

Market Commentary

May 2009

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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 15 May 2009. 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

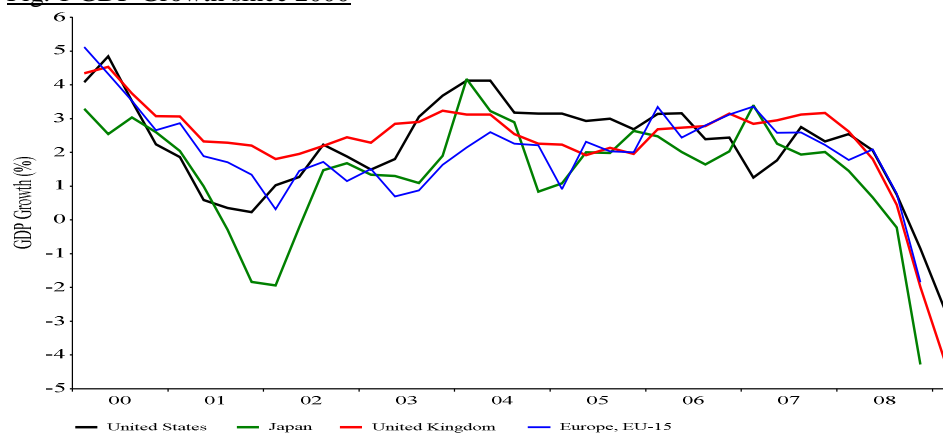
In its April 'World Economic Outlook', the International Monetary Fund (IMF) forecasts that total global output will decline by 1.3% this year with only a modest recovery in 2010. For the world economy to achieve no growth in aggregate is without modern precedent, but the pace of the decline is more disarming still. As recently as October 2008 the IMF was forecasting 3.0% world growth for 2009. This was a significantly lower figure than the 5.3% recorded at the peak of the business cycle in 2007.

Governments across the developed world, already struggling with banking crises and dysfunctional credit markets, have resorted to Keynesian-style fiscal stimuli in an attempt to breathe life back into their faltering economies. A bewildering array of new policy initiatives is now in place and, while it is too early to judge their success, the aggressive action taken thus far to underpin fragile financial systems does appear to be achieving its objective. The agreement at April's G-20 summit to triple IMF funding to \$750bn has also boosted confidence and the almost total risk aversion within financial markets seen in the final quarter of 2008 has now eased.

Having reduced official interest rates as far as practically possible, monetary authorities in the US and UK have now turned to unconventional measures to support their economies. These policies entail expanding the quantity of money in the economy (so-called quantitative easing) to drive the cost of borrowing money down, force liquidity into the financial system and support the value of financial assets. Such actions are aimed at preventing the current deep recessions turning into self-sustaining depressions or multi-year slumps, as investors, businesses and consumers reduce their borrowings.

Fig. 1 shows the extent of the slowdown in major economies. There are a number of factors crucial in determining whether a prolonged depression can be avoided or how long and how deep recessions will be. These include the extent of further falls in house prices and how far unemployment rises, with the attendant secondary effects on asset prices, consumer spending and confidence.

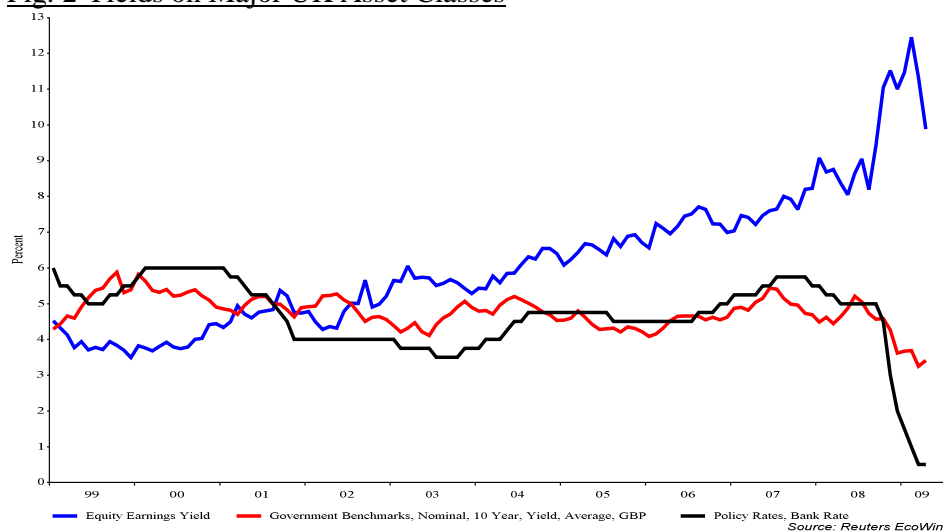
Fig. 1 GDP Growth since 2000



During the last 18 months, many of the assumptions on which confidence in an ever-expanding global economy and strong financial markets were built have been turned on their heads. One such assumption was that those economies enjoying credit-fuelled consumption growth would fare worse than economies such as China, Japan and Germany when credit availability stalled. This has proved not to be the case. As demand from UK and, particularly, US consumers has slumped, those economies reliant on exporting their goods and services have been severely impacted. Another assumption was that conditions within capital markets would remain stable and accommodative. Businesses built on this assumption failed very early on in the crisis. Northern Rock in the UK and Washington Mutual in the US are two high profile examples. There are many others, from investment banks such as Lehman Brothers to hedge funds that were borrowing short term money to invest into higher yielding, longer term assets (the now infamous carry traders).

Within the mainstream asset classes, equities have suffered acutely as expectations of much-reduced economic growth, and therefore lower corporate profitability, have been priced into valuations. Superficially, equities did not appear to reach levels at which they were expensive on measures such as price to earnings ratios in the current business cycle. However, it can now be seen that corporate profits had been driven to unsustainable levels due to over expansion of credit. Equity prices subsequently fell, taking yields to levels not seen in the last ten years (see Fig. 2).

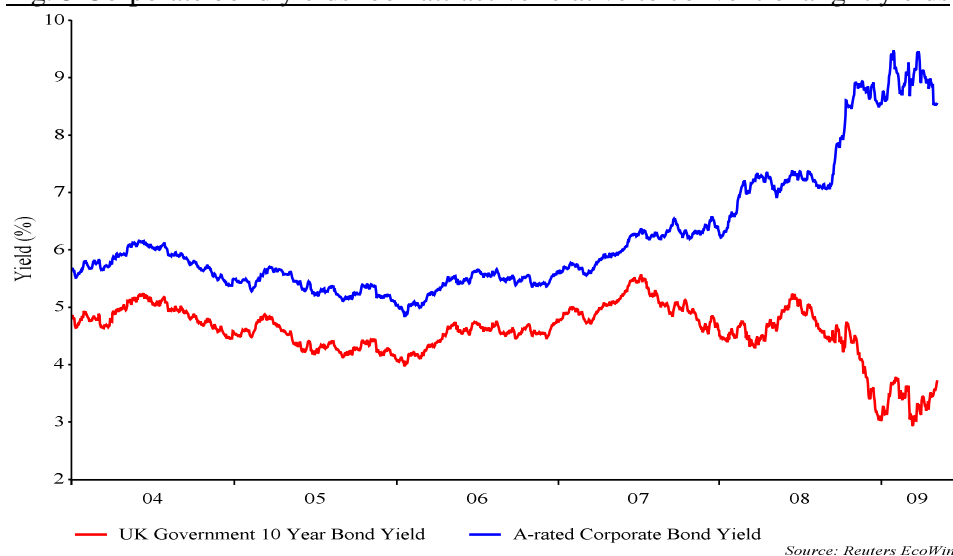
Fig. 2 Yields on Major UK Asset Classes



The yield shown for the equity market is the earnings yield. This gives a fair reflection of the full earnings of equities, rather than just those earnings distributed in dividends (as measured by the dividend yield). The earnings yield is calculated as earnings divided by price for the relevant index and is therefore the reciprocal of the price to earnings ratio.

Turning to other asset classes, fixed interest markets have seen a very marked rise in risk aversion as investor appetite for complex structured instruments, such as collateralised debt obligations (CDOs), has disappeared. As a result, government bonds have performed strongly relative to corporate bonds, particularly non-investment grade issues. Corporate bonds are not complicated instruments, but prices have nevertheless fallen due to concerns about corporate earnings and, again, forced selling by leveraged investors. As a result, corporate bonds are offering very high yields relative to government bonds (see Fig. 3). In our view they now present an attractive opportunity for investors prepared to take a longer term view.

Fig. 3 Corporate bond yields look attractive relative to conventional gilt yields



Commercial property values rose strongly for five years until mid-2007. Values have now been undermined both by the withdrawal of debt financing and the economic downturn which has weakened tenant demand.

Considering our recommended asset allocations, reductions in equity weightings during 2007 have helped to protect portfolios from some of the market falls but, with perfect foresight, we should have gone much further. However, after the sharp falls, equity markets now look relatively attractive on a range of measures versus their long term averages. 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 assets.

The MSCI World Equity Market index has provided a total return of +3.49% in sterling terms over the last six months and -18.35% over the last year.

2. Equities

2.1. UK Equities

Conditions in the UK economy have deteriorated rapidly as a result of the global financial crisis. As measured by GDP, the economy recorded its third consecutive quarter of contraction in the first three months of this year. At -1.9% compared to -1.6% in the final quarter of 2008, the rate of decline is still increasing and the UK is now in the midst of its worst recession since at least the early 1980s. Recession is also evident in the labour market, with unemployment rising to 2.1m in the three months to the end of February. This is the highest figure since 1997 and amounts to 6.7% of the labour force. With unemployment rising rapidly, inflation is less of a concern for policymakers. On the government's target measure, the Consumer Price Index (CPI), prices rose at 2.9% per annum in March, down from a recent peak of 5.2% in September. The more familiar Retail Price Index (RPI) has fallen faster still and is now showing prices, in aggregate, declining by 0.1% per annum. The main differences between the two measures are that mortgage interest payments and house price depreciation, both components of the RPI, are excluded from the CPI.

With inflation no longer a threat in the short term, the Bank of England (BoE) has reduced interest rates aggressively. Reductions of 1.50% and 1.00% in November and December 2008 respectively and further 0.50% reductions in each of the first three months of this year have taken the Bank Rate to 0.50%. This is far lower than at any time since the creation of the BoE in 1694 and is indicative of the scale of the economic and financial crisis.

To bolster the ailing economy, the government has announced a fiscal stimulus package worth up to £30bn, including a temporary cut in VAT. In addition to the fiscal measures, the government has continued to support the banking sector. However, falling tax revenues have resulted in a gaping hole in the public sector finances, necessitating sharp tax increases, especially for the higher paid.

Turning to the stockmarket, the path of UK equities from here will depend crucially on the depth and longevity of the recession and the extent to which earnings downgrades are already reflected in much lower share prices. Our view is that the sizeable correction in equities seen to date means that shares offer value in all but the very worst outcomes for growth and corporate earnings. We recommend that current allocations to UK equities are retained, where appropriate.

The FTSE All-Share index has provided a total return of +1.90% over the last six months and -26.88% over the last year.

2.2. European (excluding UK) Equities

Continental European consumers are not as indebted as their US or UK counterparts and most European economies do not have the corresponding balance of payments deficits seen in these two countries. Continental Europe, however, has not proved immune to the credit crisis or the accompanying economic slowdown. Eurozone GDP was 1.6% lower in the final quarter of 2008 (the latest figures available) when compared with the previous year, with investment spending falling sharply and exports declining much more rapidly than imports.

Germany is particularly dependent on overseas markets. In 2008 it exported goods of value equivalent to 47% of its GDP - far higher than any other major developed economy (the comparable figure for the UK is 21%). German exporters have been long term beneficiaries of both Far Eastern demand for capital goods, such as machine tools, and the ongoing, strong growth in Eastern Europe. Both regions have been impacted by the credit crisis and Germany has suffered from a very rapid decline in export orders for industrial goods. These now stand at half the level of 12 months ago.

The strength of the European single currency has exacerbated the eurozone's economic woes. The European Central Bank (ECB) has been slow to reduce interest rates and has, thus far, been reluctant to adopt quantitative easing as a policy option. A 0.25% reduction in early May took official rates down to 1.00% but the ECB's refusal to move as quickly as the US, UK and Japan has driven the euro higher and risks exacerbating the recession in member countries. We remain of the view that the ECB will join the Federal Reserve, the BoE and the Bank of Japan in reducing interest rates to close to zero and fully embracing quantitative easing in due course.

Having advised a significant reduction in weightings to European equities at the end of 2007, we recommend that remaining allocations are retained.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of -5.82% over the last six months and -35.19% over the last year. The strengthening of the euro means that, when translated into sterling, the returns are +7.32% over the last six months and -26.27% over the year.

2.3. North American Equities

In what was an historic statement, the Federal Reserve (the Fed) cut interest rates from 1.00% to “between zero and 0.25%” on 16 December and stated that it will leave rates at exceptionally low levels for as long as it takes to steer the US economy away from a deflationary slump. The Fed’s response to the developing crisis has been impressive; interest rates were 5.25% just eighteen months ago. 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 injections of capital into US banks similar to those used in the UK rescue. The Fed has also followed the BoE’s lead in embarking on a policy of quantitative easing. It announced a programme to purchase up to \$300bn of US Treasury bonds in early March, with the express aim of easing conditions in the private credit markets.

US retail sales, so long the mainstay of the US economy, have declined very steeply. In March they were 9.4% lower than a year earlier. Recovery here will depend on a return to stability in house prices and better labour market conditions. According to the Case Shiller index, US house prices were 18.8% lower in February (the latest available data), compared with the previous year. On a positive note, the rate of decline appears to be easing. However, with prices more than 30% lower than their mid-2006 peak, the impact on household wealth has been considerable. After recording more than half-a-million job losses in each of the last five months, the US unemployment rate is now 8.9%, its highest level since 1983.

The virtuous circle of easy credit availability driving house prices ever upwards has turned into a vicious circle of decline. Aggressive policy responses from the Federal government, designed to break this vicious circle, are now being put in place. These include programs to facilitate remortgaging at lower rates and to modify mortgage terms for those whose income has fallen. Given the scale and speed of the policy response we believe that the US will be one of the first economies to emerge from recession. Also the US corporate sector is highly flexible and restructuring is likely to take place rapidly.

US equities now look inexpensive relative to their history. We will be looking for opportunities to increase weightings when the outlook for the global economy becomes clearer; in the meantime, we recommend 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 -8.53% over the last six months and -35.31% over the last year. The strengthening of the dollar means that, when translated into sterling, returns are -0.26% over the last six months and -13.54% over the year.

2.4. Japanese Equities

Japan, having suffered its own asset price collapse in the 1990s, seemed, at least initially, one step removed from the present financial crisis. Japanese banks have less exposure to the sub-prime assets that have damaged their US and European counterparts and the economy has not seen excessive house price increases or household indebtedness. However, as a major exporter of manufactured goods, Japan is highly sensitive to the health of the global economy. Its economy has suffered as export demand collapsed with the impact of the global downturn magnified by the surging value of the yen. The Japanese currency has been driven sharply higher by the narrowing of interest rate differentials against other major currencies as rates have been cut aggressively around the world. Yen strength can also be attributed to the reversal of the carry trade, in which borrowers sold yen to invest in higher yielding assets denominated in other currencies. As export demand has fallen, Japan's trade balance has turned negative for the first time in thirteen years and economic growth has given way to recession. Output shrank by 0.5% in the third quarter of 2008 and 3.3% in the fourth quarter, making this Japan's worst recession since the 1970s.

Japan's already very low interest rates were cut further, to just 0.10%, in December. The interest rate reduction was accompanied by a step up in the Bank of Japan's programme of buying Japanese government bonds. Policymakers are also considering legislation to significantly increase public spending, including up to ¥50 trillion (c\$500bn) to be spent on supporting new industries and infrastructure projects in an attempt to stimulate the economy.

In the 12 months to 30 April, the yen appreciated by 29.57% against sterling, mitigating, to some degree, the very weak performance of the Japanese equity market. Japanese equities remain deeply out of favour with international investors, despite now appearing attractively valued versus both their own history and by comparison to their international counterparts. However, given the difficult economic outlook in Japan we believe it is too early to increase recommended allocations to Japanese equities. Current allocations should therefore be maintained, where appropriate.

The FTSE Japan index provided, in yen terms, a total return of -2.45% over the last six months and -38.13% over the last year. The strengthening of the yen means that, when translated into sterling, the returns are +6.33% over the last six months and -12.16% over the year.

2.5. Asia Pacific (excluding Japanese) Equities

The theory that the economies and equity markets of the Asia Pacific region had decoupled from their western counterparts has now been conclusively disproved. Increased intra-regional trade and proximity to the Chinese growth story offered little protection to the export-led Pacific economies in the midst of the synchronised global slowdown. GDP growth forecasts for the region, while still relatively healthy in comparison to those for the western economies, are now being revised downwards.

Strong economic growth drove several years of excellent returns for Asian equity markets, but also pushed them to relatively demanding valuations. These have now mostly corrected as Asian equities have fallen along with their western counterparts (see Fig. 4).

Fig. 4 FTSE All-World Asia Pacific ex Japan compared to MSCI World since 2008 (rebased)



We have, since 2006, recommended only small allocations to Asia Pacific equities in acknowledgement of the relatively high valuations and investor inflows that were taking on increasingly speculative proportions. However, we believe that the long term prospects for these markets are good and will be looking for opportunities to increase weightings when the outlook for the global economy becomes clearer. For now we continue to recommend that clients maintain their current tactical equity weightings to the region, where appropriate.

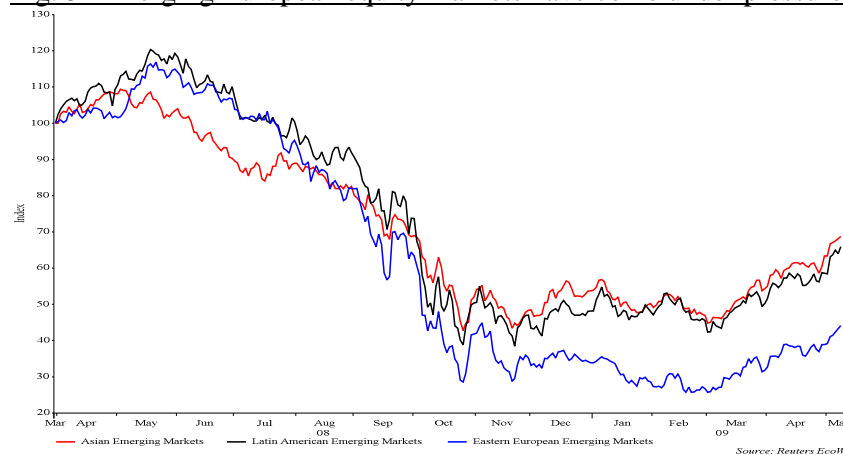
The FTSE All-World Asia Pacific ex Japan index provided, in local currency terms, a total return of +15.00% over the last six months and -30.73% over the last year. In sterling-adjusted terms, the returns are +28.65% over the last six months and -20.18% over the year.

2.6. Emerging Markets Equities

Having been a favourite destination for developed market investors, equities in the emerging markets* suffered sharp setbacks as the financial crisis developed. Falling demand for exports, and natural resources in particular, means that many emerging economies are now slowing markedly from the impressive rates of growth seen in recent years.

While the emerging Asian and Latin American regions largely avoided the debt-funded asset bubbles which were the root cause of the credit crunch, the same cannot be said of central and eastern Europe. Rapid increases in property prices encouraged high levels of borrowing, often in a foreign currency, and many emerging European nations are now being forced to turn to the IMF and other transnational institutions for financial rescue. This has placed considerable pressure on eastern European currencies, and equity markets have suffered significant losses (see Fig. 5).

Fig. 5 Emerging European equity markets have come under pressure



We have been recommending fairly small allocations to emerging markets equities for the last two years as, driven by strong speculative inflows, we believed these markets had become overvalued. The sell-off had gone some way to address this issue but the recent rally in risk assets has driven emerging markets sharply higher once more. We recommend current allocations are maintained for the present.

The FTSE All-World Emerging index provided, in local currency terms, a total return of +18.77% over the last six months and -41.89% over the last year. In sterling-adjusted terms, the returns are +29.50% over the last six months and -22.34% over the year.

* MSCI includes 23 countries in its emerging markets indices: Argentina, Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey.

3. Fixed Interest

The value of UK government fixed interest stocks (gilts) as effective portfolio risk diversifiers has been demonstrated over the course of 2008 and early 2009. From a peak of more than 5.50% in mid-2007, the yield on the 10-year conventional gilt retreated by more than 2½ percentage points to below 3.00% by mid-March 2009. This generated capital gains within portfolios that went some way to offsetting losses on equity holdings. Conventional gilts benefited from declining economic growth and inflation expectations and, importantly, their 'safe haven' status amid the turbulence in credit markets and falling equity prices. In addition to cutting the base rate to an historic low of 0.50%, the BoE also announced its intention to increase money supply by initiating the process of quantitative easing. This involves the purchase of £125bn of conventional gilts from banks, pension funds and insurance companies, who will hopefully place the funds on deposit to be used for lending to businesses and the consumer. However, such measures, together with the UK government planning record levels of new gilt issuance, have raised concerns about resurgent inflation and a lack of appetite for newly issued gilts. Ten year gilt yields have now risen from their sub-3.00% lows to 3.50% at the end of April.

Exposure to index-linked gilts also proved beneficial early in 2008 due to concerns about commodity driven inflation. However, as these concerns faded and investors focused instead on the possibility of recession and deflation, yields on index-linked gilts rose sharply in the third quarter of 2008 before falling back once again. Since the start of the new year, index-linked gilts have broadly performed slightly better than conventional stock thanks to the easing of concerns about a prolonged spell of deflation.

Our long-held belief that corporate fixed interest securities offered little value has meant that, since 2004, our recommended allocations to fixed interest have been weighted almost entirely towards government bonds. While this has had a positive effect on portfolio returns, conventional gilt prices are now, in our view, too high and are therefore vulnerable to rising inflation expectations. We have therefore been advising clients, where appropriate, to take profits in this area and look to invest in the now much more attractively valued corporate bond sector. The lack of liquidity in the European high yield bond market means we are more cautious on the non-investment grade sector and recommend allocations to fixed interest are focused on higher grades of corporate bonds.

The ABI UK Pension Gilt sector provided a total return of +7.04% over the last six months and +9.04% over the last year. The ABI Sterling Corporate Bond sector provided a total return of -3.37% and -14.07% over the same periods. The ABI UK Pension Index-Linked Gilt sector provided a total return of +3.90% over the last six months and -1.00% over the last year.

4. Property

After several years of strong returns, investors in UK commercial property have suffered a major setback with values receding substantially. Until 2007, the sector had been a major beneficiary of the large quantities of low cost debt finance that characterised the credit bubble. Increasing levels of gearing were used to leverage the steady but 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 purchases. This, together with the effect of the slowing economy on property demand and, hence, falling rents, has served to drive yields sharply higher and prices correspondingly lower. UK commercial property returns, including rental income, were negative in both 2007 and 2008 as measured by the ABI UK Pension Property index.

Although commercial property yields now look attractive relative to government bonds, the level of oversupply continues to increase as projects begun before the downturn are completed and as the continued deterioration of the economic backdrop undermines demand. Commercial property valuations, therefore, are likely to remain under pressure. We are monitoring developments closely with a view to taking a more positive stance on this asset class in due course. In the meantime, allocations to property within client portfolios are being met through vehicles, such as closed-ended funds, where we are satisfied that the underlying property assets are first class and where any gearing employed is manageable. Many such vehicles are now available at attractive discounts to asset value.

The ABI UK Pension Direct Property index provided a total return of -16.18% over the last six months and -23.75% over the last year.

5. Cash

Sterling deposits and monies held in AAA-rated liquidity funds can presently earn returns of around 0.50% over the BoE Bank Rate of 0.50% p.a. National Savings & Investments are also offering relatively attractive rates at present.

Despite lower rates, cash still has its attractions and we continue to favour an overweight position in the asset class, particularly where attractive fixed rates from government-backed, or 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 return of +0.75% over the last six months and +3.22% over the last year.

6. Note on Hedge Funds

Our view that hedge funds are riskier than generally perceived has 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. The arrest of hedge fund manager Bernard Madoff for fraud and the subsequent losses from many purportedly expert fund of hedge fund managers highlight the lack of disclosure in such vehicles and our consequent unease with the asset class.

According to Hedge Fund Research, a composite index of hedge funds fell 19% in 2008, the biggest annual decline since the company began tracking data in 1990. Among the casualties are some high profile names; Citadel Investment's flagship fund, which at \$10bn is one of the industry's largest, fell 55% in 2008. Atticus European, meanwhile, lost investors more than 43% over the year. 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 likely to have intensified in the fourth quarter as hedge fund investors continued to file significant redemption requests. We expect the industry to emerge from the financial crisis in a very different shape. There will certainly be fewer funds, charging, on average, lower fees and offering better reporting, transparency and 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 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 -1.83% over the last six months and -20.23% over the last year.

The above commentaries reflect our views as at 15 May 2009. 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 October 2008 to 30 April 2009 and the twelve month period from 30 April 2008 to 30 April 2009 (source: Lipper Hindsight).