

Summary

- **Prospect's UK equity portfolio outperforms FTSE 100 by 2.0% in Q3.**
- **Economic growth in the major regions should be close to trend in 2007 - positive for equities.**
- **First signs of a slowdown in corporate cash-flow are visible. Too early though to take profits on equities.**
- **UK government bonds offer real yields of 2.3%, higher than the long term average and fair value.**

Review of 3rd Quarter

Following the sharp equity market correction in May and June, global equities rallied during the third quarter. Evidence of a slowdown in US economic growth raised hopes that US interest rates had peaked in the current cycle. This was also good news for bond markets, which performed well as slower growth in the global economy lowered expectations for longer term inflation. By contrast, commodities had a sharp correction, as would be expected in this environment, and lived up to their reputation for moving in the opposite direction to equities.

UK equities underperformed the global markets, partly due to the heavy weighting of energy and mining in the FTSE 100 index, but also because the Bank of England surprised investors with a 0.25% rise in base rates in August.

Japanese equities produced the lowest return, exacerbated by a 4% fall in the yen against sterling. European equities,

by contrast, benefited from continued strong company earnings reports and produced the highest returns of all the asset classes over the quarter.

Interest Rates and Currencies

A sharp slowdown in the US housing market caused the Federal Reserve Board to bring to an end the regular interest rate rises that had been in place since June 2004. The Bank of England raised UK interest rates as it became apparent that growth in the UK was stronger than expected. Consumer spending accelerated as wages rose faster than inflation and house prices also started to rise again. Although the rate rise knocked consumer confidence temporarily, retail sales remain strong and a further rate rise is already anticipated in November.

Higher UK interest rates, together with upgrades to expected economic growth in the current year, helped the pound to appreciate against all the major currencies. Against the US dollar the pound rose by 1% and rose by 2% relative to the euro.

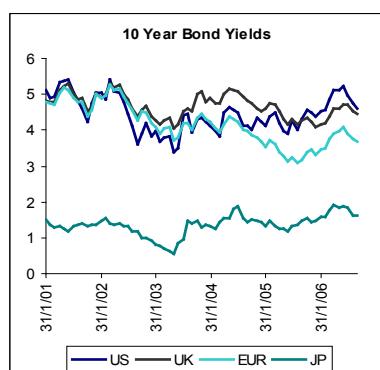
**A further UK rate
rise is anticipated in
November**

October 2006

Bonds

At the start of last quarter we commented that real bond yields in the UK were attractive, being in line with their long term average yield. Events have vindicated our optimism. The rise in short term interest rates, the fall in commodity prices and stronger sterling all contributed to lower inflation expectations for 2007. The result has been a fall in 10 year government bond yields from 4.7% to 4.5% over the quarter, producing a total return of 2.6%. Bond returns in other countries were even higher, as economic growth elsewhere has been downgraded, in contrast to the upgrading in UK growth.

UK corporate bonds performed much in line with government bonds over the quarter. The higher yields on corporates were offset by a marginal deterioration in credit quality in response to early evidence that the growth in corporate cash flow is slowing. The **Prospect bond model portfolio** produced a return



of 2.1% compared to the benchmark return of 2.7%, reflecting the significantly lower risk profile of our portfolio.

Equities

Equities have benefited for the past two and a half years from rapid company earnings growth that has, with the exception of the US, helped valuations to move from being expensive to close to fair value. The last quarter saw this trend continue, with robust

earnings growth being reported in all markets, leading to generalised gains in equities. Within each market, sector performance has reflected expectations of an economic slowdown, with the commodity related stocks performing poorly and the more defensive areas doing well.

The **Prospect UK equity model portfolio** has out-performed the FTSE 100 by 2.0% over the quarter, having been underweight in mining and energy, which were the worst performing sectors of the market. Holdings in defensive sectors such as food producers (**Dairy Crest**), pharmaceuticals (**Astra Zeneca**) and fixed line telecoms (**BT**) all performed particularly well over this period. We also took advantage of weakness in the technology sector to add a holding of **Sage**, which has out-performed the market by 8% since purchase.

International equity markets performed modestly better than UK equities, after taking account of currency weakness. The best performing markets were Europe and the Pacific Basin, both of which were overweighted in our asset allocation.

Alternative Investments

UK commercial property continued to perform well this quarter, despite rental yields being at their historic lows.

Commodities did poorly this quarter and over the past year, making investors question whether the long term bull run for commodities has hit a brick wall. The weakness was in response to slowing global economic growth, high oil inventories and the prospect of lower inflation. Our exposure to commodities has been through an actively managed fund, which has successfully limited the losses over the quarter to 3.9%, compared to a fall in the DJAIG commodity index of 7.7%.

Total Returns in Local Currency and in Sterling Terms

3 months and 12 months to 30th September 2006

	30th Sept	Total Return Local		Total Return Sterling	
		3 mths to 30 th Sept %	12 mths to 30 th Sept %	3 mths to 30 th Sept %	12 mths to 30 th Sept %
Currencies v £	Rate				
US dollar	1.87	-1.0	-5.3		
Euro	1.48	-1.9	-0.5		
Yen	221	-4.2	-9.2		
Cash (3m)	Yield %				
USA	5.31	1.4	4.0	0.4	-1.5
UK	5.00	1.2	4.6	1.2	4.6
Euro	3.39	0.8	3.39	-1.2	1.6
Japan	0.37	0.1	0.0	-4.1	-9.2
Bonds (10yr)	Yield %				
USA	4.65	5.2	1.9	4.2	-3.5
UK	4.52	2.6	2.5	2.6	2.5
Germany	3.71	3.9	-1.4	2.0	-1.9
Japan	1.68	2.8	0.0	-4.1	-9.2
Equities	Index				
USA	S&P Comp	5.6	10.4	4.6	4.6
UK	FTSE 100	3.1	12.5	3.1	12.5
Germany	DAX	6.2	21.2	4.2	20.6
France	CAC	6.5	16.9	4.5	16.3
Spain	SMSI	13.1	23.1	10.9	22.5
Italy	BCI Gen	6.4	13.5	4.3	13.0
Japan	Topix	1.8	15.1	-2.5	4.5
Australia	All Ord	2.5	15.0	1.9	6.4
Hong Kong	Hang Seng	8.6	16.7	7.2	10.1
Alternatives	Index				
Commercial Property	IPD	4.5	19.0	4.5	19.0
Commodities	DJ AIG	-7.7	-10.3	-8.6	-15.0
Hedge Funds	HFR	0.5	5.6	-0.9	-0.9

Source: Reuters

Macroeconomic Overview – 30th September 2006

US	UK	Eurozone	Asia
GDP Growth			
US housing starts down 6% MOM and 20% YOY in August but new home sales rebounded on lower mortgage rates. Durable goods orders fell 2% in August as manufacturers fear slowing consumer demand. But with stable or lower interest rates, economy should rebound in first half of 2007.	Mortgage approvals at 5 month high. Retail sales in September were at 21 month high. Consumer spending driving growth. Services and Gov't spending in Q2 were downward revised. Overall GDP grew 0.7% compared to Q1, improving to long run trend.	Eurozone business confidence at 5 yr high, including good scores for industrial, retail and construction sectors. Improving domestic spending and investment are compensating for cooling export demand.	In Japan, industrial production up 1.9% YOY but dept store sales have been falling for past 5 months. In Q2, China grew 11.3% and India 8.9% YOY.
Employment			
Unit labour costs rising. Unemployment rate 4.7%, still trending downward.	Record high employment and rising incomes explain strong consumer spending.	Positive development: labour costs growth moderating (eg VWV) even as unemployment is falling. But German railway workers striking over job security.	Japan jobless rate at an 8 year low. August job to applicants ratio at 1.08, just off peak of 1.09 in July. Wages set to rise.
Inflation			
CPI eased to 3.8% in August from 4.1% in July. Fed says 'inflation likely to moderate over time' (as housing market cools the economy and oil price falls) but 'some inflation pressures remain' (high capacity utilization, risk of new spike in oil). Fed left rate at 5.25%, first cut expected March 2007.	August CPI was 2.5% YOY, a 9 yr high. Money supply growth is 13.7% YOY in August. Stronger consumer spending and improving housing market make a November rate rise likely, despite weakening global growth.	Inflation is moderating, now at 2.3% YOY, well above 2% target. Improved business confidence could be grounds for a further ECB rate rise in October.	7 years of deflation in Japan now over. Japan now has negative real interest rates. Indian inflation at 4.6% with target of 4%; India is likely to raise interest rates for 4th time this year.
Fiscal Policy			
US Congress failed to restructure taxes. Still have not implemented abolition of inheritance tax. They did reduce dividend and capital gains tax to 15%.	Budget deficit in June widened to a record £7.3 bn for that month (£6.6 bn expected), 3.6% of GDP. UK has been warned by IMF to cut deficit. Tax increases are likely.	Budget deficit overall for Eurozone is less than limit of -3%. Germany (-3.3%), and Italy (-4.1%) and Portugal (-6%) are worst, and Spain, with a budget surplus of 1.1% of GDP is best.	New Japanese Premier Shinzo Abe intends to improve gov't efficiency, cut gov't debt (now 170% of GDP), but what will he do to stimulate growth? Indian government increasing infrastructure spending by 25%.
Balance of Payments			
US current account deficit widened to 6.7% of GDP in Q2. Bush and Paulsen have convinced 2 Senators to drop bill for 27% tariffs on Chinese imports.	UK current account deficit has narrowed. Exports still weak, -0.3% of Q2 GDP, but improving.	As consumer spending picks up while exports wane, the Eurozone has a slight current account deficit in July. Also net outflows of direct investment.	Yuan has risen 5% against USD in past 15 months. China will let yuan appreciate further in return for US dropping trade sanctions.

Economic Forecasts as at 30th September 2006

	Real GDP growth		Unemployment rate		Inflation (CPI)		Budget % GDP	Central Bank rate		Current A/c % GDP
	2006 %	2007 %	2006 %	2007 %	2006 %	2007 %	Latest %	Nominal %	Real %	2007 %
US	3.4	2.5	4.9	4.7	3.5	2.6	-3.6	5.25	1.75	-6.7
UK	2.6	2.5	4.7	5.5	2.2	2.2	-3.4	4.75	2.55	-2.7
Eurozone	2.3	1.8	8.6	7.8	2.2	2.0	-2.3	3.00	0.80	-0.4
Japan	2.8	2.3	3.5	4.2	0.4	0.8	-5.2	0.25	-0.15	3.6
Asia	6.8	6.0			3.6	3.2				

Source: Lehman Bros, The Economist and Bloomberg

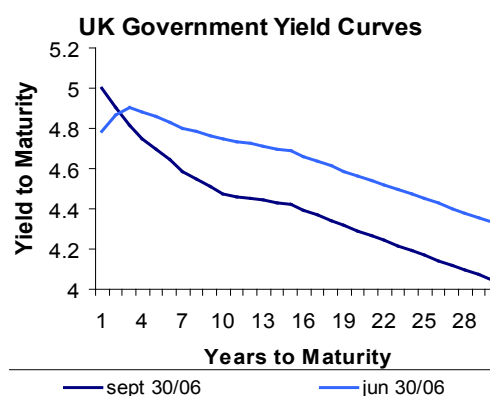
Market Outlook

Interest Rates & Currencies

The pound has been supported by the expectation of another interest rate rise and the prospect of more predictable growth in 2007 than in the US, Europe or Japan. The dollar is still labouring under the pressure of a huge current account deficit and is expected to depreciate against sterling over the next six months. However, a slight slowdown in the US would likely reduce the trade imbalances and this may allow the dollar to maintain its recent stability relative to the euro.

UK Bonds

The Bank of England rate rise in August was not expected by the market and consequently lowered inflation expectations. The chart shows how short term interest rates have risen over the quarter whilst longer term bond yields have fallen.



This represents a tightening of monetary policy and is consistent with a fall in monetary reserves, both of which point to lower inflation over the coming year. Real 10 year bond yields are now at 2.3%, slightly above the long term average and therefore fair value. With a benign inflation background, this means that government bonds remain attractive.

The prospect of higher short term interest rates and slower company earnings growth is not benign for corporate bonds, however. The yield advantage that corporate bonds enjoy relative to government bonds is currently at the low end of its range and we will be particularly watchful for any deterioration in credit quality that could lead to a rise in corporate bond yields (and a fall in prices).

Global Equities

After three years of positive returns from equities and a recent set-back in prices, it may be tempting to call the end of this bull market. However, the signs are that we are entering a mid-cycle slow-down rather than the prelude to a more serious set-back. Expectations for growth next year in all the major economies are close to the long run trend of 2.5%. This is the ideal rate of growth for equity markets, implying stable interest rates and sufficient demand for corporate profits to grow healthily. With energy and metals supply and demand having moved back into balance, commodity prices should trend lower, which will also help company profits.

The rate of growth in company earnings should slow after the rapid expansion of the last two years and there is evidence in the US and the UK that this is already happening. Future gains in share prices are therefore unlikely to match those of the last couple of years, but equities still appear the most attractive

asset class for the next 6 to 12 months. Valuations, with the exception of the US, are a little expensive (see the chart for the UK on the following page) but not sufficiently so to warrant underweighting equities at this stage.

In the **US**, the recent slowdown in house sales may point to future weakness in consumer demand. However, the latest data show signs that the housing market may be stabilising and if interest rates remain at current levels, the stock market should take heart from current consensus forecasts of 15% growth in company earnings over the next 12 months. This may be bolstered by hopes that government spending will pick up as we enter the run up to the Presidential election, due in 2008.

We remain cautious however, due to the early signs that cash flow growth is slowing and because the US remains the most expensive of the global equity markets on the basis of cash flow yield. For UK investors, the prospect of a weakening dollar adds a further risk to US investment.

Market Valuation Criteria

	BONDS					EQUITIES						
	Inflation forecast %	10 yr bond yield		10 yr bond yield		P/E '06 %	Valuation		Earnings growth		Volatility %	
		Nominal %	Real %	3m chg %	12m chg %		ERP** %	Div Yield %	2006 %	2007 %		
US	2.6	4.6	2.0	-0.51	0.25	S&P 500	15.4	1.8	1.8	15.7	11.0	7.2
UK	2.2	4.5	2.3	-0.23	0.21	FTSE 100	12.2	3.9	3.25	11.9	7.0	10.5
Eurozone	2.0	3.7	1.7	-0.39	0.51	EURO Stoxx 600	12.6	3.7	3.3	13.0	9.5	11.1
Japan	0.8	1.7	0.9	-0.32	0.16	Topix	20.0	3.8	1.1	14.3	10.2	16.0
Hong Kong	2.0	4.0	2.0	-0.80	-0.18	Hang Seng	13.9	3.2	3.2	8.6	-5.8	12.0

Source: Bloomberg, Citibank

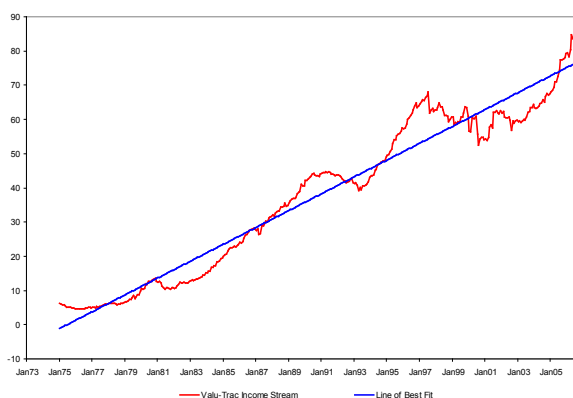
Equity Intrinsic Value Yield - United Kingdom



Source:Valu-Trac

In the **UK**, corporate profitability is now at a 40 year peak according to government data. Despite this, the stock market is not expensive, as the chart above shows. Corporate cash flow growth is slowing (see chart below) and it is significant that the momentum of equity market price change is falling. This all points to lower returns from equities, but with the rate of economic growth rising, we should still see better returns from UK equities than from bonds in 2007. With sterling strong and strengthening we are underweight the overseas earning companies and expect the UK service sector to perform well. We are over-weight in insurance (**Prudential, Caitlin**), computing (**Northgate Information, Sage**) and media (**WPP, Reed Elsevier**), sectors where we see attractive value and good strategic potential.

Corporate Cash Flow and Trend - United Kingdom



Source:Valu-Trac

European equities remain the most attractive of the international equity markets both on valuation grounds and in terms of expected growth in company earnings. European earnings have grown spectacularly over the past three years and there is no sign of a slowdown as yet. European companies are benefiting from long awaited productivity gains and a resurgence in consumer demand. If euro interest rates rise, this should be positive for the currency, so there is potential for UK investors to gain from currency appreciation as well. Our policy is to be overweight in European equities.

We have been substantially overweight in **Pacific Basin** equities, which has worked in our favour over the past quarter. Recently, there has been a sharp fall in corporate cash flow, which raises a note of caution for this region. Equity valuations are not expensive though, so we will maintain an overweight position for the time being and look for a suitable opportunity to move back to a neutral weighting.

Alternative Investments

Our policy is to remain neutrally weighted, other than in exceptional circumstances, in alternative assets as these are intended as a diversification to the bond and equity asset classes.

Commercial Property:

Though direct commercial property in the UK performed well again this quarter, yields are at historic lows and the asset class is clearly vulnerable to further rises in interest rates and the next downturn in the economy. At the moment though, demand for office

space in London is very strong, exacerbated by substantial inflows of investment funds from retail (as opposed to institutional) investors. The well known Norwich Property Trust, for example, has recently been receiving £100m per month for investment in commercial property. The result is that prices are being forced up to unsustainable levels. Additionally, construction activity is high for this stage in the cycle, i.e. after only one year of rent increases, which suggests there may be only another 2 years of rental increases before oversupply hits the market. The global real estate bubble may not collapse over the next few months, but it surely has little upside from here.

Commodities

During the past quarter evidence emerged of both slowing global business cycle and increased supply of oil and oil products. Metals have been moving sideways since May, when they stopped surging upwards. While Indian and Chinese economic growth remains strong thus far, a slowdown in the US will inevitably affect the rest of the world. Once metals begin to turn down, like oil, their price movements can be exaggerated by the removal of hedges and by

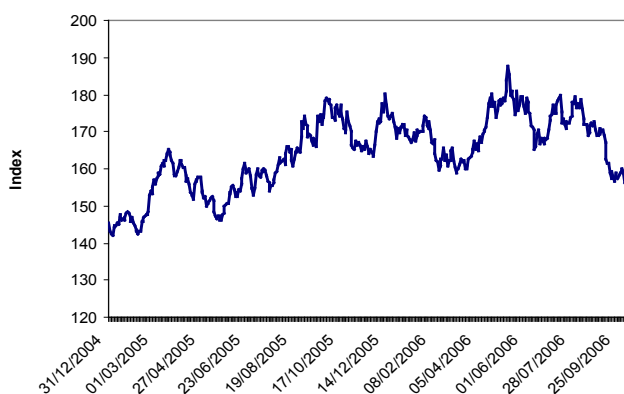
speculators, hedge funds, and proprietary trading desks putting on short positions. Though we still believe we are in a long term secular uptrend for commodity prices, the signs are that the oil price cycle has peaked and is now in a downturn and the same could happen to metals. We do not expect a basket of commodities to outperform equities over the next 6 months.

Hedge Funds

Over the past year, hedge fund returns in aggregate have not lived up to their promises of high returns that are uncorrelated with equities. This is not entirely surprising given the high fees typically charged and the exponential rise in the number of funds in the market place. The more players there are, the greater is the probability that returns will revert to the mean.

Our exposure to hedge funds is through the Valu-Trac strategic fund, which applies a disciplined valuation model to make decisions and is able to take short as well as long positions across a wide range of asset classes, including commodities. Returns are genuinely uncorrelated to equities and the fund has a record of producing attractive risk-adjusted returns over a three year time horizon.

DJ AIG Commodity Index



Asset Allocation For October 2006

25% Bond / 65% Equity / 10% Alternative Model

		Strategic Benchmark			Q4 2006 Tactical weights %	Weighting vs Strategic Benchmark %
		Min %	Benchmark %	Max %		
Cash		0	0	10		
Bonds:	UK Government	15	25	35	14	-11
	UK Corporate	0	0	20	10	+10
	Total Bonds	15	25	35	24	-1
Equities:	UK	33	43	53	38	-5
	US	2	12	22	8	-4
	Europe (ex UK)	0	5	15	11	+6
	Japan	0	3	13	3	0
	Asia ex Japan	0	2	12	6	+4
	Total Equities	55	65	75	66	+1
Alternatives:	Property	0	4	14	4	0
	Commodities	0	3	13	3	0
	Hedge funds	0	3	13	3	0
	Total Alternatives	0	10	15	10	0
Total			100		100	0

Source: Prospect Wealth Management

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