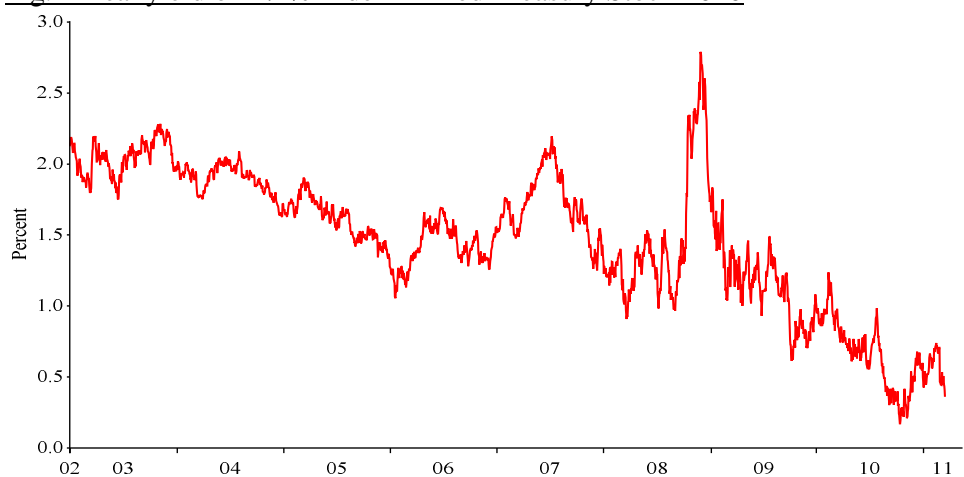
3. Fixed Interest

Since the end of August 2010, government bond yields in major western economies have risen sharply, with the 10-year gilt yield climbing from 2.83% to 3.75% at the time of writing. Inflationary pressures and positive sentiment regarding economic growth suggest that yields may go higher still, and prices therefore lower. However, we would be surprised to see gilt yields return to their more normal 4.5-5.5% range until the UK's economic recovery becomes self-sustaining. With unemployment still elevated at 7.9%, this may still be many months away.

At present, conventional government bonds only look attractive in a scenario that sees the global economy slide back towards recession and deflation. With policy measures in the developed world largely supportive of economic growth, and leading macroeconomic indicators, such as business sentiment and orders surveys, pointing towards reasonably strong growth, we think this risk is remote. We therefore continue to recommend zero allocations to conventional government debt, considering it vulnerable to rising inflation expectations and gradually normalising interest rates.

While much of the current inflationary pressures in the UK can be explained by tax and commodity price rises, higher wages in Asia are now also acting to push up the prices of imported goods. So far, this has not led to rising wage pressures in the UK, with the high rate of unemployment limiting workers' bargaining power. However, if expectations for future inflation remain elevated, there remains the risk that rising wage claims become wide spread, allowing price inflation to become entrenched. Therefore, we recommend maintaining existing allocations to inflation-linked bonds. However, we view UK index-linked gilts (ILGs) as fairly fully valued. Fig. 2 shows that the real yield on the 2½% Index-Linked Treasury Stock 2020 is low relative to its own history, though has moved upwards over recent months.

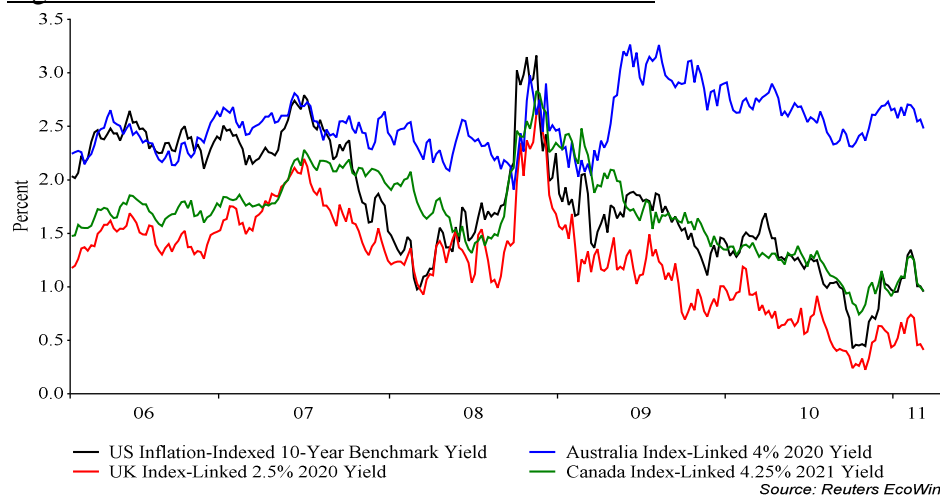
Fig. 2 Real yield on 2½% Index-Linked Treasury Stock 2020



Source: Reuters EcoWin

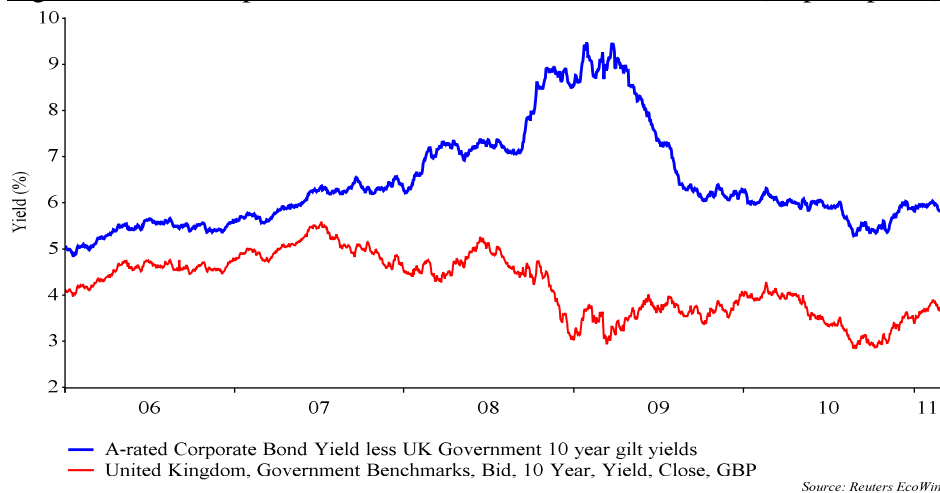
While real yields on ILGs remain so low, we continue to recommend that, where appropriate, investors obtain part of their inflation protection through sterling-hedged funds of global index-linked bonds. These provide access to bonds with significantly higher real yields than on their UK counterparts (see Fig. 3), and their managers may 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. 3 Global Index-Linked Government Bond Yields



Turning to corporate bonds, which have been our preferred defensive asset class since January 2009, we have seen the yield spread relative to government bonds (see Fig. 4) narrow over the year to date.

Fig. 4 A-Grade Corporate Bond Yield and 10-Year Gilt Yield (Gap = Spread)



This spread has provided a cushion against rising interest rate expectations but, given concerns about inflation, we think it is no longer sufficiently wide to fully protect investment grade corporate bonds from capital losses if government bond yields rise much further. We are therefore recommending that clients now sell their interest rate sensitive corporate bond holdings.

However, in our view, the credit spread on its own still looks attractive relative to historical levels. Prior to the credit crisis, corporate bonds traded at much lower yield premia to government bonds, thanks to the high level of liquidity in bond markets and strong investor demand for yield. While we do not expect liquidity to return to 2006/07 levels, the degree of cost cutting and balance sheet repair companies have carried out over the past two years makes defaults less likely and should justify lower spreads. We therefore continue to recommend allocations to corporate bonds, though believe that these should be achieved via funds whose managers have the scope to separate out the credit and interest rate sensitivity components of corporate bond returns and, as appropriate, hedge out the latter. Such funds, often labelled 'Strategic Bond', may also have the flexibility to invest across other fixed income sectors, such as non-investment grade bonds and emerging markets debt.

The ABI UK Pension Gilt sector provided a total return of -4.12% over the last six months and +5.27% over the last year. The ABI UK Pension Index-Linked Gilt sector provided a total return of +0.56% over the last six months and +8.46% over the last year. The ABI Pension Sterling Corporate Bond sector provided a total return of -1.03% and +7.54% over the same periods.

4. Property

The yield on the UK commercial property market has been virtually static at c6.5% since May 2010, reflecting limited capital growth and broadly flat rental values. In our view, this situation looks likely to persist over 2011, with the occupational market outside Central London remaining weak. The capital is much more integrated into the global economy than most of the UK, and is seeing strong occupier demand and rental growth despite spending cuts and the recent weakness of the domestic economy. Outside London, and particularly in regions (such as Liverpool and Middlesbrough) with high unemployment and a dependence on the public sector for jobs, the occupier market remains sluggish, with falling rents and high vacancy rates.

Turning to the investment market, the supply of prime quality assets popular with institutional and overseas investors remains tight. This is providing some support to current valuations. However, bank lending is still heavily rationed, particularly for properties in poorer locations and those with short leases, limiting the scope for leveraged buyers to enter the market and bid prices up. Banks (notably Lloyds, RBS and Irish "bad bank" NAMA) also hold a lot of property assets on their balance sheets, of which they may now begin to sell. However, while this may weigh on prices, the impact it would have on banks' balance sheets gives us confidence that disposal programmes will be orderly.

As long as the above concerns and uncertainties persist, we believe it remains appropriate for property allocations to be invested in funds of prime and near-prime properties, whose managers can add value through refurbishments and relettings. Such asset management initiatives should help to provide stability of income and the potential for some capital growth over the coming year.

The ABI UK Pension Direct Property index provided a total return of +2.71% over the last six months and +7.96% 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. 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 Chicago-based group Hedge Fund Research, the third quarter of 2010 saw hedge fund launches overtake liquidations for the first time since 2007. As investment banks have downsized their proprietary trading desks, a number of traders have taken the opportunity to set up their own funds. Despite this, the number of liquidations may climb since, as at the end of the third quarter, 44% of hedge funds were yet to meet their high-water mark for 2010, a serious issue for those managers without substantial assets under management.

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. A smaller universe of 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 are, in our view, all welcome developments. For completeness, we include the HFRX Global Hedge Fund index figures for hedge fund performance below, although we are, as might be expected, somewhat sceptical about the validity of these figures.

The HFRX Global Hedge Fund GBP index provided a total return in sterling terms of +6.41% over the last six months and +6.26% over the last year.

The above commentaries reflect our views as at 9 March 2011. 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 August 2010 to 28 February 2011 and the twelve month period from 28 February 2010 to 28 February 2011 (source: Lipper Hindsight).