Market Commentary

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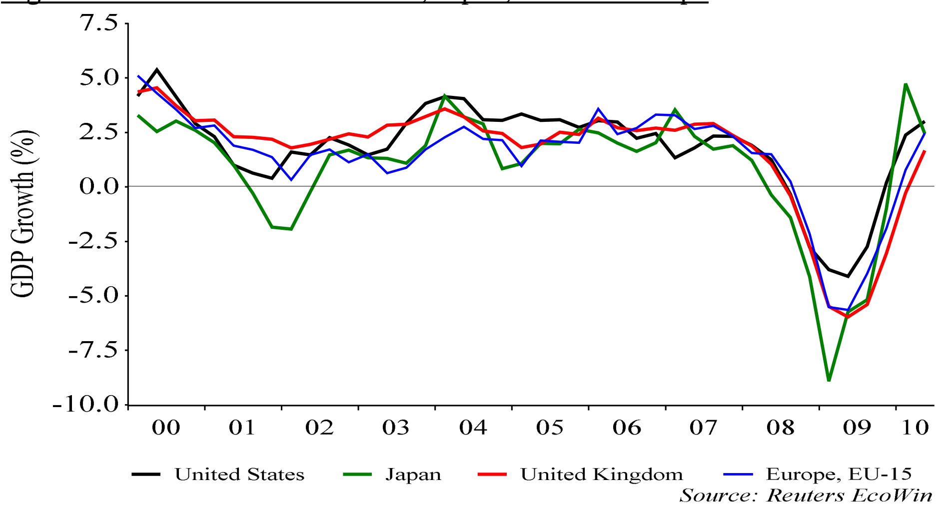
1. Economic Outlook

Surveys and data releases continue to indicate that the pace of the global economic recovery is moderating. In recent weeks for example, both US employment and US housing data have disappointed. The world's largest economy is simply not creating sufficient new jobs to reduce unemployment, which has now been above 9.5% for more than a year. Volume in the housing market remains extremely low and house prices, which fell by almost a third from peak to trough, have made only a lacklustre recovery. Poor job prospects, weak wage growth, households in negative equity and reduced access to credit finance continue to weigh on consumers' willingness to spend.

It has been our view for some time that the strong initial pace of the economic recovery was unlikely to be maintained. Reasons for this include the fading effects of both the inventory-rebuilding phase of recovery and the government administered fiscal stimuli. Fig. 1 shows that the initial recovery has been robust. We now expect growth rates to level out as stimuli fade and economic fundamentals reassert themselves.

Fig. 1 Economic Growth in the US, Japan, UK and Europe



While we expect economic growth to moderate, we remain optimistic that there will not be a 'double-dip' in global growth or a prolonged period of deflation. Our reasons are twofold. Firstly, while conventional policy levers in developed economies do not leave much scope for further action, central banks stand ready to administer further stimulus measures if needed. Indeed, the US central bank, the Federal Reserve, appears likely to begin a second phase of quantitative easing in the near future in an attempt to lower borrowing costs for embattled households and support asset prices. Secondly, economic growth remains strong in emerging economies via demand for developed market exports. This is likely to provide a degree of support for growth in developed economies.

The MSCI World Equity Market index has provided a total return of -4.50% in sterling terms over the last six months and +8.91% over the last year.

2. Equities

2.1. UK Equities

After a strong second quarter, during which the UK economy grew by 1.2%, we are doubtful that the strong pace of the recovery will be maintained. The coalition government's austerity Budget in June announced tax increases and sharp cuts in public sector spending that together aim to eliminate the UK's structural budget deficit over the life of this parliament. Although back-end loaded, we expect higher taxes and public sector job cuts to weigh on consumers' ability to spend and lead to higher unemployment, unless the private sector can take up the slack. This seems unlikely, despite the resilience of the corporate sector and the strong contribution of business investment to economic growth in the first half of 2010. Access to debt funding remains constrained for all but large companies and the strength of end demand is still highly uncertain. This suggests that companies will stay focused on keeping costs down and will try to defer capital expenditure while they further strengthen their balance sheets.

That said, our view is that the probability of a double-dip recession in the UK is low. We are encouraged by the Bank of England's stated intent to keep interest rates lower for longer and its ability to restart quantitative easing if necessary. Loose monetary policy should help support growth in the household and corporate sectors, as the government's contribution to GDP shrinks, and allow trade to make a positive contribution to growth by ensuring that sterling stays weak.

Turning to the stock market, we believe that UK equities look attractive on a number of measures. During the economic downturn, many UK corporates aggressively cut costs and raised fresh capital to strengthen their balance sheets. This has left them in fundamentally sound shape and with scope to expand profit margins as the high rate of unemployment acts to depress wage pressures. As a result, any increase in revenues should translate into significantly higher profits. This has been borne out by strong second earnings announcements, with many companies' profits beating expectations.

Despite this, valuations of UK companies remain relatively low. The UK stock market now offers a high dividend yield relative to 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 and our belief that the risk of a double-dip recession is small, our recommendation is that current allocations are maintained.

The FTSE All-Share index has provided a total return of +0.31% over the last six months and +12.49% over the last year.

2.2. European (excluding UK) Equities

Given the concerns during the past year about possible sovereign debt default in Greece and the potential for contagion to other troubled eurozone countries, it is perhaps surprising that recent economic data in the region has been encouraging. Service sector and manufacturing activity surveys have been positive, while the eurozone economy as a whole managed growth of 1.0% in the second quarter of 2010. However, such positive data has largely been due to the export-led German economy. German GDP rose by 2.2% in the second quarter, almost 1% above consensus and at its fastest pace since the country's reunification two decades ago. By contrast, Greece and Ireland experienced contractions of 1.5% and 1.2% respectively.

The joint provision by EU member states and the IMF of €110bn of loans to the Greek government, together with an ECB facility for €750bn in loans and guarantees for fiscally troubled eurozone countries, eased concerns of financial market crisis in the region. However, the latest developments in the non-core eurozone countries provide further reminders that the region's fiscal crisis is far from over. The cost of the banking sector bailout in Ireland is expected to push the country's budget deficit to c32% of GDP while, in September, Spanish sovereign debt was downgraded from Aaa to Aa1 by Moody's. The ECB is, therefore, likely to continue to support the peripheral economies by offering unlimited lending to commercial banks, though, at least for now, abstain from undertaking further quantitative easing.

While the peripheral European economies are expected to experience a sustained period of lacklustre growth as painful fiscal adjustment and structural reforms take effect, the core eurozone region contains many companies that generate a significant proportion of their revenues in the US, Asia and emerging markets and should therefore be relatively immune from continued weakness in the non-core economies. German companies, for instance, have spent much of the past two decades establishing a strong foothold 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.

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

The FTSE Europe (ex UK) index provided, in euro terms, a total return of +0.02% over the last six months and +7.21% over the last year. The weakness of the euro means that, in sterling-adjusted terms, returns are -2.48% over the last six months and +1.63% over the year.

2.3. North American Equities

As the favourable impetus from the inventory cycle wanes and the impact of the government's fiscal stimulus package fades, economic activity in the US has began to slow once more. The second and third quarters of this year saw domestic macroeconomic data disappoint, raising concerns that the world's largest economy may slide back into recession. This view is supported by consideration of the major headwinds facing the US consumer. Consumer spending accounts for approximately 70% of the US economy and, with households hampered by high unemployment, high levels of debt and a weak housing market, personal consumption is clearly under pressure. The Federal Reserve has taken extensive measures over the last 18 months to combat these pressures and, after agreeing at its August meeting to begin reinvesting proceeds from expiring mortgage-backed securities into Treasury bonds, now looks set to embark on a second round of quantitative easing. With the Fed standing ready to address significant further deterioration in the economic backdrop, we believe the most likely prospect for the US is for a continued but slow recovery. According to the IMF World Economic Outlook, the US is projected to record growth at 2.6% this year and 2.3% in 2011.

Against this backdrop, company news flow has been encouraging. According to Thomson Reuters, S&P 500 earnings growth was 38.2% in the second quarter (annualised) and 75% of companies beat analysts' forecasts. A buoyant corporate environment looks set to continue for the remainder of this year, with the consensus estimate for the S&P 500 operating earnings per share rising 45.4% for 2010 as a whole, implying the biggest annual gain in corporate earnings since 1988. Analysts' forecasts for 2011 show a more modest 13.6% increase. However, with significant cost cutting already undertaken and margins fully recovered, a pick-up in demand may be needed for strong earnings growth to be maintained. While this seems unlikely, even if the rate of growth plateaus, the US equity market looks attractively valued both on current and forward estimates. Further, the S&P 500 yield relative to the 10-year Treasury yield indicates equities are, with the brief exception of the 2009 market lows, at their most attractive for several years.

On this basis, we believe the US equity market is well placed to make progress. We have been recommending allocations to US equities are selectively increased, where appropriate.

The S&P 500 index provided, in US dollar terms, a total return of -1.74% over the last six months and +10.16% over the last year. In sterling terms, the returns are -5.81% over the last six months and +11.81% over the year.

2.4. Japanese Equities

Macroeconomic indicators released in September continued to paint a weak picture for the Japanese economy. Persistent yen strength continued to impact negatively on net exports, while large manufacturers became marginally more pessimistic about the business outlook, according to the quarterly Tankan survey released this month. The labour market, however, showed signs of stabilisation as unemployment fell slightly to 5.1% and the ratio of jobs to applicants increased slightly to 0.54.

Politics were in the spotlight yet again. After fending off a leadership challenge from within his own party, Prime Minister Naoto Kan found himself confronted by an increasingly belligerent China. Tensions began to build after a Chinese fishing boat collided with two Japanese coast guard vessels near the disputed Senkaku islands, which contain rich oil and gas resources. Japan's detention of the boat's captain for questioning prompted China to retaliate by arresting four Japanese contractors on suspicions of spying. The incident is a setback to political relations, and the lack of a resolution continues to delay both government-led and private investment activity. In an effort to placate the Chinese, Japan has released the boat's captain without conditions. Beijing has since responded by freeing all four detainees, but high-level talks have not resumed. Japanese opinion polls reveal a sharp drop in approval ratings following Kan's mishandling of the situation, prompting talk of another leadership change.

The yen continues to strengthen against the US dollar. Upon falling through the ¥83/$ mark, it prompted the finance ministry to intervene for the first time since 2004. The initial response was encouraging, but weakness in the dollar has continued to push the yen higher (it is now trading about the ¥82/$ mark). The Japanese authorities have yet to intervene again. The recent Tankan survey indicates Japan's largest manufacturers have budgeted for an average JPY/USD rate of 89.66, so profitability in yen terms is likely to be squeezed at these levels.

Japan faces a number of headwinds, but this is to some degree reflected in the low valuations on which Japanese equities trade at relative to their international peers. Furthermore, we note that large companies continue to adapt to a strong-yen environment and engage in aggressive cost cutting. Many companies, world leaders in their own right, continue to trade close to, or at a discount to, their balance sheet value. On balance, we believe the normalisation of global economic conditions will offer opportunities in due course, but are not, for the present, recommending increased allocations.

The FTSE Japan index provided, in yen terms, a total return of -15.21% over the last six months and -6.94% over the last year. Yen strength means that, in sterling-adjusted terms, the returns are -9.51% over the last six months and +1.22% over the year.

2.5. Asia Pacific (excluding Japanese) Equities

China continues to be the key driver of growth in the region. Asian markets moved higher after the PMI Manufacturing number (purchasing managers index) suggested industrial activity continued to expand in the month of September. Based on the IMF's latest World Economic Outlook, published this month, China is still expected to be the fastest growing major economy (India is a close second), with growth projected to be c10% over the next year. Asian economies, which are typically dependent on trade, benefited in September from an unexpectedly strong surge in imports to China. August trade data revealed that imports rose by 35.2% year-on-year, compared with consensus estimates of around 27.5%.

The Southeast Asian equity markets performed well in September, with some notable performances from Thailand (up 20% over the quarter) and Indonesia (up 22% over the quarter) following resolutions of domestic political issues and an increase in fund flows to emerging market debt and equity. Prices of physical commodities continued to move higher as investors speculated that recent Japanese intervention would trigger a fresh round of 'competitive' quantitative easing by the central banks. As a result, the Australian dollar had a strong month, rising 9% against the US dollar during September, and the local equity benchmark, the S&P ASX 200, rose by c5%.

Considering the environment of rising asset prices, fuelled by fund flows and rising input costs, we expect local authorities to bring forward calls for tighter monetary policy in the region. This should support the longer-term trend of emerging market currency appreciation relative to the US dollar, euro and sterling. We think that these gains are likely to be beneficial to a UK-based investor's total returns over the long run.

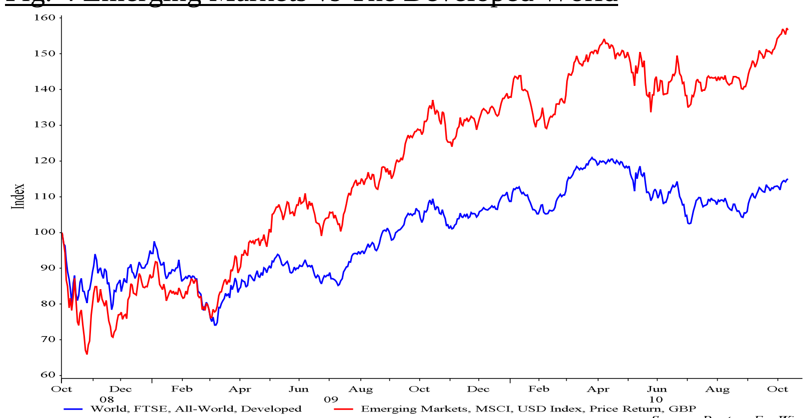
In our view, better economic fundamentals, including favourable demographics, better public sector balances and lower consumer indebtedness, mean that the equity markets of the Asia Pacific nations should be well placed to provide attractive returns when global growth recovers. On fundamental measures of value, equity valuations in the region trade just above their long-term averages, but well below their historical peaks. The MSCI indices for China, Hong Kong and Taiwan, for example, trade at an average of 14-15 times forward earnings, and on a dividend yield of just under 3%. We do not think these valuations are expensive given the considerably higher growth potential of their domestic markets, and thus, continue to recommend increased allocations to Asia Pacific, where appropriate.

The FTSE All-World Asia Pacific ex Japan index provided, in local currency terms, a total return of +6.20% over the last six months and +13.07% over the last year. When translated into sterling, the returns are +3.83% over the last six months and +20.32% over the year.

2.6. Emerging Markets Equities

From their low point in October 2008, emerging markets* rallied c130% to the end of March 2010. Concerns regarding the strength of the economic recovery arose in April of this year, as fear of a double-dip in global growth resurfaced. Emerging markets were unable to side-step these concerns, with Eastern European equities hit particularly hard following the Greek debt crisis. However, investors are now starting to focus on the relatively buoyant economic conditions in some of these countries, such as Egypt and Turkey, where the local economies are booming. In addition, a return in risk appetite, following the Fed's statement that a second round of QE is likely, boosted sentiment towards emerging markets in general.

Fig. 4 Emerging Markets vs The Developed World



As is often the case with developing markets, as one problem eases, another arises. The possibility of a trade war between the US and emerging market nations has materialised on the back of continued dollar weakness. Brazil intervened in the currency markets in order to limit the appreciation of the real, while Chinese Premier Wen Jiabao was emphatic in stating that the undervaluation of the renminbi relative to the dollar is not the cause of high US unemployment. Given this, it is likely that any appreciation of emerging market currencies will be slow and gradual.

Following the market correction during the second quarter, valuations of emerging market equities now look reasonable and, in our view, present an attractive entry point to access the strong long-term growth potential of the emerging economies. We have therefore been recommending increased allocations to the region, where appropriate.

The FTSE All-World Emerging index provided, in local currency terms, a total return of +9.20% over the last six months and +21.49% over the last year. In sterling-adjusted terms, the returns are +4.69% over the last six months and +23.31% over the year.

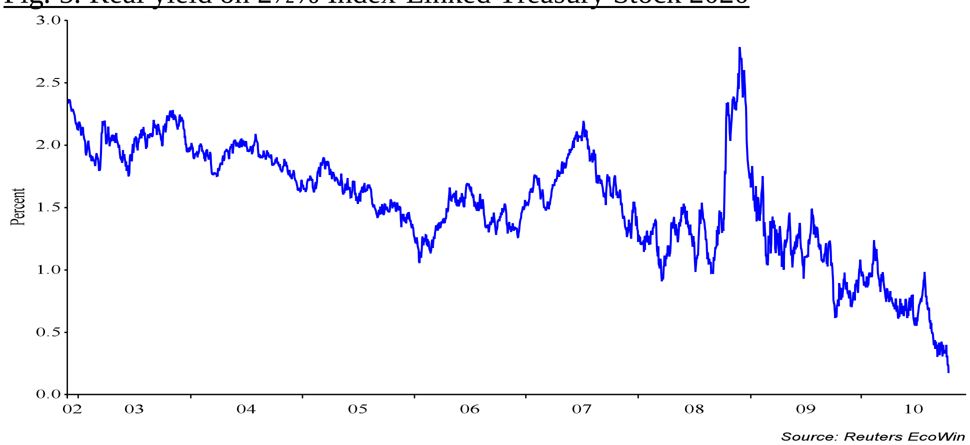
* MSCI includes 21 countries in its emerging markets index: Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey.

3. Fixed Interest

Concerns about the possibility of a double-dip recession over the summer caused nominal government bond yields to fall sharply, thereby pushing prices up. Despite a recovery in risk appetite during September, government bond yields have remained at extremely low levels on expectations of a second round of quantitative easing. This has left the benchmark 10-year gilt yielding just 2.88% at the time of writing. While we believe that the diversification value of gilts is attractive, particularly in a Japan-style deflation scenario, the insurance they offer, in our view, comes at too high a price. We therefore continue to recommend zero allocations to conventional gilts, being mindful that they could incur substantial capital losses if the economy grows more strongly than the market is expecting, or if policy errors lead to an inflation shock or a loss of confidence in sovereign credits.

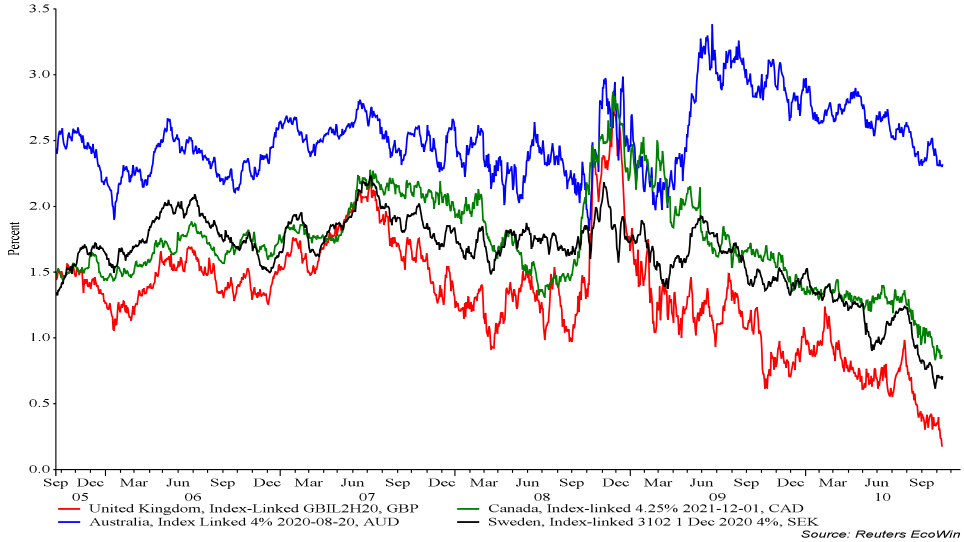
The extraordinary monetary stimulus employed to contain the effects of the financial crisis has, in our view, created a risk that inflation rises meaningfully at some point in the future. As a result, we recommend maintaining existing allocations to inflation-linked bonds. However, in our view, UK index-linked gilts (ILGs) are looking quite fully valued, trading on slim real yields. Fig. 5 shows how low the yield on the 2½% Index-Linked Treasury Stock 2020 is relative to its own history.

Fig. 5. Real yield on 2½% Index-Linked Treasury Stock 2020



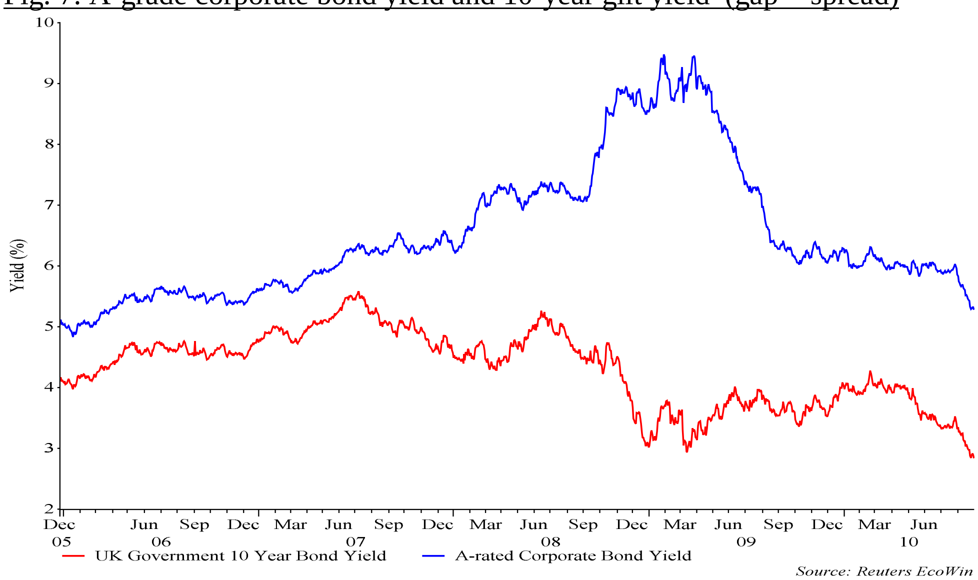
A key driver behind the low yields on ILGs is the need for pension and insurance funds to buy them, almost regardless of price, in order to match the real liabilities of inflation-linked pensions. This structural demand for index-linked bonds is largely UK-specific. As such, Canadian, Swedish and Australian inflation-linked bonds offer significantly higher real yields than their UK counterparts (Fig. 6). We therefore recommend that, where appropriate, allocations to inflation-linked bonds are weighted towards sterling hedged funds of global bonds. As well as obtaining higher real yields, managers of these may also 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 they have traded at in the past.

Fig. 6. Global index-linked government bond yields



Turning to our preferred defensive asset class, corporate bonds, we still believe that valuations are attractive despite the compression of absolute yields since early-2009. Spreads over government bonds remain wide relative to recent history (see Fig. 7). Implied default rates remain low and, in aggregate, corporates have strong cash balances due, in part, to the outsourcing of labour and component sourcing to cheaper areas overseas. According to Moody's, US non-financial companies have c$1.8trn in cash on their balance sheets, or 7% of company assets, the highest level in nearly fifty years. This healthy cash position can be observed by the recent increase in takeover activity including BHP Billiton's hostile bid for Potash Corp., HP's acquisition of 3Par, HSBC's bid for Nedbank and Intel's purchase of both McAfee and Infineon's wireless division.

Fig. 7. A-grade corporate bond yield and 10-year gilt yield (gap = spread)



While continuing to favour corporate bonds we do acknowledge that they may be vulnerable to a correction if government bond yields rise sharply, and we certainly do not expect a repeat of the substantial capital gains seen from January 2009 to the end of September 2010. We have therefore been recommending that corporate bond allocations are invested in bond funds with more strategic mandates. The managers of these funds invest where they believe the market is rewarding them appropriately for risk, while avoiding areas that look expensive. They can also hedge interest rate risk and exploit arbitrage opportunities between different bond issues to protect and add value. Such funds are also our preferred route for obtaining exposure to non-investment grade corporate debt, which is less sensitive to interest rates but carries greater default risk.

The ABI UK Pension Gilt sector provided a total return of +8.74% over the last six months and +6.91% over the last year. The ABI UK Pension Index-Linked Gilt sector provided a total return of +6.00% over the last six months and +9.63% over the last year. The ABI Pension Sterling Corporate Bond sector provided a total return of +6.63% and +13.50% over the same periods.

4. Property

The UK commercial property market has recovered from extremely oversold levels in the summer of 2009 and is now, in our opinion, broadly fair value. Property yields are, on average, close to 6.5%, which provides a reasonable spread over gilt yields to compensate investors for the illiquidity of commercial property assets, depreciation and the risk of default by tenants. However, yields vary across regions and sectors. Central London offices now produce yields as low as 4%, with investors anticipating a strong recovery in rents as the capital's economy recovers and occupiers pay up for limited space – a consequence of a dearth of construction during the credit crisis. In contrast, regional industrial assets can still be purchased on yields above 9%.

Despite attractive yields, the recovery in commercial property capital values has slowed recently. In our view, this is the result of a number of factors and is likely to persist over the coming months. Firstly, after strong gains over the last year, some investors will naturally be taking profits. Secondly, we note that there has been a fall in the number and value of purchases, particularly from institutional investors, since the start of the summer. Simultaneously, there has been an increase in sales from banks and receivers.

We believe that, in order for capital values to make significant progress from here, rents, which had been declining for two years and now appear to have bottomed, need to start rising again. This is likely to depend on the pace of the economic recovery in the UK, with rental growth historically closely correlated with GDP growth. As discussed earlier, we do not expect the UK's economic recovery to maintain the pace it achieved in the second quarter throughout the rest of 2010. Therefore, rental growth, except in areas of constrained supply, such as London offices, may still be some way off.

However, that does not mean we are pessimistic on the prospective returns from UK commercial property over the coming year. If prices remain static, an income yield greater than that offered by cash and gilts is still attractive. We also believe that, in a reasonably stable environment, skilled and well-resourced fund managers should be able to add capital value through asset enhancement, lease extensions and re-lettings.

The ABI UK Pension Direct Property index provided a total return of +3.99% over the last six months and +17.00% 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 provided a return of +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 of 2008 and early 2009. 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.

Almost one in ten hedge funds closed in 2008, according to Chicago-based research group Hedge Fund Research. Despite a partial economic and financial recovery, 240 hedge funds were liquidated in the first quarter of 2010, marking the seventh straight quarter in which closures exceeded new fund launches. A number of high profile hedge fund managers have also decided to close their funds, including Stanley Druckenmiller, who has begun the process of returning capital to investors in Duquesne Capital Management, because he was "dissatisfied" with its performance.

Hedge Fund Research reported the average hedge fund gained 1.79% in September, bringing the year to date total return to 1.86%. Investors hoping for positive, uncorrelated returns from hedge funds have clearly been disappointed and, 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. Hedge fund closures, together with an increase in consolidation means that there are now fewer funds, generally employing lower leverage, charging, on average, lower fees and offering better reporting, compliance, 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 are, as might be expected, somewhat sceptical about the validity 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 will 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 +0.28% over the last six months and +4.11% over the last year.

The above commentaries reflect our views as at 14 October 2010. 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 March 2010 to 30 September 2010 and the twelve month period from 30 September 2009 to 30 September 2010 (source: Lipper Hindsight).