

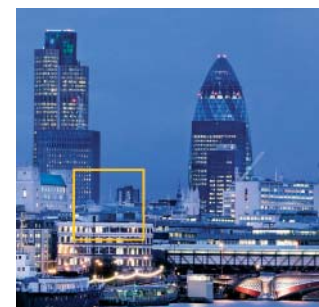
It is clear that equity markets face a wide range of challenges in the coming months. Global economic growth is slowing, inflation is rising driven primarily by rising commodity and food prices, and property prices continue to fall. Lead indicators of economic growth are declining in most areas of the G7, giving rise to concerns of a more synchronised global economic slowdown. The credit crisis that started almost 12 months ago is now beginning to have a significant impact on the real economy, where debt

is becoming increasingly expensive and hard to obtain. Company profit forecasts are beginning to decline, particularly in financials and consumer orientated stocks. In the more distressed sectors, such as banking and house building, companies are being forced to raise new capital from the equity market to repair balance sheets. This combination of factors has already produced a sharp reaction from the UK equity market which has fallen over 15% from its 2007 peak.

There are many uncertainties facing investors at the current time. For example it is difficult to predict the extent to which slowing economic growth will reduce commodity prices and hence inflation, or the full extent of property price falls in the US and UK, or the ultimate peak in unemployment in this cycle. The equity market is, however, a good discounting mechanism and many of the headwinds facing investors are well known. A simple word count for "Recession" in newspaper articles in the UK has risen sharply near to levels last seen in 1990 or 2001. Many commentators have focussed on the whether the current situation most closely resembles previous periods of weakness such as the early 1990s or the 1970s. Although there are some similarities with the situation that prevailed during these periods there are also important differences such as the relatively low levels of interest rates and inflation today. Central banks are limited in the extent to which monetary policy can be used to stimulate the economy, but a sharp increase in interest rates remains highly unlikely given the deteriorating outlook for growth. In short, a recession in both the US and the UK remains a real possibility, but is by no means a certain outcome.

In this environment forecasting company profits is extremely difficult, particularly when in aggregate companies have in the last few years achieved record margins and returns on equity. Forecasts from the consensus of sell side analysts remain unrealistic, particularly for 2009 where many companies are still expected to increase margins further despite rises in input costs and a weaker outlook for sales growth. As a result the apparent low price earnings multiples for many of these stocks have offered no protection. However, equity markets are beginning to offer substantial value even if a poor economic outcome is assumed. If we assume company profits return back to their trend growth level, the market still trades at a discount to its long run average. The prospective dividend yield of the market, at 4.4%, compares favourably to the 10 year UK government bond yield of 5.1% particularly given the potential for real dividend growth in the medium term. Other measures such as price to book or price to sales are also approaching the valuation lows of 2003. Whilst we have limited confidence in consensus analysts forecasts, using these numbers would imply that the UK equity market trades on a 1 year forward price earnings multiple of 9.9.

The portfolio is currently fairly defensively positioned, and this has benefited relative performance against the benchmark. We have for some time now favoured larger quality growth companies with strong balance sheets, where we have confidence that the businesses can withstand a deteriorating economic backdrop. However the speed and extent of the correction in certain sectors is producing some interesting opportunities and there are signs of excessive pessimism. Timing the purchase of these stocks in such an environment is difficult particularly when profits are being downgraded, newsflow is poor, and the stocks continue to react poorly to this newsflow. Stocks have a tendency to overreact in this environment and at the current time it is difficult to predict when this difficult period will begin to improve. As a result we will begin to reposition the portfolio for recovery cautiously, with close attention to the fundamental attractions of the individual companies.



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