



## Loadsamoney

It is widely believed that the rich are getting richer at the expense of the poor. Structural factors like globalisation are blamed. The wages of the many have been depressed while a few ‘super rich’ have benefited from increased profits. In this issue of *Fundamentals*, James Carrick argues that cyclical factors might also be at work. Tight labour markets, falling commodity prices and high interest rates should see income inequality narrow.

I’ve got loadsamoney!! That’s what Harry Enfield’s TV character used to say to unemployed people during the late 1980’s property boom. But he didn’t stay around forever (unlike Hula Hoops, which Harry Enfield also told us were round, will stay round and will be around forever). Like the house-price bubble, the ‘Loadsamoney’ character was killed off by 1990.

But another stereotype seems to be with us today. Some call it ‘plutonomy’, others the ‘super rich’. But whatever it’s called, the story is always the same. Globalisation has benefited the capitalist at the expense of the worker. Outsourcing has depressed wages but driven profit shares to record highs. Moreover, lower inflation (thanks to cheaper import prices) has reduced

inflation-risk premiums, allowing assets to re-rate. So the rich (who earn all the money and own all the wealth) are getting richer. If you extrapolate the trends far enough, we’re heading back to medieval times of an army of serfs toiling for the benefit of a handful of lords. So a number of commentators are advising investors to ditch stocks of companies serving the poor and replace them with ones geared for the super-rich (private jets, fine art and the like).

As this view is so consensus, we investigated whether it’s profitable to invest in a contrarian view. Could the world become more equal? And does the spending power of the ‘super rich’ live up to the hype? We found a number of reasons to suggest the consensus is wrong.

### Inside:

Page 5  
**Market Overview:**  
Implications of restrictive lending standards

Page 7  
**Snapshot:**  
G7 Purchasing Managers Indices

Page 8  
**Forecasts:**  
Outlook remains positive for the UK economy

SPENDING IS MORE EVENLY DISTRIBUTED THAN INCOME

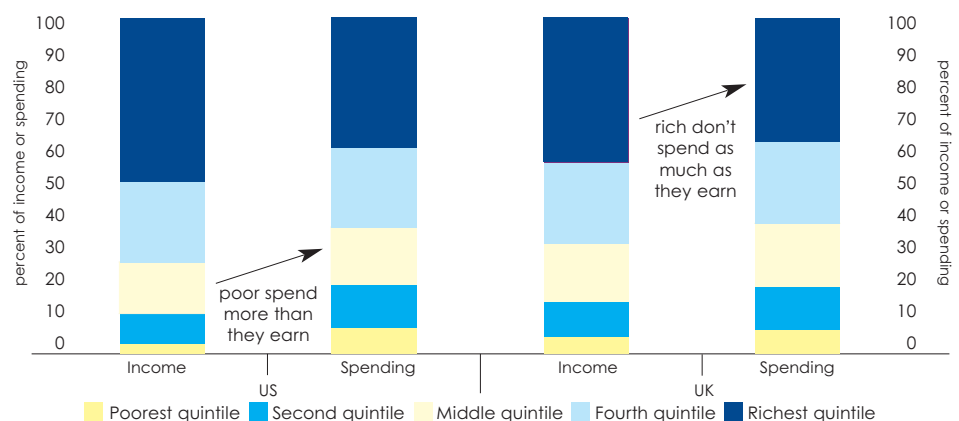


Figure 1

Source: ONS, BLS

1. We live in a democracy with a progressive, redistributive tax system. So the gulf between pre-tax income and wealth distributions between rich and poor is not matched by actual spending.

2. Incomes in developed economies (including the US) are more evenly distributed than those in developing economies. So as the growth cycle matures from manufacturing investment and commodity extraction to consumer services, fewer millionaires should be created.

3. The recent rise in the share of spending by the rich is cyclical, not structural. With tighter labour markets boosting wages, the workers' share of income looks set to increase, particularly if we take into account the recent rise in self-employment.

4. Lower oil prices will boost real incomes of the poor more than the rich.

5. Higher wages and a lack of capital outflows from oil-exporters could boost interest rates in developed markets. This may dampen asset price rises at certain points, which could disproportionately hurt the super rich.

**Tax and spend**

“From each according to his ability, to each according to his need”. The Berlin wall might have collapsed but that doesn't mean Karl Marx hasn't influenced western society. Believers in the 'super rich' point to extraordinarily uneven distributions of wealth and income in society. For example, one estimate suggests that the top 1% of earners in the US receive a fifth of the total income while the wealthiest 1% of the population own a third of total assets.

But that doesn't mean that the top 1% of the population accounts for 20% of total spending as there is not a one-for-one relationship between income and spending. Let's put it another way. The poorest 20% of the US population receive just 3% of the income. But they account for 8% of consumer spending. How can this be? Are they being forced to sell their homes or run up large credit card deficits? No. They simply get a cheque from the government every week.

**RICHER COUNTRIES ARE MORE EQUAL THAN POORER ONES**

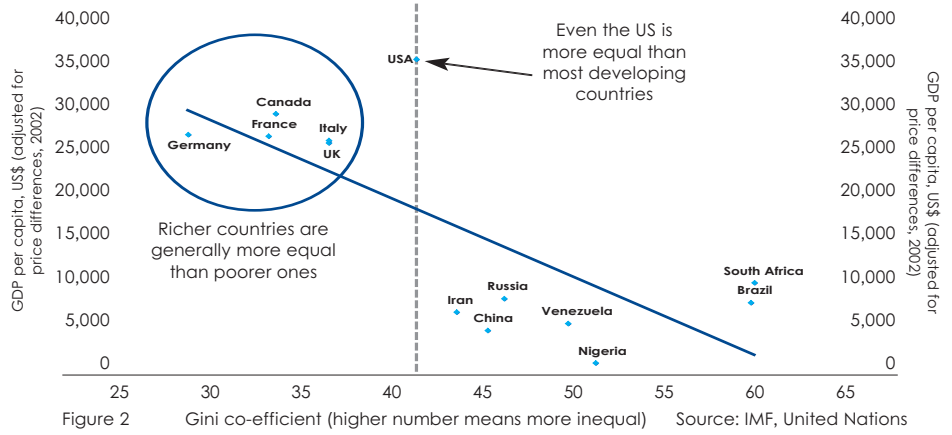


Figure 2 Source: IMF, United Nations

There is a huge difference between pre-tax income and post-tax (and benefit) income flows. For example the bottom 20% households in the UK get almost 80% of their income from social security benefits. And these are financed by taxing richer households. So if a 'super-rich' household earns an extra £1 million, the government will get around £400,000. This allows for a more even distribution of spending in both the UK and the US than is commonly thought (Figure 1).

**More equal than others**

Of course, the super-rich might try and find ways of avoiding paying the tax. But in a democratic society, there is a limit on the extent to which the rich can benefit at the expense of the poor. This can be seen by plans to boost the minimum wage in the US or restrict migrant workers from Romania and Bulgaria in the UK. This political bias to equalise spending power in developed economies can be seen by their income inequality coefficients. Their economies are generally much more

equal than less developed economies (such as Asia, Africa, Middle East or Russia). Despite popular misconceptions, even the US is more equal than less developed countries (figure 2).

As the growth cycle matures, we expect global income inequality to fall. When interest rates are low, consumers buy durable manufactured goods, many of which are now produced in Asia. Low interest rates have also encouraged people to invest in emerging markets. Both factors (increased demand for goods and increased supply of finance) have led to increased demand for commodities from countries like the Middle East, Africa and Russia. As these economies are very unequal, this explains the sharp rise in the number of millionaires in these economies. In 2005, the number of millionaires rose by 12% in Africa, 10% in the Middle East and Latin America, 7% in Asia and North America but only 5% in Europe (source Merrill Lynch and Capgemini).

**US LABOUR INCOMES HAVE PICKED UP**

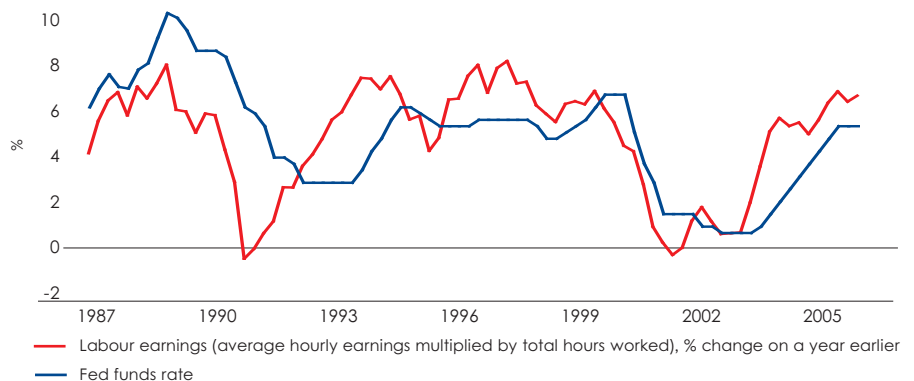
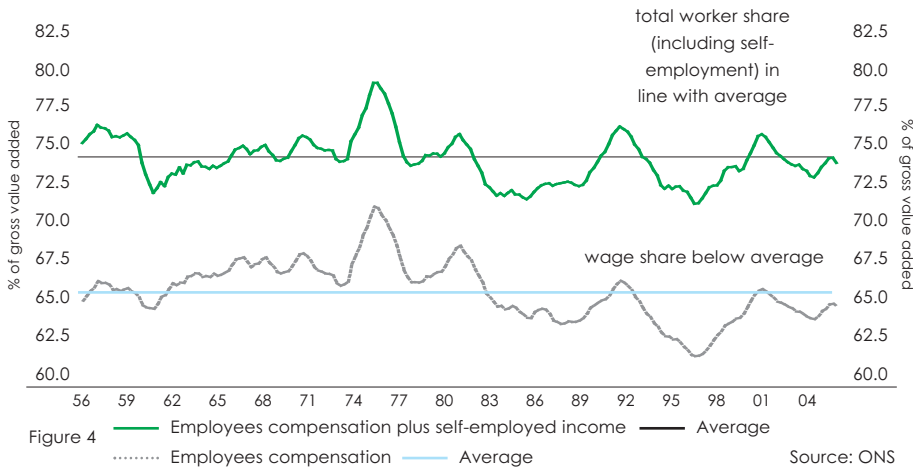


Figure 3 Source: EcoWin

LABOUR SHARE OF INCOME IS NOT LOW IF WE INCLUDE SELF EMPLOYMENT



Looking forward, economic growth is now being driven more by rising wages and employment than low interest rates. For example, the Fed funds rate is 5.25% now compared with 1% at the start of 2004. But labour earnings (average hourly pay multiplied by total hours worked) are growing by over 6% now, compared with 1.5% at the start of 2004 (Figure 3). The situation in Europe is similar. A combination of high interest rates and stronger labour incomes typically leads to increased spending on locally produced services (such as restaurants or media) than foreign-made durable goods. So growth should be concentrated in developed service-oriented economies and this is more likely to be evenly distributed than before.

Labour pains

Because growth has been so strong for so long, spare capacity has been eroded and firms have been forced to re-hire. The US labour market remains tight with wage inflation continuing to build. The UK labour market has also improved. After rising for just over a year, unemployment has now fallen in five of the last six months. As in the US, there is also evidence to suggest that pay pressures are building. Incomes Data Services estimate that pay settlements in 2007 could be up to 1% higher than a year earlier. This should improve the wages and salaries share of income.

But we should be careful not to focus too much on this one measure of income

distribution. We also need to take into account the rise in the number of self-employed, particularly given recent trends. There has been a sharp rise in self-employment in recent years in the UK, partly reflecting the ageing of the labour force. Older workers (50+) account for 25% of the economically active population, but 40% of the self-employed. Over the past year, the number of self-employed people has risen by 2.7% (or 101,000 in absolute terms) compared with a 0.6% gain (or 156,000) in employees. If we take self-employment income into account, the share of income accruing to workers is even higher (Figure 4). We have seen a similar pattern in Europe. Recent labour market reforms in Germany have encouraged self-employment.

Oil be back

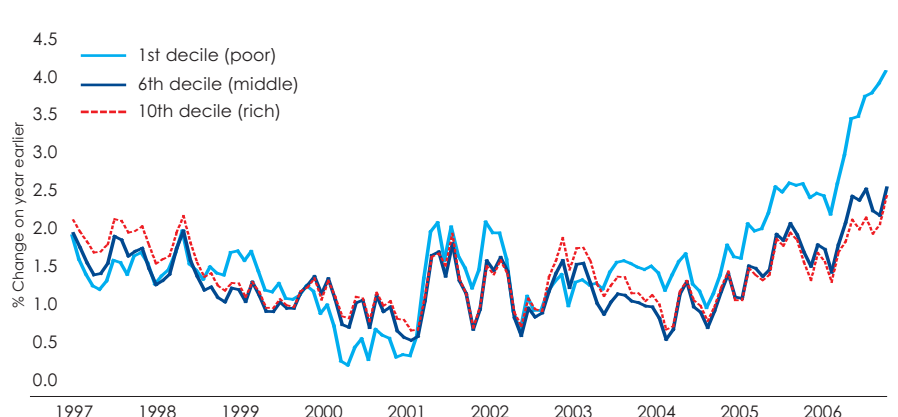
As well as benefiting from higher wages, workers could also benefit from lower commodity prices. We have written extensively on this subject before. High oil prices have encouraged people to switch to

other technologies (e.g. biofuels). Consumers and businesses have also become more energy efficient and this process will be helped by a shift in growth away from commodity-intensive Asian capex towards western services. Speculative demand for energy might also decline given the current large cost involved in buying energy (an investor in energy futures has had to pay an annualised cost of up to 40% recently as the forward price is more expensive than the spot).

Lower oil prices boost the real incomes of poor and middle-income workers more than rich ones. In recent years the inflation rate of poor people has grown much faster than that of richer ones due to higher energy prices (Figure 5). But as energy prices fall, they should benefit disproportionately. This is because they spend a greater proportion (27%) of their money on the essentials of life – food and utilities - than rich people (who spend 12%).

So a potential wildcard to really boost the incomes of the poor is trade liberalisation of agricultural products. The poorest members of society have not really benefited from free trade as they spend more of their money on essentials like food than cheap manufactured goods. If we were to see a 10% fall in food prices within the European Union as a result of trade liberalisation (perhaps as a result of the current Doha negotiations), this would reduce the inflation rate of the poorest decile of society by 1.8%, compared with an 1.3% fall for the average consumer and an 0.9% decline for the richest 10%.

INFLATION RATE OF THE RICH AND POOR



## Oilgarch

Not only will lower oil prices boost the incomes of the poor, but they could also reduce the incomes and wealth of the super-rich. As well as making Russian and Middle Eastern oligarchs poorer, lower energy prices could also affect the risk-reward outlook for global asset prices.

Surging oil revenues have encouraged oil exporters to import more goods and services from abroad to help develop their economy or improve their infrastructure (purchase of new aircraft from the US or Europe for example). If the oil price were to fall back to around \$45/bbl we estimate that the oil-exporters' trade surplus with the world would disappear.

This could affect the risk-reward outlook for global financial markets, particularly corporate debt. The oil-exporters' trade surpluses have been recycled back into western financial markets, boosting demand for government bonds (the Greenspan 'conundrum' or the Bernanke 'savings glut'). In turn, low government bond yields have forced investors to search for higher yields, so they have bought things like exotic corporate debt instruments.

A lower oil price would take money away from high-saving 'oilgarchs' and give it to low-saving workers in developed markets. Not only would global aggregate demand rise (boosting interest rates) but the supply of capital that has artificially depressed bond yields, also fall. Were we to see a large rise in 'risk-free' government bond yields, this could in turn temper demand for this risky assets such as corporate credit or emerging-market debt.

Who would this affect the most? Well presumably the people who own the most wealth – the super rich. Indeed, their share of spending is remarkably cyclical, coinciding with asset price movements (Figure 6). So optimism about the prospects for the super rich boils down to the outlook for financial

% OF US CONSUMER SPENDING ACCOUNTED FOR THE RICHEST 20%

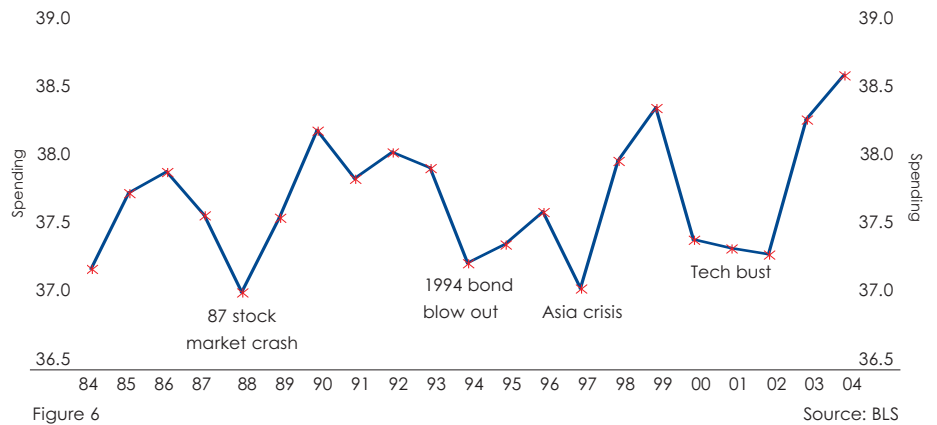


Figure 6

Source: BLS

markets. If a combination of rising labour incomes, lower oil prices and higher interest rates helps end the 'carry trade', then the super rich could disproportionately suffer.

And who would benefit? We think older people as they tend to have more interest-bearing deposits. Higher interest rates boost their incomes, allowing them to spend more. The types of goods and services that would benefit the most from this are health, food at home, travel and leisure.

Higher real wages would boost broader spending, particularly on services. Some labour-intensive companies might suffer from higher wage inflation (e.g. hotels/restaurants/retail/agriculture). But capital or energy intensive ones (e.g. airlines, telecommunications) might fare better.

## Summary

In broad terms, we think the spending power of the 'super rich' has peaked.

Growth should switch any from commodity-producing oilgarchs to western services providers. And within the west, rising labour incomes and lower commodity prices should boost the spending power of the poor. People will drink beer rather than champagne and Netjets will find life less "easy" than budget airlines.

Anyone wishing to be rich in the years ahead should probably buy a basket of "mass-market brands" stocks rather than luxury-goods stocks, the reverse of the last four years (Figure 7). Mass market brands tend to perform better when purchasing power returns to the people.

TIME TO BUY MASS MARKET BRAND STOCKS

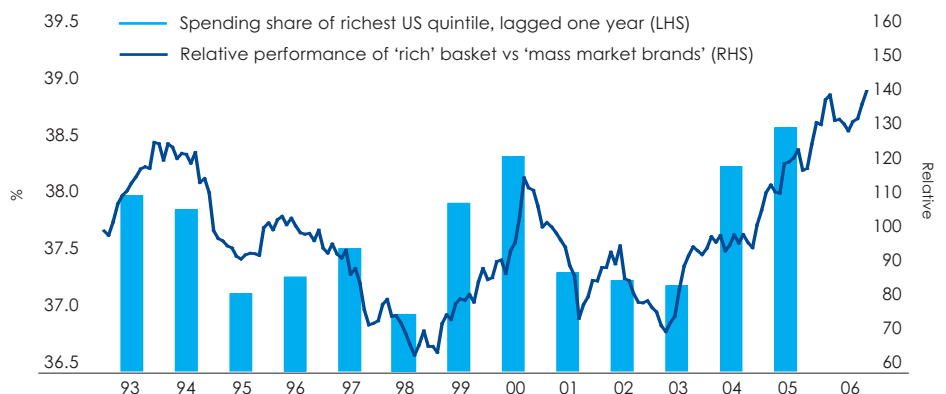


Figure 7

Source: BLS, EcoWin

## Market Overview

# Implications of restrictive lending standards

In recent years, the easy availability of cheap credit has been a key driver of two of the main market themes: strong household consumption and the surge in leveraged private equity deals. It is not surprising therefore that the latest Senior Loan Officers survey from the US attracted a lot of attention.

This survey reports the proportion of banks that are tightening their lending standards to both the household and corporate sectors. Banks lending to the corporate sector have been gradually tightening lending practices since early 2005. At the low point in Q2 2005, -24% of banks were tightening, that is, lending standards were being loosened. Now, 5% of banks are tightening standards, but mainly to smaller, riskier firms.

This contrasts with lending standards to households, which have been largely unchanged since early 2005, if not a touch easier. But the headline grabber in the latest survey was the jump in lenders tightening their mortgage lending practices. The latest survey reported that 16.4% of banks were becoming more restrictive in Q1. That may not seem like a particularly high proportion, but that represents a jump from just 1.9% at the end of 2006, and is now the highest since 1991.

Whilst tighter mortgage lending practices received considerable attention, the move to tighter lending practices to the corporate sector raises the possibility of broader problems within the corporate credit market through 2007. Corporate credit default rates tend to follow lending standards with around a 6-month lead. Defaults have remained incredibly low through the current cycle, gradually falling to just 0.72% at the end of 2006, despite the gradual rise in lending standards over the past year. This steady rise, coupled with the softer corporate investment data in the latest GDP release, implies that cracks may be beginning to appear in an otherwise healthy corporate sector.

## London

### MPC hike to 5.25%, with a further hike likely

The UK economy began the year on a solid footing. The Purchasing Managers Surveys continue to point to solid growth ahead, particularly in the service sector, despite coming off their recent highs. The strength of the economy towards the end of 2006 prompted the Bank of England to raise rates to 5.25% at the January meeting, ahead of the release of the December inflation data that showed headline inflation at the top of the permitted range. Subsequent data releases have shown that housing market activity has begun to respond to the previous rate hikes, with weaker mortgage approvals and fewer agents reporting higher prices. That said, the MPC are likely to hike rates once more, in an attempt to head off the risk of higher wage inflation. Money markets expected rates to reach 5.50% by the end of the year.

Despite the robust economic backdrop, the UK equity market made a lacklustre start to the New Year posting a total return of -0.3%. Only small caps managed to deliver a positive return (+1.2%) while midcaps performed worst of all (-0.6%). At the sector level, Oils continued their poor run due to a falling oil price and disappointing trading from BP. Conversely, Telecoms continued with the good form from the end of 2006 with all major companies in the sector performing well. Christmas trading news from retailers was decidedly mixed with strong trading from food retailers such as Morrisons and clothing retailers Next and M&S, but poor performances from companies such as Debenhams and Dixons. There was a lull in corporate activity with the conclusion of the auction for Corus, the only real notable

event despite much speculation. We continue with our generally optimistic view on the market based on attractive profits growth, reasonable valuations and the prospect of further corporate activity.

## Wall Street

### Equity market remains constructive for 2007

Incoming economic data from the US has been mixed so far this year. The output side of the economy looked a touch softer, with weaker industrial output and the Manufacturing PMI survey falling back below the 50 no-change level. Core durable goods orders were also disappointing. In contrast, consumer related data was much more encouraging. Household spending data has picked up in response to much improved disposable incomes, and confidence across a range of measures improved. This pick up in spending in the latter part of 2006 helped to boost Q4 GDP growth to a stronger than expected 3.5% (annualised). There are also tentative signs that the housing market is stabilising after a year of decline. With such mixed data, the Federal Reserve kept rates on hold at the January meeting. Going forward, the improvement in economic data has prompted money market participants to revise up their expectations of rates through the year. A few months ago money markets were pricing in at least one rate cut some time in the first half of the year; now there is just one rate cut priced in by the end of the year.

In the equity markets, the S&P 500 rose 1.4% during January. Fourth quarter earnings numbers have on the whole met analyst estimates. Earnings growth has moderated to a 10% year on year pace. Going forward, Energy and Material sector earnings are expected to decline in 2007 due to falling commodity prices. This drag notwithstanding, S&P 500 earnings should increase 8-10% in 2007. The

outlook for the equity market remains constructive for 2007. While the profits cycle is likely to slow, valuations are very supportive for equities, both against bond yields and on a P/E basis compared to history. Investors will continue to watch reported inflation data very closely, which has remained at the upper end of the Federal Reserve's tolerance zone. Corporate balance sheets remain very strong, with free cash flow at levels that will likely support the equity market in any period of market consolidation.

## Europe

### Mixed economic performance across the region

European economic performance has been mixed so far this year. Data from Germany showed that the economy remained robust through to the end of 2006, ahead of the VAT hike in January. This fiscal tightening prompted households to bring forward their purchases of larger items, in particular cars. Industrial data were also robust, reflecting solid global demand. This contributed to ongoing strength in investor sentiment in Germany. By contrast, France and Italy showed some weakness in activity indicators. With such mixed data, the ECB have kept rates on hold since the December meeting, although money markets expect a hike at the next meeting in March. This view is based on credit growth and higher inflation rates with which the ECB are uncomfortable. Rates are expected to reach 4% by the end of the year.

Overall, European markets outperformed the UK and US in January. Regionally, the Spanish IBEX and German DAX indices were among the top performers, with total returns of 3.3% and 2.9% respectively. The FTSEurofirst 300 index returned 2.2%. The Steel (12.4%), Electronics (8.9%) and Household Goods (7.1%) sectors provided the key support for European markets over January, while Software Services (-12%) and Real Estate (-3.8%) were the laggards. Going forward, the ability of the German household sector to absorb the 3% rise in VAT will be an important determinant of equity market performance. As will developments in residential housing markets. The rise in house prices and mortgage borrowing since 2002 has been a strong support for European domestic demand. With early signs of weakness from

several residential housing markets, investors will be watching for signs of material weakness in credit growth going forward.

## Japan

### Bank of Japan delay rate hikes

Economic commentary from Japan has focused on the Bank of Japan's decision to keep interest rates unchanged at the end of January meeting, despite a widely held expectation that they would raise rates to 0.5%. The consensus expectation was driven by the improved economic outlook for 2007, largely in response to solid corporate sentiment and more positive news from the US. However, while remaining positive on the economic outlook, the Bank of Japan decided to wait for signs of improvement in the household sector before hiking rates. In particular, the Bank of Japan are concerned that household spending data is still weaker than a year ago, and labour cash earnings growth remains flat. With positive sentiment on the outlook for global demand, money markets are pricing in rates at 0.75% by the end of the year, with an implicit expectation that household spending data improves.

The Japanese stock market so far in 2007 has been characterised by demand for high yield. With interest rates still very low in Japan, domestic investors are seeking higher returns for their huge stash of savings. This has prompted large buying of high yielding overseas bonds, and a surge in demand for high yield domestic products which tend to invest in those sectors traditionally offering above-average yields such as REITS, steel, shipping and food companies. Elsewhere, with the Bank of Japan reluctant to raise rates, the Yen has continued to hit multi-year lows against the USD and the EUR. This weakness has helped demand for Japanese exports, provoking further share price appreciation from companies such as Toyota and Nintendo.

## Pacific Basin

### Potential for correction in Chinese equity market

In January the FTSE AW Asia Pacific ex Japan fell marginally, down 0.1% in sterling terms. Malaysia, up 9%, performed strongly and was a beneficiary of investor disillusionment with Thailand and government moves to attract foreign investment in areas such as property. Strong economic momentum underpinned Singapore up 4.6%.

Underperformers included China down 3.2%, after the strong rally in December. At the end of the month the Vice Chairman of the National People's Congress (NPC) warned that the domestic stock market was developing into a bubble after a rise of 130% in 2006. South Korea fell 4.9% as GDP growth slowed to +4% year-on-year in Q4 2006 versus +4.8% in Q3 2006. A decline in the growth of exports, given the strong currency and weak consumer spending, was the explanation.

Asian markets typically enjoy seasonal strength in the first quarter of the year after which consolidation or correction is typical. Possible triggers for correction include unanticipated rises in local interest rates, adverse moves in the Yen forcing funds to de-leverage their positions, or the Chinese authorities announcing measures to cool strong economic growth. The bubble warning from the Chinese Vice Chairman of the NPC points to the potential for a correction in the domestic Chinese stock market and the risk of contagion in Hong Kong H shares.

# Snapshot

## G7 Purchasing Managers Indices

Of the many forward looking activity indicators that are published, one of the most useful is the Purchasing Managers Surveys, which are published each month across a wide range of countries. They provide timely information on sentiment in both the manufacturing and services sectors. In particular we find it useful to combine the PMIs for all the G7 countries.

The G7 PMI has a good, but not perfect, fit with G7 GDP growth as shown in Figure 1. This combined measure has trended down since it peaked in late 2005, leading the peak in GDP growth by 2 quarters. The steady fall through to the latest data point in January suggests that G7 growth will steadily slow from its current 2.5% pace, to around 1.5% in early 2007.

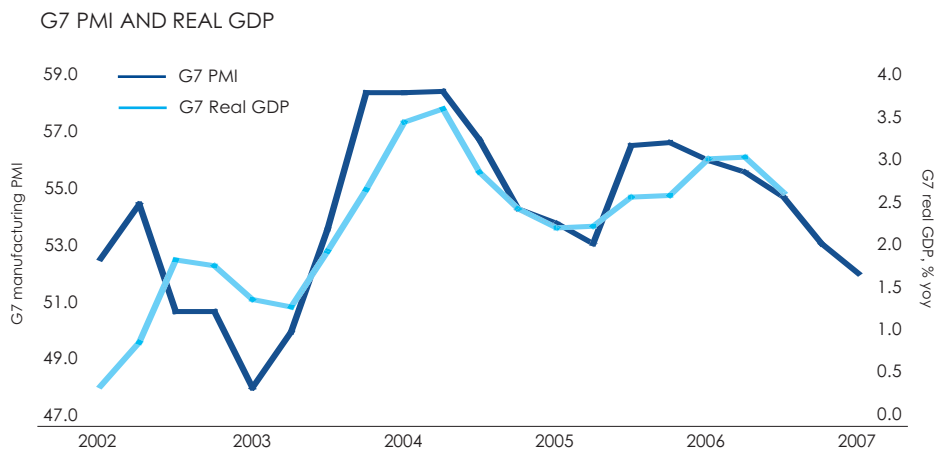


Figure 1 Source: Thomson Financial and LGIM Research

But this isn't the whole story. The US has the largest weight in this combined index and the US manufacturing PMI survey fell through 2006 as weaker than expected demand led to inventory accumulation. The recent improvements in US consumer spending helped to reduce these inventories in Q4, and will ultimately be positive for growth as stocks will have to be rebuilt.

The UK, France and Italy also experienced weakening manufacturing sentiment through 2006 and this weakness is expected to persist in 2007. This weakness in Europe will likely offset the expected pick up in the US to some extent. As will the pick up in the services PMI, which rose from the end of Q3, illustrated in Figure 2. Taking these considerations together, we would expect to see the G7 PMI, (Figure 1), picking up as we move into the second quarter.

This fits with the thesis we set out towards the end of 2006, that developed world services will do well in the current late-cycle growth environment. The US and UK are set to benefit most from this growth environment, as these economies provide services to the world, compared with Europe, which largely provide goods.

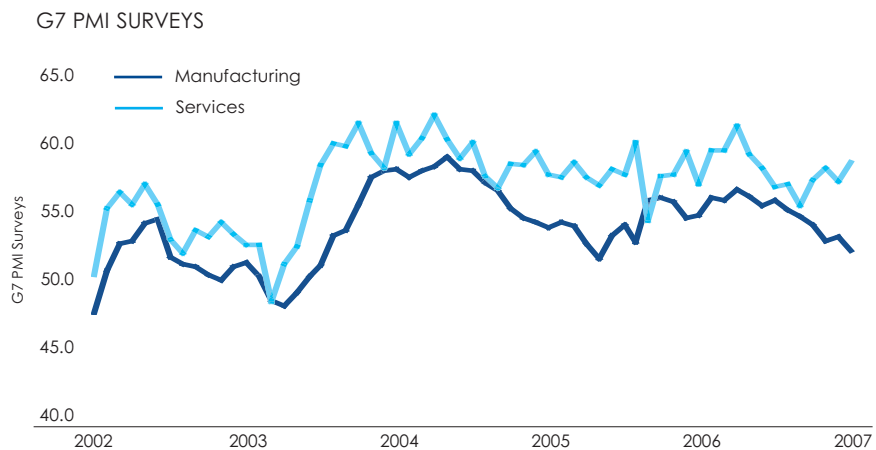


Figure 2 Source: Thomson Financial and LGIM Research

## Views Commentary

## Outlook remains positive for the UK economy

	Price Inflation (RPIX)		GDP (Growth)		Earnings (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro		FTSE 100
	End 2007 %	End 2008 %	End 2007 %	End 2008 %	End 2007 %	End 2008 %	End 2007 %	End 2008 %	End 2007 %	End 2008 %	End 2007	End 2008	End 2007	End 2008	
ABN Amro	3.40	2.80	2.75	2.50	6.50	7.00	5.10	-	5.50	6.00	2.06	2.06	0.66	0.68	7000
Citigroup Smith Barney	-	-	2.90	2.80	5.60	5.70	4.85	4.95	5.50	5.50	1.93	1.93	0.66	0.64	6800
CSFB	2.20	2.30	2.80	2.70	7.30	6.20	4.80	-	5.50	5.50	1.89	-	0.68	-	6400
Deutsche Bank	2.60	1.90	2.70	2.70	7.90	6.60	4.80	-	5.50	-	1.85	-	0.73	-	6600
Goldman Sachs	2.40	2.90	2.60	3.00	6.40	5.30	4.76	5.01	5.25	5.25	1.94	1.94	0.69	0.71	6833
HSBC Securities	1.90	2.20	1.70	2.60	5.00	6.00	5.10	4.60	5.00	4.75	1.92	1.93	0.75	0.70	6850
JPMorgan	2.60	-	2.70	2.60	-	-	-	-	5.50	-	-	-	-	-	-
L&G Investment Management	2.70	2.50	2.80	2.80	8.00	8.00	4.75	4.75	5.25	5.25	1.78	1.85	0.69	0.69	6450-6550*
Merrill Lynch	2.72	2.73	2.80	2.30	6.50	7.00	4.50	-	5.50	5.00	1.87	1.73	0.71	0.74	6000
Morgan Stanley	2.80	2.40	2.30	2.50	6.00	6.00	5.30	5.30	5.25	5.25	1.85	1.73	0.67	0.67	6550
UBS	3.10	3.00	2.60	2.80	5.30	7.80	4.65	4.70	5.25	5.25	1.96	1.92	0.68	0.69	6550
Median (ex L&G Inv Mgt)	2.60	2.57	2.70	2.65	6.40	6.20	4.80	4.95	5.50	5.25	1.92	1.93	0.68	0.69	6600
Last Month	2.60	2.70	2.60	2.65	6.50	5.30	4.70	5.03	5.00	5.00	1.90	1.88	0.68	0.69	6600
Actual end :															
2006		3.80		3.00		12.20		4.74		5.00		1.96		0.67	6220
2005		2.00		2.00		22.70		4.10		4.25		1.72		0.69	5618
2004		2.50		2.60		6.71		4.53		4.75		1.92		0.71	4814

KEY Median figures indicate change over previous month 0.00 increase 0.00 decrease 0.00 no change

\*This is our estimate of fair value at end 2007, not a point forecast.

Respondents to our survey this month remain positive on the outlook for the UK economy. The median GDP growth expectation for this year was revised up slightly from last month, to 2.7%, and is expected to continue at a solid pace through 2008. RPIX inflation is expected to remain at around 2.6% over the two year period. Reflecting this positive economic outlook, respondents to our survey currently expect another 0.25% rate hike this year, with one rate cut expected by the end of 2008. In the currency markets, sterling is expected to ease slightly against both the dollar and the euro.

Gilt yields are expected to reach 4.8% by the end of this year, slightly lower than current levels, rising to 4.95% by the end of 2008. Meanwhile the median expectation for the FTSE at the end of 2007 is unchanged from last month's survey, at 6600. The level of uncertainty surrounding the outlook for equities remains high, with the Bull-Bear gap at 1000 index points.

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