

Summary

- *The economic recovery is sustainable. We do not expect a “double-dip”.*
- *Bond market returns are likely to be modest in the coming 3 months, though the risks are low.*
- *Equities still have considerable upside in this cycle and it is too early to take profits.*
- *Nevertheless, be prepared for a period of equity market consolidation.*
- *Alternative investments offer plenty of scope for positive returns, especially property.*

Review of Recent Events

Record Rise in Equities

A progressive improvement in the global economic outlook over the third quarter produced the strongest three-month return from equities since the 1970's, with the UK market up 22% in the period. At the start of the quarter our key measures of value and momentum both indicated close to maximum opportunity for global equities, so we positioned portfolios overweight in this asset class and benefited in full from the rally. Almost all portfolios outperformed their benchmarks during the quarter as a result.

The stabilisation of the banking sector and the commitment of the central banks to underwriting the recovery through low interest rates and quantitative easing provided the background to a recovery in confidence around the world. China played its part early in the cycle with a huge boost to infrastructure spending, whose effects have rippled through all the industrialised countries. By the end of the quarter, consumer spending was in general stronger than expected, in spite of rising unemployment, and forward-looking

**We are still in the
early stages of an
equity bull market**

business surveys were pointing to growth in services and manufacturing in all the major economies.

The biggest beneficiaries of this stage of the recovery were those sectors that had underperformed the most previously - banks, mining and real estate. Additionally, those stocks geared to the economic cycle continued to produce exceptional returns, reflected in the performance of our contrarian “Alpha” portfolio, which was up 31% over the quarter and has risen by 45% so far this year, outperforming the FTSE 100 by 30%. Our standard equity portfolios also outperformed, but to a less exceptional degree, due to the tight risk controls in place. Our UK equity portfolio outperformed as our focus on undervalued shares worked well in this recovery environment.

International markets produced mixed results. Europe was the best performer, reversing the extreme oversold position in the previous period. By contrast, the Japanese equity market actually fell by -2% over the quarter as strength in the yen was seen to threaten the recovery in the important export sector. We had very little exposure to Japan over the period, having reduced our position in March on concerns the strong yen would depress exports. Stock markets in the Pacific Basin region also lagged, as the pace of economic recovery did not match previous market gains.

Currency Gains

International equity performance was enhanced by gains in all the major currencies against sterling, as can be seen on page 3. This reflected expectations that UK economic growth will lag that of the US and Japan and the fact that UK real interest rates are relatively unattractive, being now the lowest amongst the major currencies.

Bonds Rally

Government bond markets were pulled between concerns that quantitative easing would lead to runaway inflation on the one hand and that protracted low economic growth would produce deflation on the other. As the quarter progressed, the deflation camp came to the fore as it became apparent that the huge excess capacity in the global economy would prevent inflation from taking hold in the near term. UK government 10 year bond yields fell to 3.6% as a result, for a total three month return of 1.1%.

Corporate bonds benefited from the improved economic environment as default risk on investment grade bonds declined, continuing the trend of the previous quarter. Highly rated bonds, such as the utility company RWE, saw their yield fall from 2.1% above gilts to just 1.1% above, for a total return of 4.7% over the quarter. Returns on lower credit names, such as the insurance company AIG, achieved double digits over the same period. The gains have been such that corporate bond yields are now back to the level last seen in

January 2008, well before the financial crisis at Lehman Brothers appeared on the horizon. We maintained a substantial overweighting in corporate bonds over the period and as a result outperformed the benchmark by more than 5%.

Alternative Investments

Commercial property appeared to reach a turning point during the quarter, even though rents continued to fall. Since the start of this year investors have been eyeing the opportunity to buy into property on attractive valuations and the tipping point seems to have been reached. The IPD property index turned positive in July for the first time in 2 years and there are signs that life is returning to the market. We purchased the Aviva Property Trust in early September and have seen a 6% appreciation since then.

Commodity markets have seen varying returns, with copper up 20% as China rebuilt its stockpiles whilst oil was unchanged at \$69 per barrel. Overall, commodities produced a 3.5% return, reflecting the positive growth outlook for the world economy. Our commodity fund underperformed by 5% over the quarter.

The hedge fund index was up 9%, a modest return given the correlation that we have seen in the last 18 months between hedge funds and equity markets. Our hedge fund produced a return of 10% for the quarter, gaining from being overweight equities and bonds.

Finally, our Deposit Alternative portfolio continued to generate returns well in excess of deposits after all fees.

Prospect Wealth Management: Performance of Model Portfolios at 30th September 2009				
Model Portfolio	Inception Date	Total Return Since Inception		
		Prospect %	Benchmark %	Benchmark Name
Bond	30 June 2006	25.0	26.6	FTSE 5-15 years
UK Equity	12 May 2006	-16.5	-13.2	FTSE 100
UK Alpha	12 May 2006	-10.2	-13.0	FTSE 100*
UK Equity Funds	30 June 2006	-13.5	-12.0	FTSE 100
International Equity	30 June 2006	5.8	6.3	FT All World ex-UK
Alternatives	30 June 2006	23.8	-17.2	Prospect Composite**

* Adjusted for transition date. ** IPD Property index, DJUBS Commodity index, HFRX Directional index

Total Returns in Local Currency and in Sterling Terms

3 months and 12 months to 30th September 2009

	30 th 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 %
US dollar	1.60	3.7	11.7		
Euro	1.09	7.5	15.5		
Yen	144	10.7	31.5		
Cash (3m)	Yield %				
USA	0.47	0.2	4.4	3.9	16.6
UK	0.50	0.2	6.3	0.2	6.3
Euro	0.80	0.3	5.3	7.8	21.6
Japan	0.29	0.1	1.0	10.8	32.8
Gov't Bonds (10yr)	Yield %				
USA	3.31	2.4	8.3	6.2	21.0
UK	3.59	1.1	11.7	1.1	11.7
Germany	3.21	2.2	11.0	9.9	28.3
Japan	1.30	1.1	3.2	12.0	35.7
Equities	Index				
USA	S&P Comp	15.7	-6.5	20.0	4.5
UK	FTSE 100	21.9	9.5	21.9	9.5
Germany	DAX	19.1	1.6	28.0	17.4
France	CAC	22.0	-1.5	31.1	13.8
Spain	SMSI	22.6	8.9	31.8	25.8
Italy	BCI Gen	25.1	-1.0	34.5	14.3
Japan	Topix	-1.6	-14.2	8.9	12.8
Australia	All Ord	21.9	8.9	38.4	35.3
Hong Kong	Hang Seng	14.8	20.2	19.1	34.6
Alternatives	Index				
Commercial Property	IPD	2.2	-20.1	2.2	-20.1
Commodities	DJ UBS	3.5	-23.7	7.4	-14.8
Hedge Funds	HFRX	8.9	-2.9	13.0	8.4

Source: Reuters

Macroeconomic Overview as at 30th September 2009

US	UK	Eurozone	Asia
GDP Growth			
<p>After gross domestic product fell 0.7% in Q2 this year, 3.5% growth is forecast for Q3. Latest data point to slow recovery, hampered by rising unemployment and low business investment. However, surveys point to expansion in both services and manufacturing as low interest rates support consumer spending, the restocking cycle starts and infrastructure spending impacts the economy. Housing starting to pick up, albeit slowly. Dollar likely to depreciate further, supporting exports.</p>	<p>Economy contracted 0.7% in Q2, but growth of 0.3% forecast for Q3. Business investment still weak and consumers repaying debt at record pace, limiting discretionary spending despite low interest rates, falling petrol and utility bills. However, September house prices rose for fifth month, most in 2 years on lack of supply; mortgage approvals at 14-month high. Service sector now expanding strongly though manufacturing remains fragile despite depreciating sterling.</p>	<p>September Eurozone confidence at 12 month high. Q3 GDP grew 0.75% qoq, but recovery seen as slow and fragile, dependent on low interest rates and stimulus spending. Strong euro/dollar is challenging exports. Germany expected to grow just 0.3% in 2010 and to return to 2008 GDP level only by 2013. Despite tax cuts, German consumer spending set to fall by 0.7% next year after end of car incentives. Optimism has not yet spread to Russia, where economy is contracting after 7% average growth 2003-2007.</p>	<p>Japan: Stimulus package and exports have pulled Japan out of recession. GDP +3.7% (+3.9% expected) annualised in quarter to June after falling 11% in Q4. September consumer spending up 2.6% yoy (0.2% expected!), best in 19 months. But confidence in the global recovery is low.</p> <p>China: New lending unexpectedly rose in August after falling by 75% in July from June. The \$586 bn stimulus plan will run through 2010 to compensate for weak exports in a slow global recovery.</p>
Employment			
<p>September non-farm payrolls fell more than expected though underlying trends are improving. Jobless rate rose to 9.8%, expected to peak at 10% at end of 2009 and stay above 9% through 2010, according to Bernanke. Pay is declining; payrolls down more than production. August household income is down 2.6% yoy. Productivity gained 6.5% in Q2, better than expected - good for company profits.</p>	<p>Unemployment rate is 7.9% overall, highest since 1995 but lower than other Western economies. More job losses than predicted in September. Further job losses in manufacturing and services could pull jobless rate above 10% eventually.</p>	<p>Eurozone unemployment expected to rise from current 9.4% to 11.5% next year, which will cause retail consumption to lag the manufacturing recovery. In May, German government extended wage subsidies to 1.4m short-time workers for a further 6 months. Opel will fire 10,500 workers across Europe and 50 auto parts suppliers face insolvency.</p>	<p>Japan: The September jobless rate fell from 5.7% to 5.5%. (5.8% expected) Manufacturing overtime rising. But jobless rate expected to peak at 5.9% in Q2 2010. JAL firing 6800 people.</p> <p>China: The lending curbs will bring more unemployment and downward pressure on wages.</p>
Inflation			
<p>US now experiencing deflation with CPI at -1.2%. Large amount of excess capacity in the economy means that inflation should remain subdued through 2010. The Federal Reserve Bank will continue buying bonds (quantitative easing) perhaps until 2011, in response to deflationary forces.</p>	<p>Inflation is below Bank of England target of 2.0% but higher than elsewhere due to weakness of sterling. Despite quantitative easing there is little risk of higher inflation in short term as money supply growth remains weak: bank credit is limited and demand is constrained by excess capacity and rising savings.</p>	<p>Eurozone: Strength of the euro and rising unemployment places downward pressure on inflation so interest rate rise unlikely before end of 2010. Trichet pessimistic on sustainability of recovery. Merkel reins in her post-2011 tax cut plans as deficit soars, placing constraints on future growth.</p>	<p>Japan: BOJ will end QE in December as funding availability improving.</p> <p>China: Money supply rose by record amount in August. Deflation is unlikely to persist as stimulus continues up. Asian credit default swap rates rising on worries over US recovery.</p>
Balance of Payments			
<p>Current account deficit has improved dramatically from 6% to 3% as imports have declined in the recession and because of depreciation in dollar. Excluding oil and China, US is now in trade surplus. US authorities are expected to devalue dollar further to underwrite economic recovery, leading to further reduction in the deficit.</p>	<p>UK authorities clearly want to encourage a weak pound to help exports and further reduce the current account deficit, down from 4% of GDP to 1.8% now. Low real interest rates make sterling unattractive and support depreciation.</p>	<p>Eurozone balance of payments has turned negative as the euro has strengthened against US dollar and sterling. Reflected in weakness in European economic growth as export oriented Germany now struggling. Outlook is for further deterioration.</p>	<p>Japan: exports down 44% in May and trade balance down 22% as strong yen stifles exports. Recovery expected in H2 this year. Japan is sacrificing short term exports to help US recover and promote global growth.</p> <p>China: continues to run huge balance of payments surplus. has recently stopped the appreciation of the yuan currency, but will have to resume a stronger currency policy to address global imbalances.</p>

Economic Forecasts as at 30 September 2009

	Real GDP growth		Unemployment rate		Inflation (CPI)		Budget % GDP	Central Bank rate		Current A/c % GDP
	2009 %	2010 %	2009 %	2010 %	2009 %	2010 %	2009 %	Nominal %	Real %	2009 %
US	-2.6	2.4	9.8	10.5	-1.5	1.8	-13.5	0.25	1.75	-2.9
UK	-4.3	0.9	7.9	8.6	2.0	2.2	-14.4	0.5	-1.1	-1.8
Eurozone	-3.9	0.6	9.5	10.5	0.3	1.2	-6.5	1.0	1.6	-0.9
Japan	-6.1	1.4	5.7	6.2	-1.2	-0.6	-7.4	0.1	2.3	2.7
China	8.1	8.8	9.0	7.5	-0.5	2.1	-4.2	5.3	6.5	6.1

Source: The Economist and Bloomberg

Market Outlook

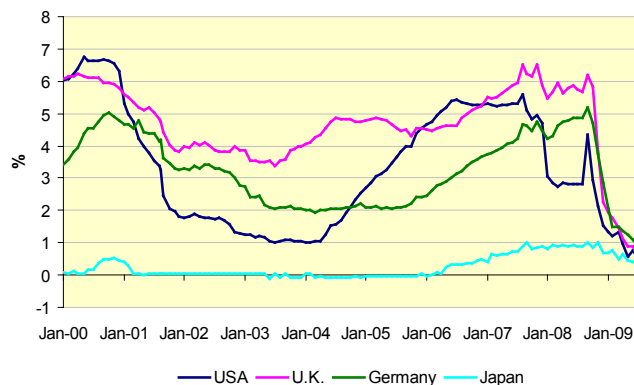
Interest Rates & Currencies

The consensus forecasts shown above for 2010 do little to inspire confidence that a sustainable recovery is underway. Of the developed countries, only the US is forecast to achieve growth close to the long term trend rate next year. It is not surprising therefore, that many forecasters predict a renewed downturn as unemployment rises, taxes increase to pay off debt and bank lending is constrained by property losses.

Our view is more positive and we expect growth forecasts to be upgraded in the coming months as the recovery gathers momentum. Record low levels of interest rates provide a huge boost to consumer purchasing power as is evidenced in robust retail spending and consumer confidence in both the US and the UK. Whilst unemployment is rising, the pace of deterioration is now slowing and the projected increase is unlikely to tip either economy back into recession.

More significant is that industry is refinancing itself through the capital markets, circumventing the banks, which are still slow to lend. The quantitative easing

3 Month Interest Rates
January 2000 - September 2009



Source: Reuters

programmes, which both the Federal Reserve of the US and the Bank of England are likely to continue into next year, means that such refinancing can be effected on attractive terms, allowing companies to take advantage of the re-stocking cycle that is in its early stages. In addition, although the “cash for clunkers” car purchase schemes may be coming to an end, a large proportion of the additional government spending plans in the major economies, such as on infrastructure, will continue into 2010.

We expect these powerful stimuli to underpin the recovery, as is reflected in the forward-looking business surveys which point to expansion in all the major economies. Clearly, there are many uncertainties and for this reason we expect interest rates in the US and

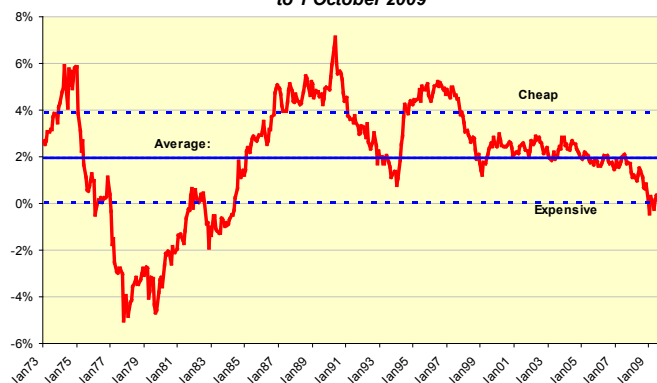
the UK to remain at current levels until at least the middle of 2010.

A further support to recovery should come from depreciation in the US dollar and sterling. It appears that Japan and Europe are prepared to acquiesce to a further devaluation in the dollar in an effort to revitalise the engine of world growth, the US economy. Sterling is also being talked down by the governor of the Bank of England, justifiably, as sterling is still overvalued against the dollar on a purchasing power parity basis. With large surplus capacity in the UK economy, there is little chance that further currency depreciation would lead to higher inflation, so this is an attractive policy option.

UK Bonds

Although higher inflation appears a remote prospect in the current weak growth environment, the risks for the UK bond market are nevertheless rising. As the chart above shows, real (i.e. after inflation) UK bond yields remain close to zero, making them fundamentally unattractive. If expectations for economic expansion start to improve, concerns that inflation will rise will surely follow. At this point the Bank of England will

Real Yield - UK Government Bonds
to 1 October 2009



have to reduce its bond holdings to withdraw the excess monetary stimulus of the past year. Already price momentum is extended and sending a warning signal that a reversal is possible. We already have a defensive position in government bonds, but if the recovery evolves as we expect then we will take additional steps to lock in the gains of the past two years.

Corporate bonds now offer less protection against a rise in government bond yields as the yield premium has declined dramatically, as explained on page 2. Whilst some financial sector bonds still offer attractive value, the big gains have now been made on corporate bonds as a wall of money has chased a limited supply over the past six months. We will continue to seek out attractive opportunities, but the gains will be smaller.

Measures of Market Valuation

As at 30 June	Inflation forecast	BONDS			
		10 yr bond yield		10 yr bond yield	
		Nominal	Real	3m chg	12m chg
	%	%	%	%	%
US	2.8	3.3	0.5	-0.2	-0.5
UK	3.3	3.6	0.3	0	-0.9
Eurozone	1.6	3.2	1.6	-0.2	-0.8
Japan	1.9	1.3	-0.6	-0.1	-0.2

Source: ThomsonOne, Nomura

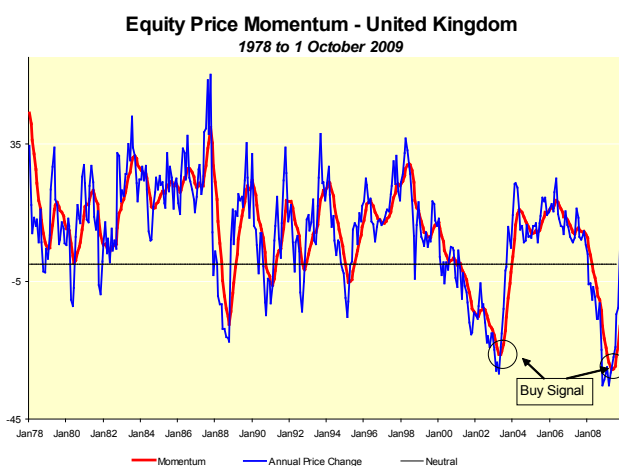
The inflation forecast is the average of the past 5 years' inflation.

	EQUITIES					
	P/E '09	Valuation		Earnings growth		Volatility
		ERP*	Div Yield	2009	2010	
	%	%	%	%	%	%
S&P 500	20.9	1.8	2.4	-23	30	11
FTSE 100	17.0	2.1	3.7	-30	28	24
EURO Stoxx 600	20.4	2.4	3.3	-13	45	37
Topix (Japan)	33.3	1.9	1.7	-60	90	38
China	22.2	n/a	1.1	25	26	12

* Equity Risk Premium = (earnings / price) * 100 - 10yr bond yield

Global Equities

Equity markets have now rallied around 50% from their low point in March. A move of this magnitude, coupled with clear signs that the worst of the economic downturn is behind us, indicate that a new bull market is most likely underway. The chart of price momentum below shows that whilst perhaps two thirds of the initial rally has been realised, this cycle has considerably further to run if history is any guide.



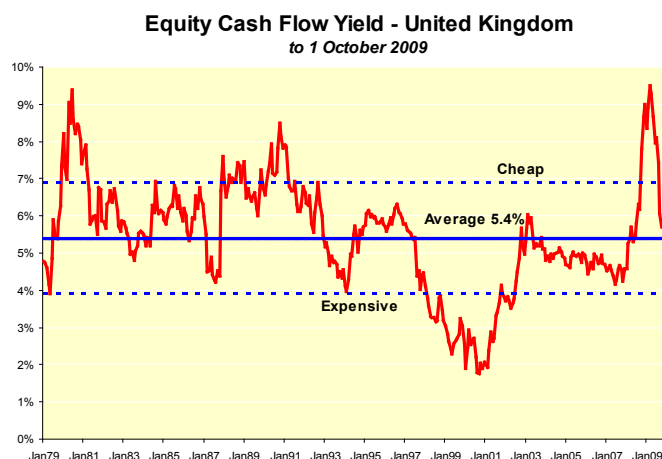
After a 50% gain though, it would not be surprising to see a period of consolidation, which raises the question of whether we should take profits on equities in the short term. Over the next three months we think it unlikely there will be sufficient economic disappointment to justify the costs, and risk, of reducing equity exposure now. Better instead to remain overweight equities, particularly as bonds appear unattractive, but switch out of those markets that have become relatively expensive.

The chart opposite shows our favoured measure of value, cash flow yield, for the UK stock market. UK equities are no longer outstandingly cheap now that share prices have rallied and company earnings have fallen. However, UK shares are still on the cheap side of fair value, so they remain fundamentally attractive.

European and Japanese equities are similarly reasonably valued, whilst the US and particularly the Pacific Basin markets, have become expensive. The Hong Kong stock market, for example is now up 95% from its low point and its cash flow yield has fallen to just 4.2%, from a high six months ago of more than 10%. As a result, we are now looking for a suitable opportunity to switch our remaining Pacific Basin exposure into Japan, where both the stock market and currency offer more upside potential.

Although valuation in most markets may now be back to more normal levels, the bull cycle for equities should be prolonged by increases in company earnings. The table on page 6 shows how rapidly earnings are expected to grow next year. The early stage of recovery is the most potent for earnings as revenues expand whilst labour and other costs remain at reduced levels, producing high productivity. Already, we are seeing this with a recent jump in US productivity data.

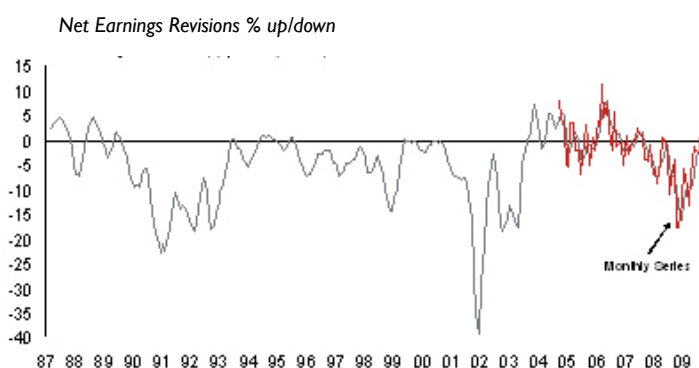
The greatest risk to the ongoing recovery in share prices is that interest rates are raised too soon. At present, this is a distant prospect in the UK and US (the Centre for Business and Economic Research does not expect UK interest rates to return to 2% until 2014) although we have already seen rates being raised in the more resilient Australian economy. In the UK,



however, the desire to raise taxes next year to reduce the huge burden of government debt is likely to mean that the Bank of England will delay any increase in interest rates until there is clear evidence of a pick-up in inflation. This should mean that the equity rally can be prolonged into next year before economic policy changes start to hamper the pace of company earnings growth and the outlook for equities.

As the chart below shows, analysts are still upgrading forecasts for company earnings, a further positive indicator for the UK stock market. In the US, by comparison, we have seen a faltering in the pace of earnings upgrades, another reason to restrict our US equity exposure to no more than a neutral weighting.

UK Earnings Revisions Balance



Over coming months we also see scope for sterling to weaken against all the major currencies and on balance this will boost the earnings of UK companies. It also makes it attractive to hold international equities, to benefit from currency gains, and hence we remain overweight international markets with a bias towards Europe and Japan.

In conclusion, price momentum, valuation and the direction of company earnings growth all point to further upside for equities for the time being.

UK Stock Comments

The best performing market sectors over the third quarter were mining, financials and property. We had moved into property through the purchase of a holding of Land Securities in March of this year and the shares produced an 11% outperformance during the period under review as the commercial property market was seen to have bottomed.

In the financial and mining sectors we maintained a weighting close to that of the overall market after taking the view that both sectors were particularly vulnerable to adverse events. We were, however, overweight in the insurance sector, which produced the strongest returns within the financials.

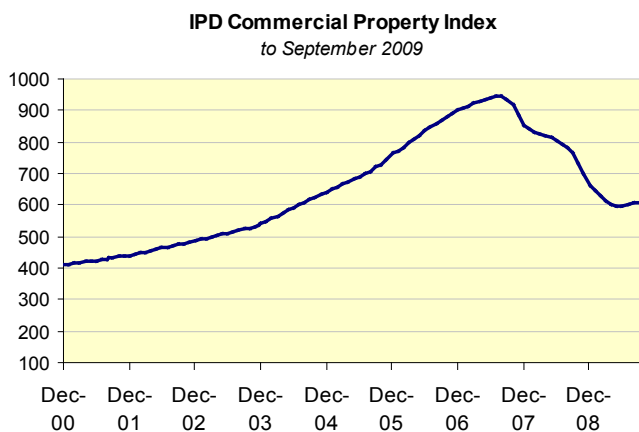
The weakest performing sectors were in the traditionally defensive areas of consumer goods and pharmaceuticals. Whilst we had avoided the expensive consumer goods sectors, we did have exposure to the more attractively priced pharma companies. These provide some protection for the portfolio in the event that the economic news takes an unexpected turn for the worse.

As the cyclical areas become more expensive (we have recently sold the engineering company, Charter International, out of the Alpha portfolio) we will look to move into the more attractively priced shares in the defensive sectors and also in those companies that typically perform well later in the cycle. This includes construction and media stocks and those companies that are highly leveraged but which are now able to refinance themselves on attractive terms.

Alternative Investments

Commercial Property

The graph below shows that property values have started to move up again after a 37% fall. The upside potential in the near term, however, is constrained by falling rents and an overhang of non-performing loans held by banks secured on property. At present the banks want to avoid realising losses, which would damage their capital ratios, so little property is coming to market. However, as the banks' financial position strengthens, so they are likely to release more property for sale. Nevertheless, there is considerable pent-up demand for property investments so we think a double dip is unlikely. For this reason we have re-invested back



Source: IPD

into commercial property in September.

Commodities

Commodity prices in general have been driven higher by the re-stocking of industrial metals in Asia and by increased demand for precious metals as an inflation hedge. Stocks of industrial metals are now at levels that suggest a period of consolidation is likely. Precious metals, in contrast, could rise further in view of the ongoing threat to inflation of quantitative easing.

Energy prices remain under downward pressure as economic growth remains below trend and stocks are relatively high.

Agricultural prices have in general weakened over the past quarter but Schroder's projections now are for an increase in sugar, coffee, wheat and corn prices in the current quarter, based on seasonal and weather factors combined with low inventory levels.

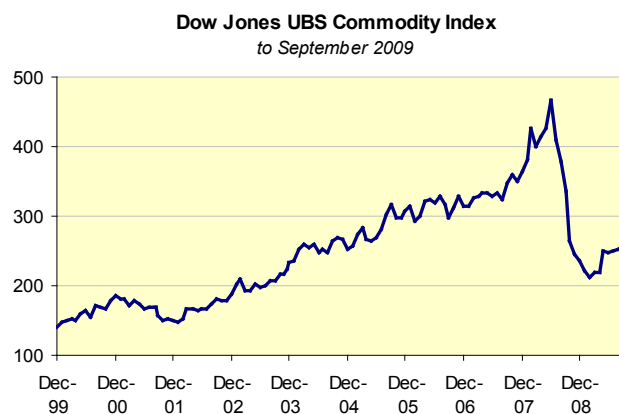
On balance, the outlook is sufficiently positive for us to maintain our neutral position in commodities.

Hedge Funds

Our Valu-Trac hedge fund uses a combination of value and momentum indicators to systematically take both long and short positions in a wide range of financial and commodity markets.

At present they are in the process of reducing their long position in precious metals but retain long positions in agricultural commodities. They have long positions in both bonds and equities, based on positive momentum, but have short positions in sterling and the US dollar. They are showing positive returns for the current quarter.

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Asset Allocation For October 2009

50% Bond / 43% Equity / 7% Alternative Model

		Strategic Benchmark			Q4 2009 Tactical weights %	Weighting vs Strategic Benchmark %
		Min %	Benchmark %	Max %		
Cash		0	0	10	1	+1
Bonds:	UK Government	40	50	60	20	-30
	UK Corporate	0	0	30	23	+23
	Total Bonds	40	50	60	43	-7
Equities:	UK	20	30	40	36	+6
	US	0	6	16	6	0
	Europe (ex UK)	0	3	13	4	+1
	Japan	0	1	11	3	+2
	Asia / Emerging	0	3	13	0	-3
	Total Equities	33	43	53	49	+6
Alternatives:	Property	0	3	13	3	0
	Commodities	0	2	12	2	0
	Hedge funds	0	2	12	2	0
	Total Alternatives	0	7	17	7	0
Total			100		100	0

Source: Prospect Wealth Management

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