Market Commentary

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Saunderson House Limited
1 Long Lane
London EC1A 9HF

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

SAUNDERSON HOUSE

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Risk Warnings

1. Economic and Investment Outlook

The world's largest economy, that of the United States, is weakening rapidly. The extent of the slowdown, however, remains uncertain. Forward-looking indicators, such as the University of Michigan consumer sentiment index and the ISM business survey, suggest that the contraction could be as sharp as that in the early part of this decade. Other signals are less bearish. Employment data remains quite robust, indicating that the US can avoid recession, while GDP figures for the first quarter of this year showed that the economy continues to expand, albeit at a very sluggish rate.

In contrast to some previous periods of economic weakness, the US authorities have taken aggressive action to mitigate the worst effects of the slowdown and head off the risk of a serious recession. Since September, the Federal Reserve (the Fed) has reduced its main interest rate, the Fed Funds rate, by 3.25%, including a dramatic 1.25% reduction in January and a 0.75% reduction in March. US interest rates are now 2.00%. This action has been augmented by other monetary measures and a Federal economic stimulus package worth $170bn.

Such actions appear justified by the weakness of the housing market, which lies at the heart of the problems for the US. House prices, according to the Case-Shiller Home Price index, were 12.7% lower in February 2008 compared to the previous year. With the number of repossessions rising and volumes in both new and existing home sales continuing to fall, there is no indication as yet that prices are stabilising.

The crisis in world financial markets is closely related to the troubled US housing market. Investors have lost confidence in many types of synthetic bonds, including those that have interest payments secured on mortgages (i.e. mortgage-backed securities). This has led to price falls and the loss of liquidity in markets for such securities. Bank asset write-downs, provisions and emergency recapitalisations have followed.

The aggressive interest rate cuts have taken their toll on the US dollar. This is helping exporters and thereby supporting one area of the economy. However, a weak dollar is threatening to reduce the Fed's room for manoeuvre by putting upward pressure on inflation. Another issue making the job of the central bank more difficult, and the path of economic growth hard to discern, is the contraction of credit availability. The bank asset write-downs and the general loss of confidence in structured debt securities, mentioned above, mean that financing – so readily available until recently – is now harder to secure. To rebuild damaged reserve ratios, banks are preserving liquidity while access to financing from bond markets is being denied to all but the most credit-worthy borrowers. These factors are combining to undermine, at least to some degree, the impact of interest rate reductions on the economy. This effect is most evident in the mortgage market where, despite aggressive interest rate cuts, mortgage rates have remained stubbornly high, thereby maintaining the debt burden on US homeowners.

The dislocation in credit markets has its roots in the period of low interest rates from 2002 onwards. During this period, the aggressive use of borrowing to ‘gear up’ the returns from investments generating stable cash flows, such as property, corporate bonds and mortgages, resulted in valuations for commercial property, non-government fixed income securities and many other assets being driven to unsustainable levels. We are now seeing a correction in the prices of these assets.

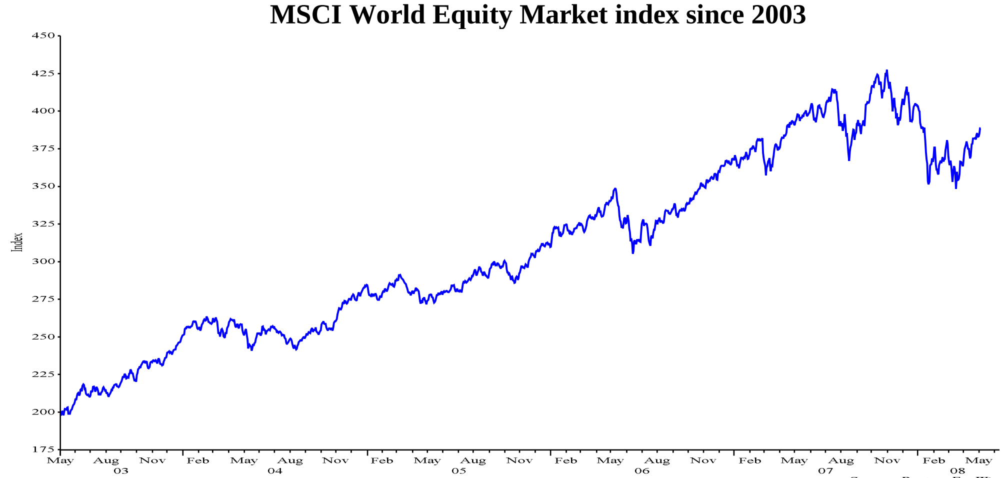
By contrast, over the same period, equity valuations (based on price to earnings ratios), did not move far above their long term average. However, equities are clearly impacted by (a) losses at financial institutions and (b) slower company earnings growth as the pace of economic expansion declines – hence the later, but still substantial, correction in equity prices. From the recent peak at the end of October to a low in late-March, equities, as measured by the MSCI World Equity Market index, fell by 15%. In monetary terms, this equated to a fall of almost $5,000bn in the value of global stock markets in just five months. The subsequent recovery has seen equities make up about half of this loss.

Equities now join commercial property and high-yield corporate bonds on investors’ list of ‘least favoured’ asset classes. This situation is not new; we reached the same point in the last business cycle in 2002. Such an investment landscape will offer opportunities for value-orientated investors in the coming months.

With December’s reduction in European equity allocations, client portfolios now have healthy weightings to cash and short and medium-dated government bonds. We will be looking to deploy some of these highly liquid and defensive assets into areas offering the potential for higher returns as opportunities present themselves though 2008.

The MSCI World Equity Market index has provided a total return of -4.04% in sterling over the last six months and +1.32% over the last year.

MSCI World Equity Market index since 2003



2. Equities

2.1. UK Equities

The pace of UK economic growth is set to slow rapidly. Consumer confidence slumped to a 15-year low in April while house prices, according to Halifax, are now suffering year-on-year declines for the first time since 1996. To mitigate the impact of the slowdown, the Bank of England (BoE) has reduced interest rates by 0.75% to 5.00% since December.

Credit dislocation issues in the UK are similar to those in the US, though they are perhaps less severe. Reports of tighter lending standards and more stringent credit scoring by the banks are already appearing in the press. Tighter credit terms for both businesses and consumers fully justify further interest rate reductions by the BoE. However, its scope to implement further cuts will depend, at least in part, on the path of inflation. Data for March showed the Consumer Price Index (CPI) at 2.5%, well above the BoE's target rate of 2.0%. The Retail Prices Index, the inflation measure used for index-linked bonds, is at 3.8%. This upward pressure on prices stems from higher energy and food prices, which have been driven by international factors such as the rapid growth of many emerging economies. It is vital for UK economic growth that inflation subsides over the course of the year, freeing the hand of the BoE to deliver interest rate cuts as it deems necessary. While inflationary pressures should ease as declining global economic growth acts to slow demand for resources, strong demand for commodities from the Asia Pacific region, together with an element of speculation, have so far kept prices high. This is unhelpful for the BoE, and may act to hold interest rates higher than otherwise necessary, causing a longer, or steeper economic slowdown.

Turning to equities, strong returns until mid-2007 were driven by supportive economic growth conditions and the return of a degree of pricing power to companies. These factors helped companies report excellent earnings growth and enabled them to deliver healthy dividend increases. Strong corporate profits growth meant that, despite share prices having risen over the previous four years, UK equities did not become expensive in terms of price to earnings ratios. After the recent falls, UK equities are, on first inspection, more attractively valued than they have been for several years. However, we are mindful that earnings expectations are likely to be pared back. Our view is, therefore, that there will be better opportunities to increase holdings in the coming months. In the meantime, we recommend that current allocations to UK equities are maintained.

The FTSE All Share index has provided a total return of -8.52% over the last six months and -4.31% over the last year.

2.2. European (excluding UK) Equities

Until December's recommended reduction in allocations, Continental Europe had been our favoured destination for investments into international equities. This proved profitable; European (ex UK) equities outperformed those of the US, UK and Japan over the previous 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, with the credit markets in turmoil, there are clearly grounds for a more cautious approach. One of the main reasons for the recommended reduction in allocations was the strengthening 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.

A key driver 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. While the European economy has proven resilient over the last six months, this has only served to drive the euro higher still, with it recently reaching all-time highs against both sterling and the dollar. With the European economy, and particularly Germany, heavily reliant on exports, we believe that this may simply exacerbate the slowdown in the coming months. Investors, unsurprisingly, have proved sensitive to these factors and Continental European equities, in local currency terms, have fallen twice as far as those of the UK and the US since the end of November.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of -13.68% over the last six months (-2.57% sterling adjusted) and -11.87% over the last year (+1.52% sterling adjusted).

2.3. North American Equities

The current economic downturn is centred on the US. After doubling in the last seven years, US house prices are now falling as the easy access to mortgage finance, which together with a speculative appetite 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. Declining house prices and reduced access to credit are now undermining consumer confidence and exacerbating this slowdown.

Alongside interest rate reductions totalling a full 3.25% over the last six months, the Fed has injected liquidity into money markets, introduced a term auction facility and allowed banks to swap top quality mortgage-backed securities for Treasury Bills (for 28 day periods). These aggressive policy responses demonstrate that the authorities are determined to avoid recession if at all possible. Moreover, all candidates for the Presidential elections are actively discussing measures to support indebted homeowners. It therefore seems likely that further policy measures will be forthcoming once a new President is installed in the White House.

Whether the combined actions of the Fed and the Federal government succeed in averting a recession will depend on several factors, including: how deeply rooted the sub-prime related issues are, the resilience of the job market, the impact of falling house prices on consumer behaviour and the extent to which economic activity outside the US remains healthy.

The US equity market has proven reasonably resilient when compared to other developed markets. Sterling based investors have also benefited from a rally in the dollar versus sterling over the last six months. We believe that allocations to US equities should be maintained for the present.

The S&P 500 index provided, in US dollar terms, a total return of -9.64% over the last six months (-5.22% sterling adjusted) and -4.68% over the last year (-3.75% sterling adjusted).

2.4. Japanese Equities

Japan continues to exasperate investors with a series of seemingly unnecessary political blunders: the Bank of Japan is without a permanent governor, the prime minister's popularity has collapsed and parliamentary stalemate may lead to a budgetary crisis. It is not surprising therefore that, amid all of this, the Japanese stock market has continued to disappoint.

Japanese economic growth has been fairly steady but domestic consumption remains weak, with the economy remaining too reliant on exports. 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 assets. This drove the yen down to very low levels. 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 10.31% against the dollar and by 15.70% against sterling over the last six months. The yen's strength over the last six months has reduced mid-teens falls from Japanese equities to only small losses for sterling based investors.

While an appreciating yen is beneficial for sterling based holders of Japanese assets, it is not helpful for the export-orientated Japanese economy. Slowing world growth is also an unwelcome development for Japan's export sector. These factors mean that the long-awaited recovery of Japanese equities may, yet again, be delayed. However, Japanese companies have almost no exposure to the credit-related problems besetting other economies and Japanese equities are looking good value relative to other markets, historical valuations and Japanese government bonds. The catalyst for a strengthening in equity markets is not obvious at present. Possible candidates include a weakening yen, political change or a return of international investors attracted by the lowly valuations. We therefore recommend current allocations to Japanese equities are maintained.

The FTSE Japan index provided, in yen terms, a total return of -14.87% over the last six months (-1.50% sterling adjusted) and -18.03% over the last year (-5.36% sterling adjusted).

2.5. Asia Pacific (excluding Japanese) Equities

The performance of the economies of the Asia Pacific (ex Japan) region has thus far remained resilient in the face of the slowdown in Western economies. The economies of South Korea, Hong Kong, Singapore and Taiwan all grew by more than 5% in 2007 and, looking forward, all are forecast by the IMF to sustain growth comfortably in excess of the developed economies. Importantly, decreasing reliance on Western export markets and sizeable foreign currency reserves mean that the periodic crises of the past are less likely to be repeated. Moreover, strong economic growth and current account surpluses point to Asian currencies appreciating 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 and, after strong upward moves in recent years, these markets no longer trade on their traditional discount to developed markets. Also, it remains to be seen how great an impact the slowdown in the US will have on the region. Opinions range from those that hold the view that the Asia Pacific countries can decouple from the West, to those who believe that maintenance of strong regional growth is dependent on the health of the global economy. Regardless of this debate, the stock markets in the Asia Pacific region have corrected in sympathy with Western markets as investors have taken profits and reduced allocations to what have been historically volatile markets.

We believe that investors with longer time horizons 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 -8.65% over the last six months and +17.27% over the last year (for sterling based investors).

2.6. Emerging Markets Equities

Emerging markets (as defined by MSCI – see below) have provided excellent returns over the four-year global equity bull market. This has been 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. The economies of India and China have delivered particularly strong growth and investors have enjoyed very strong returns. We have for some months, however, been concerned that investor appetite, particularly for shares in three of the four 'BRIC' markets (Brazil, Russia, India and China), has taken on speculative proportions. Despite recent corrections, valuations look quite high and a significant proportion of the corporate earnings growth has become dependent on continued rises in share prices and sustained strong global economic growth. The exception to this, in our opinion, is Russia. In addition to attractive equity market valuations, we believe the Russian economy to be benefiting from strong domestic consumer-led growth and well-insulated from both the credit crisis and a slowdown in economic growth in the developed economies.

Since the turn of the year, our generally cautious stance has been justified. Chinese shares listed on the Shanghai stock exchange have fallen by almost 40%, India by almost 15% and many others by more than 10%. Russian equities have fallen by 7%. We are now recommending a small increase in allocations to emerging markets, focusing particularly on opportunities in Russia.

The FTSE All-World Emerging index provided a total return of -4.66% over the last six months and +26.31% over the last year (for sterling based investors).

*MSCI includes 25 countries in its emerging markets indices: Argentina, Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey.

3. Fixed Interest

Over the last year UK government bonds (gilts) have demonstrated their value as the most effective portfolio risk diversifiers. From a peak of over 5.5% in mid-2007 the yield on the 10 year UK government bond retreated by over 125bps, generating strong capital returns This move was partly in anticipation of lower economic growth (and therefore falling interest rates), but gilts have also benefited from their ‘safe haven’ status amid the turbulence in credit markets and falling equity prices.

In contrast, corporate and non-investment grade bonds have suffered from decreasing risk appetite amongst investors amid concerns about credit quality. Within the various classes of fixed interest instruments, we have, for several years, 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 conventional and index-linked UK government bonds. This asset allocation decision tested our resolve as non-government bonds continued to outperform sovereign issues for some time. Recent developments in the credit markets have, however, seen the price of government bonds appreciating while lower quality corporate and high yield bonds have fallen abruptly. Index-linked issues have performed particularly well due to ongoing concerns about inflation. As well as offering inflation protection, index-linked bonds are capital gains tax free. This includes the gains from the indexation of capital, and makes index-linked gilts especially attractive when held outside of a tax-advantaged wrapper, such as a pension.

We are closely monitoring the now much more realistically-valued corporate and non-investment grade bond sectors. This is with a view to increasing allocations to the non-government sector when valuations become more compelling.

The ABI UK Pension Gilt sector provided a total return of +1.62% over the last six months and +4.30% over the last year. The ABI UK Pension Index-Linked Gilt sector provided a total return of +4.64% over the last six months and +9.33% over the last year.

4. Property

After several years of strong returns, investors in UK commercial property have suffered a major setback. 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. As the credit crisis unfolded from mid-2007 onwards, commercial property investors witnessed an abrupt change in the willingness of banks to lend at low rates against property purchases. This, 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 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 in 2007 as measured by the ABI UK Pension Property index. This is the first time commercial property prices have fallen since 2001 and returns have remained under pressure thus far in 2008.

For now it remains our view that the risk-adjusted returns available on cash deposits are more attractive than those on commercial property. However, value is beginning to return to the asset class and we are monitoring this closely with a view to taking a more positive view on commercial property, which we believe will be some time during the next 12 months.

The ABI UK Pension Direct Property index provided a total return of -10.22% over the last six months and -15.94% over the last year.

5. Cash

Sterling deposits or monies held in AAA-rated liquidity funds, earns return in excess of 5.00% p.a. at present. We regard these as attractive relative to the yields currently available on fixed interest or commercial property.

While UK interest rates will probably continue to fall in 2008, we still favour allocations to cash. From an asset allocation perspective, it offers 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.

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 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 much publicised demise of Peloton, the London-based hedge fund group, exemplifies our view of the potential risks inherent in this asset class. Peloton's $2bn flagship fund, the ABS Master fund, won the Eurohedge 'New Fund of the Year' award in February. The award was in acknowledgement of the fund's excellent performance in 2007, when it returned 87% after betting that US sub-prime mortgages would fall in value. However, 2008 saw a swift reversal in Peloton's fortunes. A combination of falling values in highly rated tranches of mortgage-backed securities (in which the fund was then invested), together with pressure from banks for more collateral to set against loans, caused the fund's collapse. Investors in the fund have lost 100% of their capital.

For completeness, we have quoted below performance figures for hedge funds using the widely-followed HFRX Global Hedge Fund index. We are, as might be expected, somewhat sceptical about the integrity of these figures. In our view, the index will almost certainly overstate hedge fund returns. This is because the submission of performance figures to the index compilers is voluntary and it is unlikely that failed or poorly performing hedge funds would submit numbers for inclusion in the index.

The HFRX Global Hedge Fund GBP index provided a total return in sterling terms of -3.57% over the last six months and -0.46% over the last year.

N. B. Unless otherwise noted, all performance figures are total returns (including income re-invested) for the six month period from 31 October 2007 to 30 April 2008 and the twelve month period from 30 April 2007 to 30 April 2008 (source: Lipper Hindsight).