

Market Commentary

September 2009

**Saunderson House Limited
1 Long Lane
London EC1A 9HF**

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

Authorised and Regulated by the Financial Services Authority

SAUNDERSON HOUSE



Contents	Page
1. Economic and Investment Outlook	3
2. Equities	6
2.1. UK Equities	6
2.2. European (excluding UK) Equities	7
2.3. North American Equities	8
2.4. Japanese Equities	9
2.5. Asia Pacific (excluding Japanese) Equities	10
2.6. Emerging Markets Equities	11
3. Fixed Interest	12
4. Property	13
5. Cash	13
6. Note on Hedge Funds	14

Risk Warnings

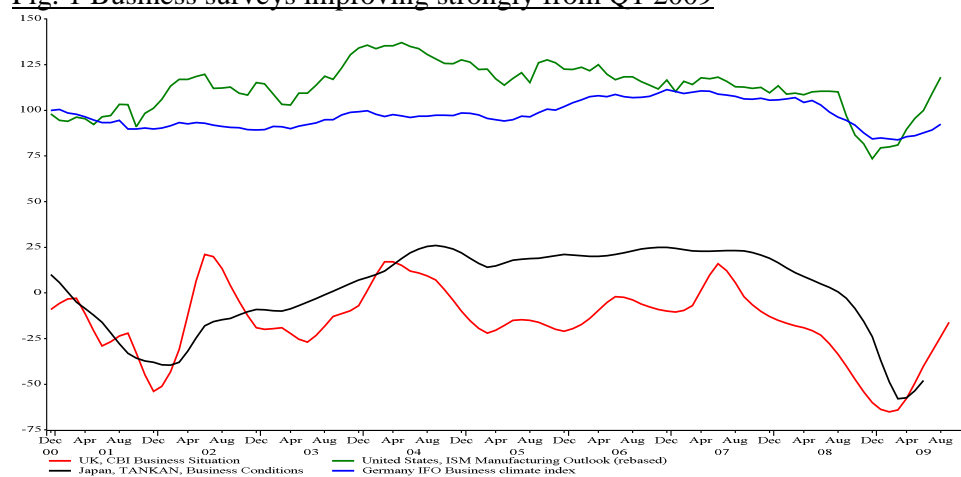
This report is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 17 September 2009. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments 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

Recently released economic data, together with forward-looking surveys of business and consumer sentiment, are indicating a more robust global recovery than most observers dared hope for only a few months ago. Concerns that the world economy might suffer a multi-year depression, reminiscent of the 1930s, or would remain mired in recession for a prolonged period have eased, and the discussion among policymakers and economists is now centred on the shape and durability of the recovery. In illustration of the degree of change in expectations, the Paris-based research body, the Organisation of Economic Co-operation and Development, earlier this month upgraded its forecast for output from the G7 in 2009 to -3.7%, only three months after downgrading to -4.1%.

Recognition for the rapid improvement in the economic outlook, as exemplified by the turnaround in business surveys (see Fig. 1), is, in large part, attributable to the speedy and aggressive response to the credit crisis from both monetary authorities and governments. Ignoring warnings about the cost or inflationary consequences of their actions, central banks have moved decisively to take official interest rates down to the lowest levels ever recorded, while governments have launched fiscal packages to support demand in their economies. A plethora of other policy measures have been undertaken to ease credit market conditions, support mortgage holders and extend loans to key businesses such as the car manufacturers. As a result, financial markets have stabilised, consumer sentiment has recovered somewhat, and businesses have begun to rebuild inventories.

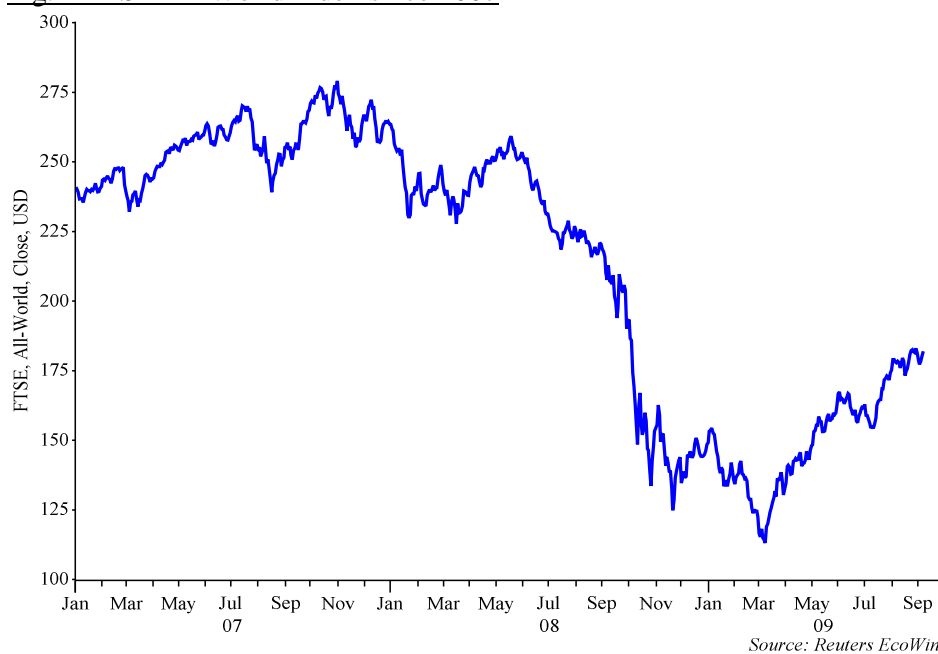
Fig. 1 Business surveys improving strongly from Q1 2009



Looking forward to 2010, we believe the key debates will centre on the extent to which recovery becomes self-sustaining and the degree to which policy support can be withdrawn without a relapse in growth.

As would be expected, the improved economic outlook has resulted in a rapid bounce in equity markets from the depressed levels of March (see Fig. 2). The move up in share prices has been supported by company results statements which have, in the main, met or exceeded analysts' forecasts over the past few months. The drivers of better corporate earnings include the inventory rebuild mentioned above, as well as benefits on costs, as companies have reaped the rewards of the aggressive overhead reductions made in late 2008 and earlier this year. Cost pressures have also been alleviated by reduced raw materials prices, compared to last year.

Fig. 2 FTSE All World Index since 2007



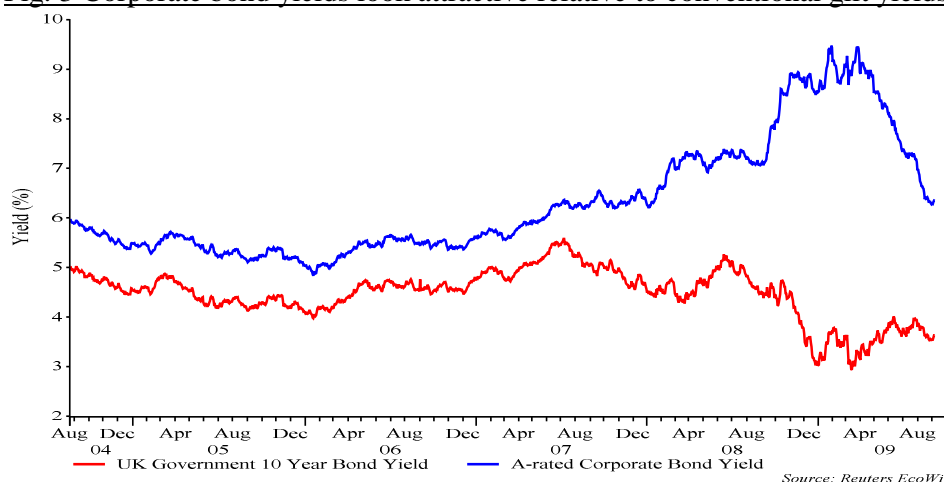
Our view is that the path of economic growth and therefore corporate profits and dividends will be the key determinant of equity market returns from here. Considering valuation, the extreme weakness in equity markets in late 2008 and the early part of this year saw dividend yields in most major equity markets move above their respective government bond yields. This was a clear indication of investors' extremely bearish expectations for both the sustainability of existing dividends and future dividend growth. The rally over the past six months has brought equity yields down once more but, unless earnings and dividends are never to grow again, they remain attractively valued relative to both government bonds and cash deposits.

The MSCI World Equity Market index has provided a total return of +28.75% in sterling terms over the last six months and -6.71% over the last year.

Turning to other key asset classes, government bonds, which had been the asset class of choice for investors in the final quarter of 2008, have struggled to make further progress. In essence, the downward pressure on sovereign bond prices resulting from the impending high levels of issuance, have largely been balanced by government policies designed to expand their money supplies via direct purchases of government bonds. The relative attractions of government bonds, when compared to cash on deposit earning exceptionally low interest rates, is also supportive of government bonds, despite the low absolute level of yields.

In stark contrast to government bonds, corporate bond yields were driven to exceptionally high levels in late 2008 both by concerns about falling corporate earnings and forced selling by leveraged investors. The increase in the yield premium on corporate bonds versus government bonds was even more pronounced than the rise in the absolute level of corporate credit yields (see Fig. 3). This situation began to correct in the first quarter of 2009 in response to the policy initiatives discussed above, since when corporate bond prices have recovered rapidly. However, in our view, corporate bonds still present opportunities for investors given the attractive yield available in comparison to both government bonds and cash on deposit.

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



Considering commercial property, the five-year property bull market came to an end in mid-2007 when prices eventually began to weaken under the pressure of credit market dislocation. Property values have continued to fall as tighter credit market conditions have removed an important source of funding for commercial property deals, and the deteriorating economy has undermined tenant demand. Commercial property remains highly sensitive to economic growth and rents may have further to fall, however, yields are now more appealing and we are beginning to seek out opportunities in the asset class.

The following sections consider our monitored asset classes, including hedge funds and cash, in more detail.

2. Equities

2.1. UK Equities

The recession in the UK is showing signs of levelling out, with GDP in the second quarter declining 0.7% compared to an average drop of 2% in each of the two previous quarters. An improvement can be seen in the housing market, where prices appear to have bottomed, and business confidence, with the Institute of Chartered Accountants in England and Wales Business Confidence Monitor turning positive in Q2 for the first time in two years, suggesting a return to economic growth in Q3. A key driver behind the stabilisation of the economy has been the adoption of ultra loose monetary policy by the Bank of England. In March, the Bank rate was cut to an all time low of 0.50% and a £125bn quantitative easing package was introduced. This was extended by a further £50bn in August.

Despite the aggressive policy responses, the upturn in the UK may not prove as robust as in other developed economies. Regardless of who wins next year's general election, the new government will have to address the country's budget deficit through a combination of tax increases and spending cuts. Households are unlikely to be able to drive economic growth, with their over-extended balance sheets requiring further saving and less spending. Also, the financial services sector, which in the previous economic cycle was a major contributor to growth (contributing £500bn to the economy in 2007, according to the British Bankers' Association), looks likely to be hamstrung by increased regulation to ensure there is no repeat of the financial crisis.

While the UK's economic recovery may not be the strongest in the developed world, UK equities still have attractions. On valuation grounds, UK-listed shares are not expensive compared to many international markets. Valuation is a key determinant of investment returns, while a weak economic outlook does not necessarily result in poor equity market returns. Also, it is worth noting that, in aggregate, major UK-listed companies generate a substantial proportion of their revenues from overseas (c60% according to HSBC). This suggests that internationally focused UK companies may be able to grow their profits at a faster rate than the domestic economy. On that basis, we recommend that current weightings to UK equities are maintained, where appropriate.

The FTSE All-Share index has provided a total return of +33.82% over the last six months and -8.20% over the last year.

2.2. European (excluding UK) Equities

Eurozone GDP was 0.1% lower in the second quarter of 2009 following a 2.5% fall in the first quarter, with the improvement aided by both France and Germany unexpectedly returning to growth. The 16-country region continues to experience deflation, with consumer prices down 0.2% year-on-year in August. The European Central Bank (ECB) has been less willing than its Anglo-Saxon counterparts to reduce interest rates and its official rate now stands at 1.00% – higher than base rates in the UK, US and Japan. Although this has prompted criticism that the ECB is not being sufficiently aggressive, the central bank's injection of €442bn of one-year funds into the eurozone banking system in June, at an interest rate of just 1.00%, shows that it is taking supportive action. European banks now have access to effectively unlimited low cost liquidity until the summer of 2010 at least. As a consequence, the ECB's balance sheet is now bigger as a proportion of eurozone GDP than that of the Federal Reserve relative to US GDP.

Unemployment in the eurozone, which rose to 9.5% in July, has not prompted aggressive fiscal policy responses from European governments. Due to their more generous welfare systems, headline-grabbing policies to support the jobs market, similar to those in the US, have been judged less crucial. These social safety nets, plus lower consumer indebtedness, should mean that European consumers can cope with higher levels of unemployment and continue to spend. However, domestic consumer spending is a less important driver of GDP in Europe than it is in the US and the UK. Continental Europe is instead more reliant on exports and it is here that the strength of the euro in 2008 and the sharp fall in world trade have been particularly painful. The euro has now weakened somewhat and economic data are indicating a degree of recovery. However, this is likely to be fragile and it should take some time before export-orientated European companies see any significant growth in demand. Having advised a significant reduction in weightings to European equities at the end of 2007, we recommend that remaining allocations are retained where appropriate.

The FTSE Europe (ex UK) index provided, in euro terms, a total return of +44.88% over the last six months and -13.61% over the last year. In sterling-adjusted terms, the returns are +43.16% over the last six months and -5.76% over the year.

2.3. North American Equities

The response of the US authorities to the credit crisis and subsequent economic downturn has been impressive. Under the chairmanship of Ben Bernanke, an expert on depression-era economics, the Federal Reserve (the Fed) has reduced interest rates very rapidly. From 5.25% in September 2007, policy rates are now effectively zero, although official policy statements declare that the target for interest rates is “between zero and 0.25%”.

Interest rate reductions have been accompanied by a policy akin to the quantitative easing undertaken in the UK. However, rather than buying government issued bonds, the US authorities are buying up to \$1,450bn of mortgage backed securities from the two government sponsored housing enterprises, Freddie Mac and Fannie Mae. The aims are similar to the UK’s quantitative easing; to force additional liquidity into the economy and drive market interest rates down towards the official interest rates. These monetary measures have been accompanied by a Keynesian-style \$700bn fiscal stimulus package, the Troubled Asset Relief Program (TARP).

These measures appear to be having their desired effect with economic output in the second quarter contracting by a less-than-projected 1.0% p.a., a marked improvement on the 6.4% p.a. contraction in the first quarter. Stabilising consumer demand is prompting companies to rebuild inventories, triggering growth in production and orders.

Consumer demand, however, remains fragile. Though improving employment prospects should encourage personal expenditure, a return to the credit-fuelled consumption patterns of previous years is doubtful. Consumer credit continues to contract as the household sector deleverages, and the need for US consumers to rebuild their savings is likely to create a meaningful headwind for demand.

Turning to the stock market, six months ago, US equities had fallen to levels that could be considered inexpensive relative to historical valuations. However, the recent rally has taken them back, in our view, to broadly fair value. We therefore 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 +40.52% over the last six months and -18.85% over the last year. The fluctuating value of the dollar means that, when translated into sterling, the returns are +22.89% over the last six months and -8.52% over the year.

2.4. Japanese Equities

With GDP having contracted at an annualised rate of 14.2% in the first quarter of 2009, the recession in Japan was the most severe in the post-war period. It was also sharper and deeper than those seen in the other major developed economies. Though acute, the contraction proved relatively short-lived as the economy returned to growth in the second quarter of the year. Measures of consumer confidence, industrial production and international trade, among others, have turned upwards, prompting the Bank of Japan (BoJ) to suggest that the worst of the economic downturn has now passed.

Despite the economic revival, the Democratic Party of Japan (DPJ), elected in an historic landslide victory on 30 August, faces significant challenges. Expectations of deflation appear imbedded and therefore, to a degree, self-fulfilling. Furthermore, with little scope to effect further monetary or fiscal stimuli, the DPJ is likely to resort to cutting infrastructure expenditure to fund attempts to stimulate demand in a population that has, with good reason, developed a profoundly cautious attitude.

At the corporate level, the outlook is perhaps more positive. As a major exporter of manufactured goods, the Japanese corporate sector proved highly sensitive to the weakness of the global economy. However, aggressive cost cutting measures have been taken and, together with lower raw materials input costs, Japanese companies should now be in a relatively strong position to benefit from recovering global demand. In addition, balance sheets that were strengthened in response to Japan's own banking crisis in the early 1990s are increasingly being put to use to acquire rival companies, both domestically and overseas.

Despite having appeared attractively valued versus both their own history and their international counterparts for some time, Japanese equities remain deeply out of favour with international investors. The economic outlook is highly uncertain and consequently we believe it is too early to increase recommended allocations. However, current allocations should be maintained, where appropriate.

Though the yen has fallen 8.41% against sterling in the six months to 31 August, it has, in aggregate, appreciated by 23.62% over the past twelve months. This has had a significant bearing on investment returns for sterling based investors. The FTSE Japan index provided, in yen terms, a total return of +29.34% over the last six months and -22.83% over the last year. The currency fluctuations mean that, when translated into sterling, the returns are +19.31% over the last six months and +1.03% over the year.

2.5. Asia Pacific (excluding Japanese) Equities

Believers in the theory that the economies and equity markets of the Asia Pacific region had decoupled from their western counterparts suffered a very uncomfortable 2008. Increased intra-regional trade and proximity to Chinese growth offered little protection to the export-led economies of the Asia Pacific region 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, were revised down sharply.

Economic indicators began to show signs of improvement in the second quarter of this year and, together with announcements of fiscal stimulus packages in several Asia Pacific countries, have prompted investors to focus once more on the region's growth potential. Investors have also taken note of the region's relatively low levels of government, corporate and consumer debt. Consequently, Asian equity markets have begun to outperform once more (see Fig. 4).

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



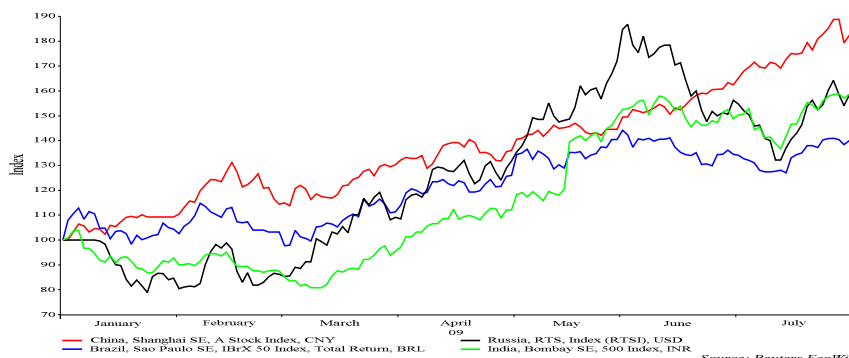
The potential for growth in the Asia Pacific economies appears significant. However, we believe this is largely reflected in equity market valuations which, on a price-to-book basis, are close to the long term average. Further gains must therefore reflect corporate profits growth. While cost cutting has helped support profitability to a degree, there is little visibility in earnings potential and we therefore believe 'average' valuations are not sufficiently attractive at present to merit an increase in allocations to Asia Pacific equities.

The FTSE All-World Asia Pacific ex Japan index provided, in local currency terms, a total return of +53.34% over the last six months and +1.41% over the last year. In sterling-adjusted terms, the returns are +50.89% over the last six months and +7.86% over the year.

2.6. Emerging Markets Equities

After the steep losses recorded in 2008, emerging equity markets* have thus far enjoyed a strong 2009 (see Fig. 5). Performance has been closely tied to the perceived health, or otherwise, of the developed economies. Though many emerging economies (with the notable exclusion of those in Eastern Europe) were largely free of the debt issues that plagued their western counterparts, investors sold emerging market equities aggressively. Investors judged, correctly, that the prospect of a protracted decline in western consumption would undermine, at least temporarily, the export driven growth models of the emerging economies. The recent improvement in economic data has, however, encouraged a renewed optimism to which emerging markets equities have responded strongly.

Fig. 5 The 'BRIC' equity markets since the start of 2009 (rebased)



Developments in China merit special attention. Fuelled by continuing robust economic data and hopes for the various policy measures, Chinese equities had, prior to August, risen very strongly in spite of concerns that the government's stimulus package would provoke indiscriminate and ultimately unprofitable loan growth. However, news that the government might move to dampen credit creation led to a sharp sell-off in August and, consequently, our concerns over valuations have, at least in part, been addressed.

Though we believe the long-term outlook is positive, emerging equity markets appear susceptible should the global recovery disappoint. We therefore do not recommend adding to allocations for the present.

The FTSE All-World Emerging index provided, in local currency terms, a total return of +74.41% over the last six months and -8.76% over the last year. In sterling-adjusted terms, the returns are +52.53% over the last six months and +2.11% over the year.

* MSCI includes 22 countries in its emerging markets index: 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 UK Debt Management Office, on behalf of the HM Treasury, is set to issue £241bn of UK debt securities in the current fiscal year. This is almost three times the £86bn sold in 2007/8. Simultaneously, the Bank of England has, via the Asset Purchase Facility, purchased £145bn of gilts from non-public holders as part of its £175bn remit. In the US, debt issuance will be approximately \$2tn, though American repurchases are being focused on the debt of the mortgage agencies as well as US treasury bonds. While the aims of these seemingly conflicting policies are clear: to fund the government's borrowing requirements and force additional liquidity into the financial system, the twin operations are almost certain to result in a period of price distortion. In the UK, the 10-year conventional gilt yielded 3.54% at the end of August. This yield, in our view is insufficient given the medium term threat of higher inflation and the fact that repurchases, which support prices, will end long before issuance levels fall back to pre-crisis levels.

In contrast to conventional government bonds, index-linked gilts remain an asset class we currently favour. While investor interest in these has waned over the last year, due to concerns over the possibility of a long period of deflation, our view is that inflation risks are likely to rise in the medium term. The current economic weakness makes near term price rises unlikely, however, in our view, the monetary policies being employed by the BoE may result in significantly higher inflation over the next decade. We believe that the 10-year inflation rate implied by the gilt market of just 2.49% p.a. at the end of August underestimates this.

We are also favouring funds of corporate bonds at present. Since late January, when we recommended increasing allocations to investment grade bonds, this sector has rallied strongly. With all but the most distressed bonds trading close to their par value, we expect that returns will now come increasingly from income rather than capital appreciation. Mindful that official interest rates must rise in the medium term, we have latterly been recommending that new money goes into strategic bond funds, whose managers can hedge out interest rate risk and allocate assets to wherever they see value within the asset class.

The ABI UK Pension Gilt sector provided a total return of +4.50% over the last six months and +10.28% over the last year. The ABI Sterling Corporate Bond sector provided a total return of +18.78% and +1.81% over the same periods. The ABI UK Pension Index-Linked Gilt sector provided a total return of +8.37% over the last six months and -1.28% over the last year.

4. Property

UK commercial property prices have fallen 44% from their July 2007 peak, according to data from Investment Property Databank (IPD). Commercial property had been a key beneficiary of the easy credit environment that existed prior to the financial crisis, with property deals often heavily reliant on high levels of cheap debt financing. Such deals disappeared at the onset of the credit crisis, removing an important source of demand for commercial property assets. The deteriorating economic outlook has further undermined property prices by putting downward pressure on rents.

The extent to which commercial property prices have fallen over the past two years, and the fact that these declines have begun to moderate, has started to raise the level of investor interest in the asset class once more. Yields of c7.9% (data from IPD) appear attractive relative to other assets, though allowances must be made for ongoing downward pressure on rental values and occupancy rates, as a result of the general economic weakness and additional supply from developments now approaching completion. Another factor complicating the commercial property picture is the c£230bn of outstanding loans backing UK commercial properties held by banks. Much of this will need to be either refinanced or repaid over the next five years. So far, banks have generally been willing to extend or refinance loans in return for higher coupons and undertakings by borrowers to inject more capital into deal structures. However, there remains the risk that lenders will be less flexible in future and force the sale of properties, thereby increasing supply and depressing prices further. Given this risk, our view is that further due diligence is necessary before we can confidently recommend increasing property allocations. In the meantime, we advise retaining current allocations to UK property.

The ABI UK Pension Direct Property index provided a total return of -3.60% over the last six months and -20.47% over the last year.

5. Cash

Sterling deposits and monies held in AAA-rated liquidity funds can presently earn returns broadly in line with the BoE Bank Rate of 0.50% p.a. Despite lower rates, cash still has its attractions and we continue to favour an overweight position in the asset class, particularly where attractive 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 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 +0.26% over the last six months and +1.74% 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.

According to Hedge Fund Research, the returns from a composite index of hedge funds returned -19% in 2008, the biggest annual decline since the company began tracking data in 1990. Investor expectations of positive, uncorrelated returns from hedge funds have clearly been disappointed. Despite a partial recovery over 2009 to date, the industry's ability to justify high charges and performance fees remains, in our view, open to question.

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 intensified in the fourth quarter of 2008 as hedge fund investors continued to file significant redemption requests.

We expect the hedge fund 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 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 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 +7.70% over the last six months and -13.03% over the last year.

The above commentaries reflect our views as at 17 September 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 28 February 2009 to 31 August 2009 and the twelve month period from 31 August 2008 to 31 August 2009 (source: Lipper Hindsight).