

Market Commentary

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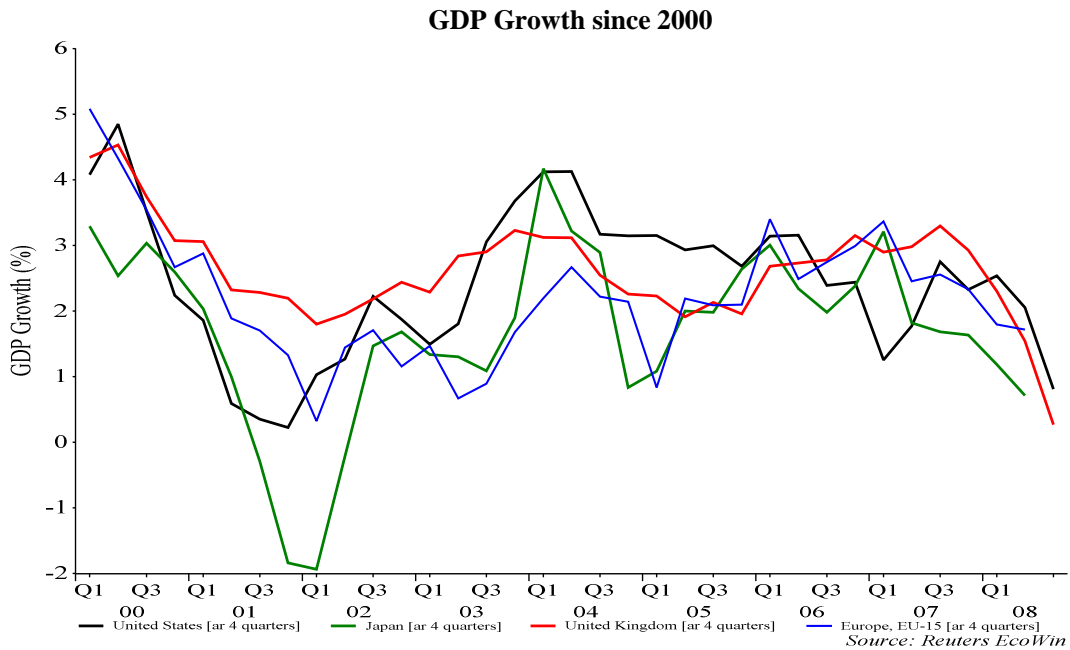
Risk Warnings

This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 11 November 2008. 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

The last two months have seen an internationally co-ordinated policy response to address the crisis in the global financial system. Governments have moved to stave off the collapse of the financial system by using public funds to recapitalise banks and guarantee future bank debt issues. Meanwhile, central banks have delivered aggressive interest rate cuts and provided huge quantities of liquidity in an attempt to lower short term interest rates. These measures appear to have had some success in stabilising the banking system.

While the authorities have been able to avert widespread bank failures, they have a harder task in attempting to steer economies away from recession. Economic indicators are unremittingly weak and the events of October will only have served to further undermine business and consumer confidence. Residual concerns about the financial system will reverberate through the real economy for months to come and it is, as yet, unclear whether the injections of capital into banks will improve credit availability for companies or consumers. It is also unclear at what level US house prices will stabilise or how far unemployment will rise. These two inter-related factors will be key to determining how long and how deep the recession will be.



During the last 12 months, we have seen the full impact on investment markets of the withdrawal of cheap, short term funding. Those businesses built on the assumption that abundant credit was a permanent feature of the financial landscape have imploded. Northern Rock and Bradford & Bingley are two high profile examples, but there are many, many others - from hedge funds that were borrowing short term money and investing in higher yielding assets (the now-infamous carry traders), to car manufacturers granting easy finance terms to allow consumers to purchase new vehicles.

Within the mainstream asset classes, equities have suffered greatly. Arguably, stock markets have become victims of their own liquidity. As markets for other assets, such as high yield bonds, property and structured debt instruments, have seized up, investors needing to raise cash have sold their more liquid assets; equities. Moreover, because so many investors have used leverage to gear market returns, the number of forced sellers (those who need to sell regardless of price) appears to be having a significant impact on the equity market.

Turning to other asset classes, commercial property had been a major beneficiary of cheap credit, and has suffered acutely from its withdrawal. In fixed interest markets, after several years of strong performance from lower quality non-investment grade bonds, investors have, rightly, become concerned about credit risk. This has resulted in government bonds performing strongly relative to corporate bonds, particularly non-investment grade issues.

Considering our recommended asset allocations, reductions in equity weightings late last year have helped to protect portfolios from the worst of the market falls but, with perfect foresight, we would have gone further. However, after the sharp falls in the last two months, equities now appear reasonably attractive. 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 asset classes.

Elsewhere, portfolios have had healthy weightings to cash and short and medium dated gilts. Both have offered capital security and liquidity.

The MSCI World Equity Market index has provided a total return of -21.10% in sterling over the last six months and -24.80% over the last year.

2. Equities

2.1. UK Equities

After recording zero growth in the second quarter of 2008, the UK economy actually shrank in the third quarter. This was the first quarterly decline in output since 1992. The magnitude of the decline, at 0.5% quarter-on-quarter, surprised analysts but the underlying drivers did not, with construction and manufacturing suffering the largest falls. In response to the weakening outlook, the Bank of England (BoE) has embarked on a policy of aggressive interest rate reductions including a 1.50% reduction on 6 November. This has taken the Bank Rate down to 3.00%; its lowest level since 1955.

Discussions about the possibility of tax cuts or other fiscal stimuli to support economic activity in general, and the beleaguered consumer in particular, indicate that the government shares the BoE's pessimistic outlook. In addition to the fiscal measures, the government has been using its newly acquired power over the banking sector to encourage banks to pass on the BoE's rate cut to mortgagees.

In taking such bold policy measures, the UK authorities are acknowledging that the prospects for the UK economy are worse than they have been for almost twenty years. The UK consumer, so long the mainstay of the economy, is under severe pressure from a deteriorating jobs market, falling house prices and cost pressures from rising utility and fuel bills. This pressure is likely to be exacerbated by reduced access to credit as the banking sector retrenches in an attempt to repair damaged balance sheets.

Turning to the stock market, the recent sharp fall in the UK equity market leaves equities looking inexpensive versus cash and government bonds. However, the path of UK equities from here will depend crucially on the depth of the economic slowdown to come and the extent to which earnings downgrades are already reflected in share prices. Our view is that the sizeable correction in equities seen so far means that shares offer value on all but the very worst outcomes for corporate earnings. We are, therefore, recommending that current allocations to UK equities are retained where appropriate.

The FTSE All-Share index has provided a total return of -28.24% over the last six months and -34.36% over the last year.

2.2. European (excluding UK) Equities

Until our recommendation to reduce allocations to European equities in late 2007, the Continent had been our favoured destination for investments into overseas markets. This proved profitable as European (ex UK) equities outperformed those of the US, UK and Japan over the three years to the end of 2007.

One of the main reasons for the recommended reduction in allocations was our view that the eurozone would not prove immune to the credit crisis or the accompanying economic slowdown that was already impacting the US and UK. This has proven to be the case, although the core eurozone economies did remain resilient for longer than the US or UK, with the exporters of manufactured goods in particular benefiting from sustained demand from the Far East. However, with exports falling under the combined impact of the strong euro and the weakening global economy, growth has started to falter. The European Central Bank, which was increasing interest rates as late as July in response to the threat of inflation, joined other major central banks in delivering co-ordinated rate cuts in early October and reduced rates by a further 0.50% in November. Eurozone interest rates now stand at 3.25%.

The core countries of continental Western Europe, including Germany, France and the Benelux nations, remain structurally sound and they will be long term beneficiaries both of Far Eastern demand for exports and the continuing development of Eastern Europe. Also, over the longer term, we expect the euro to gain in value against sterling. After the recent weakness, we therefore recommend that current allocations to European equities are retained where appropriate.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of -31.19% over the last six months (-31.30% sterling adjusted) and -40.60% over the last year (-33.07% sterling adjusted).

2.3. North American Equities

A 0.50% point reduction in the Federal funds rate on 29 October took US interest rates down to just 1%. This represents monetary easing on a grand scale; a little over one year ago rates stood at 5.25%. In an attempt to avert a deep recession, 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 an injection of capital into US banks similar to that involved in the UK rescue. President-elect Barack Obama is likely to oversee further fiscal stimuli upon taking office in late January.

US retail sales, so long bolstered by rising property values, are now being undermined by falling house prices which, according to the Case-Shiller Home Price index, were 16.60% lower in August (the latest data available), compared to the previous year. The virtuous circle of easy credit availability driving house prices ever upwards has turned vicious. The banking sector, paralysed by losses on structured mortgage assets, has retrenched, reducing the availability of credit to both consumers and thereby exacerbating house price falls and further undermining consumer confidence.

Considering that the US is at the centre of the current global economic slowdown, its equity market had, until the end of September, performed surprisingly well relative to other major markets. The recent sell-off has, however, reduced this disparity slightly. Though valuations appear supportive, we are aware that the US economy and its companies have yet to experience the full consequences of recession. We believe 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 -29.28% over the last six months (-13.32% sterling adjusted) and -36.10% over the last year (-17.84% sterling adjusted).

2.4. Japanese Equities

The Japanese economy, like those of other developed countries, is slowing under the impact of global financial dislocation. As a major exporter, Japan is more sensitive to global economic growth than other major nations. Its equity market has, accordingly, suffered most.

One factor in Japan's favour is that it stands one step removed from the global financial crisis. Japanese banks have much less exposure to the sub-prime assets that have damaged their US and European counterparts and the economy has not suffered from excessive house price increases. In fact, the health of Japanese financial institutions is allowing them to make strategic acquisitions overseas. Recent deals include Mitsubishi UFJ Group's purchase of a stake in Morgan Stanley and Nomura's acquisition of the non-US businesses of Lehman Brothers.

Japan's lack of exposure to the financial crisis together with its already very low interest rates, has meant that the yen, despite interest rates being cut to just 0.3% at the end of October, has appreciated very markedly against other major currencies. This has worsened the plight of Japan's exporters but has provided some consolation for overseas investors in Japanese financial assets. Over the year to 31 October the yen appreciated by some 28.54% against sterling, mitigating to some degree the very weak performance of the equity market.

Japanese equities remain deeply out of favour with international investors, but they are now very cheap both versus their own history and by comparison with international counterparts. We therefore recommend current allocations to Japanese equities are maintained where appropriate.

The FTSE Japan index provided, in yen terms, a total return of -36.57% over the last six months (-17.38% sterling adjusted) and -46.00% over the last year (-18.62% sterling adjusted).

2.5. Asia Pacific (excluding Japanese) Equities

For several years up until this year, equity markets in the Asia Pacific (ex Japan) region had, provided excellent returns. Rising markets were driven by strong regional economic growth, investor enthusiasm for markets linked into the Chinese development story and the expectation that Asian currencies would appreciate over the medium term. However, as the global economic outlook has deteriorated this year, investor enthusiasm has waned and Asian equities have begun to sharply underperform their western counterparts (see chart).

We have, since 2006, recommended only very small allocations to Asia Pacific equities in acknowledgement of their strong performance, their increasingly high valuations and the historic volatility of the region's stock markets. We do, however, continue to believe that investors with longer time horizons will earn good returns as the long term economic fundamentals remain very promising. Although, after the recent sell-off, valuations have become significantly more tenable, we continue to recommend that clients maintain their current low tactical equity weightings to the region where appropriate.

The FTSE Asia Pacific (ex Japan) index provided a total return of -36.58% over the last six months and -42.06% over the last year (for sterling based investors).

Asia Pacific (ex Japan) equities have underperformed developed markets over the first 10 months of 2008 (rebased)



2.6. Emerging Markets Equities

Hopes that emerging markets (as defined by MSCI *) could continue to grow rapidly, despite the sharp slowdown in developed economies, have been dashed in 2008. Upward pressure on inflation as economies have begun to encounter capacity constraints, together with slowing demand for exports, means that many emerging markets are likely to slow from the rapid rates of growth seen in recent years. While inflation may prove a transitory issue for developed economies, it appears more entrenched in some emerging markets and may require an aggressive policy response to bring it back to acceptable levels. The key point of differentiation is that wage inflation in developed markets does not look likely to rise, which would put further upward pressure on inflation. In many emerging markets, however, wages are rising rapidly as increasing job mobility and competition for workers has enabled employees to claim their share of the strong economic growth.

Assisted by robust economic growth, emerging markets equities provided excellent returns over more than four years to early 2008. As the outlook for the global economy has deteriorated, however, emerging markets have started to retrench. Having risen very strongly, to the point that many were trading on significant valuation premiums to their developed counterparts, emerging equity markets were vulnerable to sharp reversals. These have been occurring. Equity market corrections in China and India, two former favourites of emerging market investors, have been severe. Over the 10 months to 31 October, in sterling terms, Chinese shares listed on the Shanghai stock exchange fell by 67.14% while those Indian companies with shares listed in Bombay have seen, on average, a 51.75% decline.

We have been recommending only small allocations to emerging markets equities for the last two years. This has caused client portfolios to miss out on some upside but, driven by strong speculative inflows, these markets have been looking increasingly expensive for some time. As in the developed markets, we are likely to see opportunities to increase weightings to emerging markets in due course but for now recommend maintaining current holdings as appropriate.

The FTSE All-World Emerging index provided a total return of -40.03% over the last six months and -42.82% 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 fixed interest stocks (gilts) have demonstrated their value as effective portfolio risk diversifiers. From a peak of over 5.50% in mid-2007, the yield on the 10-year UK government bond has retreated by more than 140bps to 4.11%. This has generated capital gains which have helped to offset some of the losses in equity holdings. Gilts are benefiting from lower growth expectations (and therefore lower interest rate hopes), and, importantly, from their 'safe haven' status amid the turbulence in credit markets and falling equity prices.

While gilts proved highly attractive to investors, lower quality classes of fixed income securities, such as corporate and non-investment grade bonds, have suffered from increasing risk aversion. Concerns about credit quality and default risk, together with the until recently unattractive yield premiums available on non-government debt, meant that their appeal to investors was limited and they have, accordingly, underperformed their government counterparts.

Our long-held belief that non-government fixed interest securities offered little value has meant that our recommended allocations to fixed interest in total have been fairly light. However, within the asset class we have advised clients to focus on conventional and index-linked UK government bonds. Index-linked issues performed particularly well in the first half of the year due to concerns about inflation. However, yields have recently risen somewhat as fears of falling economic growth have replaced concerns about higher inflation. We expect conventional gilt yields to remain fairly low over the next year as interest rates are cut and the economy works its way through the downturn. Following this period it is likely that higher inflation expectations, together with heavy gilt issuance, will see yields move higher once more. We are therefore continuing to recommend that government bond allocations are split evenly between conventional and index linked issues. In addition, we are closely monitoring the now much more realistically valued non-government bond sectors and are selectively increasing allocations.

The ABI UK Pension Gilt sector provided a total return of +1.82% over the last six months and +4.27% over the last year.

The ABI UK Pension Index-Linked Gilt sector provided a total return of -4.72% over the last six months and +1.39% over the last year.

4. Property

After several years of strong returns, investors in UK commercial property have endured a major setback with property values receding substantially. Until 2007, the sector had been a major beneficiary of the abundance of low cost debt finance that characterised the credit bubble; higher and higher quantities of debt were used to gear the steady but otherwise 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 property purchases. This, together with reduced appetite for risk among investors, has served to drive commercial property yields sharply higher and prices correspondingly lower.

Our Investment Bulletin of October 2006 set out our view that commercial property investments could suffer as prices were forced down to levels more attractive to investors. This consolidation is now well under way. UK commercial property returns, including rental income, were negative in 2007 as measured by the ABI UK Pension Property index and are highly likely to be so again in 2008.

Given the degree of oversupply, commercial property is likely to remain under pressure for some time. However, with yields now substantially higher than 18 months ago, value is beginning to return to the asset class. We are monitoring developments closely with a view to taking a more positive stance on this asset class in due course.

The ABI UK Pension Direct Property index provided a total return of -9.04% over the last six months and -20.45% over the last year.

5. Cash

Sterling deposits or monies held in AAA-rated liquidity funds can presently earn returns in excess of the BoE Bank Rate of 3.00% p.a. However, with the economic outlook weakening it is our view that UK interest rates are set to fall further. The Monetary Policy Committee of the Bank of England, perhaps belatedly, has now recognised that inflation is set to decline quite sharply.

Despite lower rates, cash still has its attractions and we continue to favour heavy weightings. 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 total return of +2.49% over the last six months and +5.17 over the last year.

6. Note on Hedge Funds

Our view that hedge funds are riskier than generally perceived is gaining wider acceptance. 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 Hedge Fund Research, hedge funds are this year on course to suffer their worst performance since records began in 1990. Among the casualties are some high profile names; Citadel Investment's flagship fund, which at \$18bn is one of the industry's largest, lost 15% in September alone whilst similar performance from Atticus European took year-to-date losses to more than 43%. 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 set to intensify in the fourth quarter as hedge fund investors continue to file significant redemption requests.

For completeness, we include the HFRX Global Hedge Fund index figures for hedge fund performance below. We are, as might be expected, somewhat sceptical about the 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 -18.66% over the last six months and -21.34% over the last year.

N. B. The above commentaries reflect our views as at 11 November 2008. 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 30 April 2008 to 31 October 2008 and the twelve month period from 31 October 2007 to 31 October 2008 (source: Lipper Hindsight).