

Fundamentals

Economic and Investment Commentary

November 2006



Investment
Management



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The dollar's balancing act

Making a case for further falls in the value of the dollar is fairly simple given the continued expansion of the US's current account deficit. However, there may be some good reasons to believe that the US's external finances may be about to improve. In this issue of *Fundamentals*, Julien Garran, LGIM's Head of Asset Allocation, explains why LGIM has a sanguine view about the prospects for the world's most important currency.

For dollar bears the case against the US dollar has been fairly easy to make over the past few years. All they need to do is point to the US's current account, which represents its financial position with the rest of the world.

With the exception of 1991, the USA has run a current account deficit for virtually the last twenty five years. Over the past five years, the size of the deficit has grown in US dollar terms, in real terms and as a share of GDP. The most recent figures showed that the current account deficit now represents around 7.3% of total annual GDP. This all means that every day that has gone by over the last twenty five years, US citizens have found themselves deeper and deeper in debt

to the rest of the world. Every day they buy more goods and services from the rest of the world than they manage to sell to it.

In this issue of *Fundamentals* we take another look at the mighty US dollar and consider whether, despite the headline current account figures, there might still be reason to feel optimistic about the prospects for the dollar, at least in the short to mid term.

The US's balancing act

Let's begin with exhibit number one for the case against the dollar, which is shown in Figure 1. The blue line represents the US current account position as a proportion of US GDP since 1960. Prior to 1982 it shows clearly how

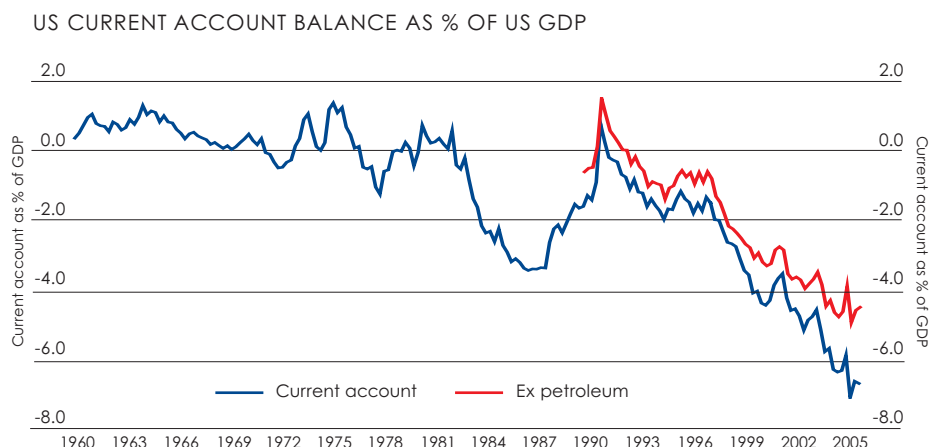


Figure 1

Source: Thomson Financial

the US economy was run with a current account surplus, occasionally interspersed with relatively short periods of deficit.

We can also see in Figure 1 how the mid to late 1980s were a kind of dress rehearsal for what was to come in the 1990s. Strong US growth over the 1980s, relative to growth elsewhere in the global economy, sent the current account balance to record lows relative to the economy's size, troughing at – 3.45% of GDP. But the deep recession that followed this period of expansion, turned the deficit very sharply into a surplus once again by 1991.

We can now see that the rate of deterioration in the US's finances since 1991 has been very similar to the rate of deterioration in the 1980s, but also that it was barely affected by the slowdown in the economy in 2001.

Figure 1 paints a grim picture for the outlook for the dollar. But does the current account deficit really matter? A huge amount of energy of many fine economists has been expended over the past few years trying to answer this question.

Economic textbooks will tell us that a persistent deficit is not sustainable. The definition that one might find relating to a sustainable deficit states that: "the discounted present value of current and future trade surpluses must equal the outstanding level of external debt". In plain English, a country, just like a person, must be able to pay off its accumulated debt by transferring an equivalent amount of real resources (net exports) abroad... at some point in the future.

But the textbooks don't tell us when this point in the future will occur, in other words, when a country's deficit has to turn into a persistent surplus, or analogously when an individual would have to pay back their debts. All the textbooks really tell us is that a country like the USA will have to run a trade surplus eventually.

In addition, it is often the case for a household or for a corporation that as long as they can afford the interest payments on the accumulated debt, that the day of reckoning can be postponed. The same is true for an economy too. As long as US growth remains strong, its creditors will not be concerned about its debts.

Does dark matter matter?

So the textbooks do not help us very much. But there is also another school of thought, with respect to Figure 1, and that is that the current account balance, as measured using traditional national accounting techniques, does not reflect the USA's true financial position with the rest of the world.

When trying to measure the mass of the universe – a task that would daunt any national statistics office! – physicists concluded that there was not enough mass in the universe to hold it all together. However, given that it was held together, they concluded that the universe must be made of a lot of stuff (a technical term) that they could not see. They referred to this as "dark matter".

Given that the US had run a sizeable deficit month after month since 1991 and for much of that time the dollar rose in value, two Harvard academics – Hausmann and Sturzenegger – argued that there must be some unaccounted for foreign assets on which the US economy had a claim. This was the

current account equivalent of "dark matter".

Hausmann and Sturzenegger argued that the United States owns valuable "dark matter" assets that must exist and that generate revenue that cannot be seen or measured. They hypothesised that these assets might include US firms' superior know-how, the liquidity service provided by the US dollar, and the lower risk of US assets than emerging country assets. When they made an estimate of the value of this "dark matter", the authors estimated the USA's net international investment position to be about \$600 billion in the black, not – \$2.5 trillion in the red, at the end of 2004.

Willem Buiter, the former Bank of England MPC member, argued that at best Hausmann and Sturzenegger's numbers were out by a factor of 83%, and was generally rather scathing of the theory! However, for the dollar bulls who believe that the US economy, as the pre-eminent global economy, has advantages which cannot be replicated elsewhere and which will allow it to continue to generate dark matter to support its officially measured indebtedness, this remains a powerful argument.

There is also another further, largely unrelated, argument that has been put forward which has comforted dollar bulls over the last few years too. This is that there exists a dollar block which considered as a whole implies once again that there is no deficit "problem".

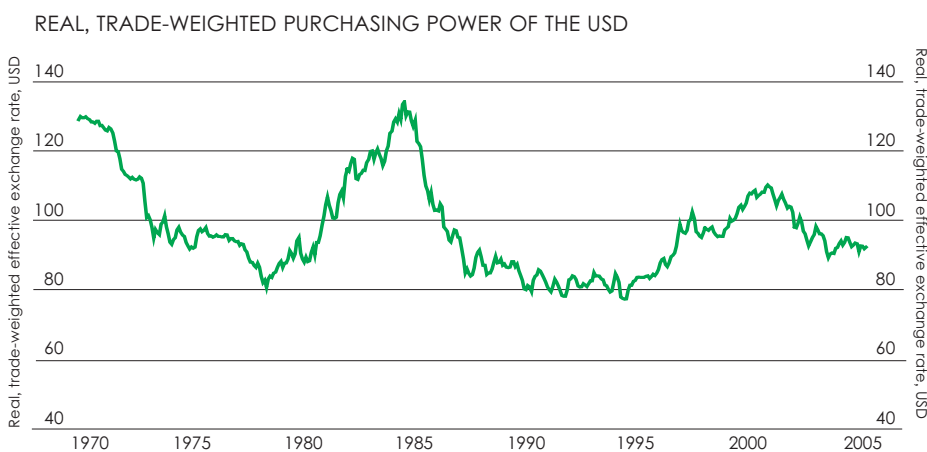


Figure 2

Source: Thomson Financial

For example, the Eurozone is made up of a number of nation states. But unless it tells us something about the wider fate of the Eurozone economy, then the fact that France may or may not be running a persistent deficit with say Germany, would have little bearing upon the euro, since it would be unlikely that an adjustment in the euro would correct the imbalance.

Some economists have extended this argument to the notion that there exists in the world a “dollar block”. Effectively a set of nations, such as the Gulf nations, and also China that are in some senses dollar economies (since many Gulf nations are pegged to the dollar, and China operates a crawling peg). When one adds up the current account positions of all of these countries, the amalgamated current account position, vis a vis the non-dollar block, only runs a deficit of around 2%.

Reasons to be cheerful

So the textbooks don't tell us when a persistent deficit has to be repaid. And, via arguments about dark matter or through arguments about the existence of a dollar block, some economists dispute that the deficit exists anyway. But are there perhaps other more prosaic reasons to be sanguine about the fate of the dollar?

The green line in Figure 2 represents the US real trade-weighted effective exchange rate going back to 1970, calculated by the OECD. This series represents a measure of the real purchasing power of the US dollar, which peaked in 1985 over this sample. We can see that the dollar rose very steadily over the late 1990s from a trough in 1995, and finally began to turn down in mid-2002.

Measured in these terms, today the US dollar is 13% lower than it was in 2002. The dollar bulls typically take comfort from the idea that the dollar has already fallen a significant amount. However, dollar bears – unconvinced by arguments about dark matter and dollar

blocks – remain concerned that compared with 1995 the dollar is still 15% higher and that despite the decline since 2002 the current account deficit has expanded from 4.5% of GDP in 2002 to 7.3% today.

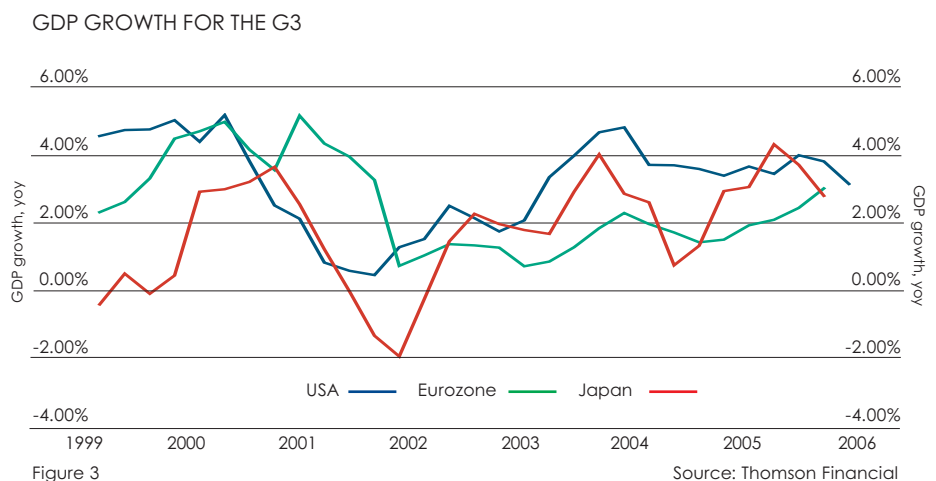
A phenomenon known as the ‘J’ curve effect may have played some part in the apparently delayed response of the trade position to the relatively substantial fall in the dollar since 2002. This effect comes about following a depreciation in a currency because both households and corporations adjust their behaviour with a lag, so that they continue to buy foreign goods and services at prices that are now higher when measured in the domestic currency, leading to an increase in expenditure on imports over a short period. This increase in expenditure on imports may not be offset initially by a greater volume of exports being sold overseas, despite the exports now being cheaper to overseas residents in foreign currency terms, as overseas economic agents would have to adjust to the new lower exchange rate too. The net effect then might be a worsening of the current account position, until economic agents at home and abroad revise their behaviour, rather than an improvement. There might be reason to hope then that the deterioration in the current account will cease at some point.

The headline current account numbers have possibly masked some improvement in the underlying position. This is shown

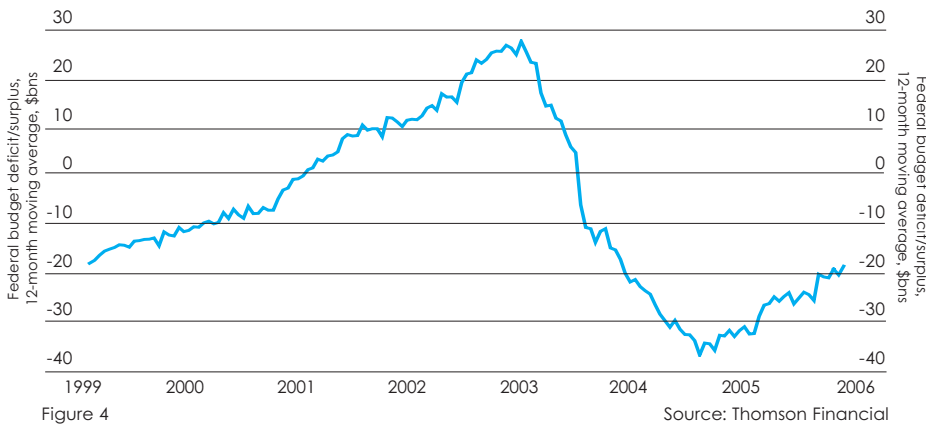
by the red line in Figure 1. This represents the current account balance excluding the cost of energy. We can see that a significant component of the deterioration in the current account over the last two years, has been a direct result of the rise in energy prices over the same period. Had energy prices not increased so rapidly then we might have begun to see an improvement in the US economy's finances.

Of course in many respects the exact cause of the worsening current account deficit is irrelevant. But if recent energy price falls stick and if, as we suspect, prices fall further, we might at last start to see an improvement in the headline measure of the US's current account position, as the terms of trade improve in favour of US households and firms.

There are two further reasons why one might expect the current account to improve from here. The first relates to the improvement in both the Japanese and Eurozone economies over the last two years or so. The blue line in Figure 3 represents US GDP growth, while the green and red lines represent Eurozone and Japanese GDP growth respectively. The extent to which the USA was holding the growth fort virtually alone is clear from this figure, particularly throughout 2004. At the end of that year the US economy had expanded by 3.4%, while the Eurozone and Japan had expanded by just 1.5% and 0.5% respectively. Worse still for the US's finances, the majority of growth in



BUDGET BALANCE



Europe and Japan at that time was export driven!

However, as the figure shows over the course of this year both Europe and Japan have performed much more in line with the US economy itself. We believe that the stronger growth environment in these two large economies should remain for the foreseeable future, which will give US exporters more buoyant markets for their goods and services, and will then in turn add to the improving background for the US current account.

The final, important structural change with respect to the current account which is underway relates to Uncle Sam's finances. One of the key supports for the US economy in 2001 and 2002 was fiscal policy. In a relatively short space of time Mr Bush's administration turned the public sector surplus bequeathed to it by the last Clinton administration, into a sizeable deficit. This deficit has been part of the overall current account deficit, since it simply represents that component of the US economy's total debt taken on by the government.

The blue line in Figure 4 represents a moving average of the monthly budget deficit/surplus. The Federal government's finances have been on an improving trend for the last two years. On current trends, and with the US economy probably already over its recent housing market related soft patch we see every reason for this trend to continue.

Other factors

We believe that there are a number of good reasons to believe that the USA's current account balance should soon show signs of improvement – the fall in the value of the real trade-weighted dollar over the last few years, falling energy prices this year, the growth renaissance in Japan and Europe and the newly found fiscal rectitude of Uncle Sam.

Dollar bears would still argue however, that the current account deficit is so large, that it would still warrant a further, significant fall in the value of the dollar. To some extent this may be true, but the markets tend to be more concerned about the direction of the current account than its actual level, in which case evidence that it is turning should help to support the dollar in coming months.

A further short-term support for the dollar should come from the Fed's

policy stance, which we still believe to be on the accommodative side. In our view the Fed's policy rate will remain higher for longer than many market participants currently believe. This will also help to support the dollar.

Finally, although central banks have shown some signs in the past of diversifying away from dollar assets, as far as most central banks are concerned the dollar remains the reserve asset of choice, where that choice is still being expressed through the purchase of US Treasuries. Up until two years ago it was South East Asian central banks that were the marginal buyers of Treasuries. Today that mantle has been taken over to some extent by the newly enriched oil nations of the world who have been recycling their petro-dollars into Treasuries. If the US's external finances are on the point of improving, then there would seem to be little reason to believe that this support for the dollar, via the Treasury markets, should subside now.

Figure 5 puts some perspective into the credit standing of the US government as a borrower. The bars represent the consolidated net debt as a proportion of GDP for a selection of countries. This debt takes into account government assets such as reserves, as well as the outstanding stock of issued debt.

As we can see, US government net debt is much lower than it is in Japan, and it is also lower than in the Eurozone's first and third largest economies. Looked at

CONSOLIDATED NON-MONETARY NET DEBT, % GDP

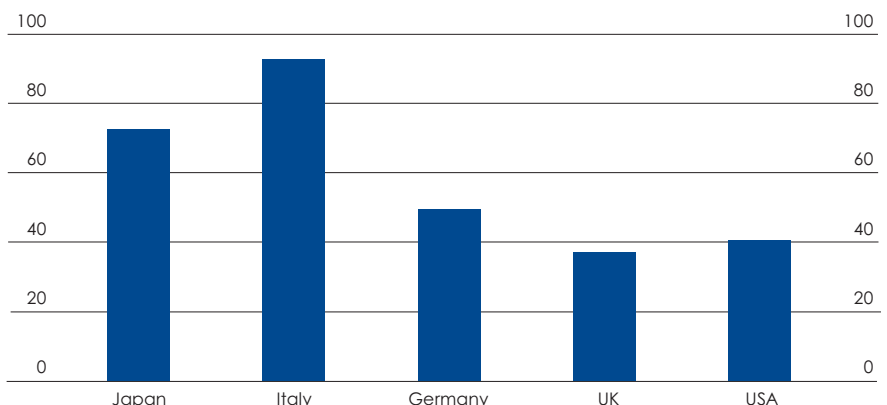


Figure 5

Source: Thomson Financial

in this light, holding central bank reserves in Treasury assets as opposed to JGBs (Japanese Government Bonds) or euro-denominated debt seems less of a problem, especially if we consider that the US economy shows every sign of generating enough future growth to service its debts, as well as a strong commitment to maintain its inflation fighting credibility.

Finally, as global resource utilisation rises, it tends to favour white collar workers and the consumption of services. As we have highlighted in previous issues of [Fundamentals](#), this is good news for the US because the price of services (which the US exports) tends

to rise against the price of goods (which the US imports). This process often helps to shrink the deficit further, and it can trigger a virtuous circle involving a rising dollar, which reinforces the downward pressure of goods against services. Such a process began in early 1995 – just at the point where investors were most worried about the rising budget deficit and the rising current account deficit. The dollar duly embarked on a seven year bull market.

Summary

The USA's current account deficit gives plenty of reason to believe that the US dollar still has a long way to fall. However, we are less convinced. Over

the short-term, there are some good reasons to feel upbeat about the dollar's prospects, and over the longer term there are reasons to believe that the current account deficit is at last on the turn. The dollar's longer term fate is not as bleak as it would appear from simply considering that the current account deficit is now at a record high.



Julien Garran
Head of Asset
Allocation

Market Overview

Commodity prices

Earlier this year the prices of many commodities hit all time highs. Since that time however, particularly following the sharp and sudden decline in global risk appetite in early May, the prices of many commodities have since fallen quite sharply.

The price of a barrel of Brent crude oil is now close to its price at the start of this year at around \$58 per barrel, having peaked at well over \$70 at one point. The gradual decline of some of the geo-political tensions surrounding the West's relationship with middle eastern economies and with North Korea; the slowdown in US growth; the improvement in supply conditions and selling pressure from both speculative and institutional investors have all contributed to this fall in the price of oil and in other energy prices. The latter three factors have propelled the prices of other commodities, such as copper and aluminium, lower too.

In some commodities markets, for example in the nickel market, prices have continued to rise over the year, but these price rises are largely due to continued supply constraints.

Generally speaking then, what is the commodity market currently telling us

about underlying global demand? Normally one would associate a fall in commodity prices with a forthcoming decline in demand and economic activity. But on this occasion the lower commodity prices reflect a correction from levels that were irrationally exuberant earlier this year. Indeed, commodity prices are still not "low", although prices in many markets have stabilised at new lower levels. That they have not returned to pre-2003 levels should probably be taken as a sign that the global economy is still in a fairly robust shape. And furthermore, that the lower commodity prices will if anything help to support growth going forward.

London

One further hike in 2007 expected

The UK economy continues to grow at an above trend pace, having grown by 0.7% for the past four quarters. Activity indicators point to further solid growth going forward, with the composite PMI up sharply at the start of the fourth quarter. The labour market continues to improve, with the claimant count measure

of unemployment stabilising over the third quarter and with solid wage growth. The housing market meanwhile has continued to accelerate. House price inflation is running at around 8% and approvals for new mortgages are at their highest level for nearly three years. The Bank of England's decision to hike rates in November was therefore not surprising. Money markets are currently pricing in a further rate hike in the first quarter.

The UK equity market made further good progress in October posting a total return of 3.0%. In line with trends in global equity markets, leadership was provided by the Industrial Metals and Mining sectors propelled by rising metals prices and a bid approach for Corus. Healthcare was the laggard with both UK pharmaceutical majors GlaxoSmithKline and AstraZeneca reporting disappointing news on their drug pipelines. Online gaming stocks such as PartyGaming plummeted after legislation was passed in the US making their activities illegal. British Energy was another significant faller after finding cracks in boiler tubes at one of its plants.

Corporate activity remained a positive theme for the market with utility company Viridian agreeing to be taken

over while rumours of approaches for Man Group and Hanson among others saw their share prices move higher.

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

Moderate improvements in consumer spending

The pace of US economic growth slowed further through the third quarter. The economy expanded by just 1.6% on an annualised basis, largely due to weak residential investment spending. Despite the weakness in the housing market, consumer spending picked up modestly during the quarter, reflecting the strength in the labour market.

Employment growth remains solid, as does wage growth. This, combined with the boost to household disposable income from falling gasoline prices, should continue to support consumer spending in the coming months. Money markets continue to price in rate cuts next year, with the first 25 basis point cut expected by the end of the second quarter. However, if consumers hold up these expectations could be revised significantly.

The S&P 500 was up 3.5% in October. The consumer discretionary sector continued to lead the market as announced production cuts by OPEC failed to impress oil traders. Crude oil (WTI) prices were down 7% over the month. Investors were trying to balance the focus on earnings growth with a focus on overall growth.

While third quarter GDP was lower than initial estimates, its composition was market positive. The S&P 500 posted 18-20% (approx) year over year earnings growth during the third quarter, with 70% of companies exceeding analyst estimates. As the earnings season winds down investors will turn their attention to economic data. Retail sales data for October will be closely watched.

Europe

More to come from the ECB

European economic sentiment has been somewhat mixed recently. The ZEW survey of investor expectations continued to weaken, as did the French and German PMI surveys. Regional business confidence picked up, however, with improvements in the German IFO and French INSEE surveys. Inflation has fallen significantly recently, although the ECB remain vigilant to inflation risks further out. As such, money markets expect the ECB to hike rates again before the end of the year, and to continue rising during 2007. They are currently not pricing in hikes beyond 3.75% as the impact of the German VAT hike is still uncertain.

European equity markets performed well over October, with the DAX and CAC indices up 4.4% and 1.9% respectively. Markets responded well to the strong start to the US earnings cycle, with European companies also reporting solid earnings. Cyclical sectors led the performance, with Steel and Mining in particular outperforming. By contrast, defensive sectors such as Food Producers, Software and Pharmaceuticals were the laggards over the month. Going forward, investors will look for signs of resilient domestic growth.

Japan

Wages stagnate amid uncertainty

Domestically growth remains weak; profitability has failed so far to feed through to an increase in wages and consumption. This is because companies remain highly conservative in forecasting conditions going forward and are reluctant to increase wages given future uncertainty. Meanwhile core inflation remains stubbornly weak and likely to prevent the Bank of Japan from being able to raise rates again until later next year.

Japanese equities continue to notably lag the other major markets. LargeCap stocks continue to drive the market, while riskier SmallCap and high-beta stocks remain underperformers with the continued absence of investor risk appetite seen earlier in the year. Corporate earnings in

Japan are showing solid growth, with a third of Japanese companies having reported interim earnings so far and recurring profit trending at 16% growth year-on-year – much higher than the flat growth forecast for the year back in April. Whether this growth target can be achieved will depend on continued strength in the second half of the year, although the most recent export data exhibits no change to the robust demand seen for Japanese exports.

Pacific Basin

Markets underpinned by falling oil prices

In October the FTSE AW Asia Pacific (ex-Japan) Index rose 2.2% in sterling terms. Asian stock markets have been underpinned by further falls in the oil price which has raised expectations that the US can avoid a consumer recession.

This month five markets were up by over 5%, namely Australia, Singapore, Thailand, New Zealand and the Philippines. Australia led (up 5.9%) boosted by a rebound in commodity prices. Strong loan growth, good bank results and a buoyant property market helped Singapore rise 5.5%. South Korea fell 2.4% hit by weak performance of technology and North Korea's decision to conduct a nuclear test. In Taiwan, (down 1.2%) President Chen has just survived his second no confidence vote, leaving many local investors sidelined.

Asian stock markets at this time of the year usually have a positive bias as fund managers chase performance ahead of the year-end. We expect this year to be no different with hedge funds desperate to boost returns in what has been a challenging year. The recent success of large IPOs (such as ICBC, the Chinese bank, which raised \$21.9bn in the world's largest IPO) and share placements would support this view.

Snapshot

Global earnings analysis

Global equity markets continued to trade well over the past month, with the Dow Jones Industrial Average reaching a new high. Performance varied across the regions however. Figure 1 shows that in local currencies the best performing region was Europe, while Japan was the laggard.

GLOBAL EARNINGS DATA

	Performance % ytd [†]	Earnings Growth [‡] (%)		Earnings Momentum (October)		
		2006	2007	Upgrades	Downgrades	% Upgrades
World	12.5	13.2	9.7	2513	1992	55.8
US	8.6	15.0	9.9	1551	1097	58.6
Europe	22.0	11.8	9.9	537	451	54.4
Germany	15.7	13.7	12.6	55	37	59.8
France	16.2	8.9	7.5	60	103	36.8
Spain	27.3	20.5	8.4	39	13	75.0
Italy	13.1	9.6	9.2	27	17	61.4
UK	12.6	12.3	7.8	72	80	47.4
Japan	4.8	7.2	11.6	117	120	49.4
Asia Pacific	15.9	10.7	6.1	259	253	50.6

Figure 1

Source: Thomson Financial

[†] Local currency, World index in USD

[‡] IBES estimated

Going forward, market participants seem fairly optimistic. Earnings growth for 2006 is expected to be strong, at 13.2% for world markets according to IBES estimates. While this is projected to slow to 9.7% in 2007, that is still a solid performance against a broad consensus view of a slowdown in global growth next year. In contrast to the world outlook, analysts expect earnings growth in Japan to improve, as economic growth, and the corporate sector in particular, is projected to remain robust.

Figure 2 shows a measure of earnings momentum. It is the ratio of analyst earnings upgrades expressed as a percentage of total revisions made during October. A figure above 50% implies positive earnings momentum. There was a sharp drop in earnings momentum around the time of the market sell off in May and June. But expectations have subsequently improved, with 56% of analysts revising up their expectations for next year.

So despite the consensus view that growth will slow next year, equity market participants are not as downbeat on the outlook. This fits with our view that growth in the US will surprise on the upside in 2007, lifting market sentiment. However, should the Federal Reserve be perceived to over-tighten policy rates, that sentiment could quickly be undermined.

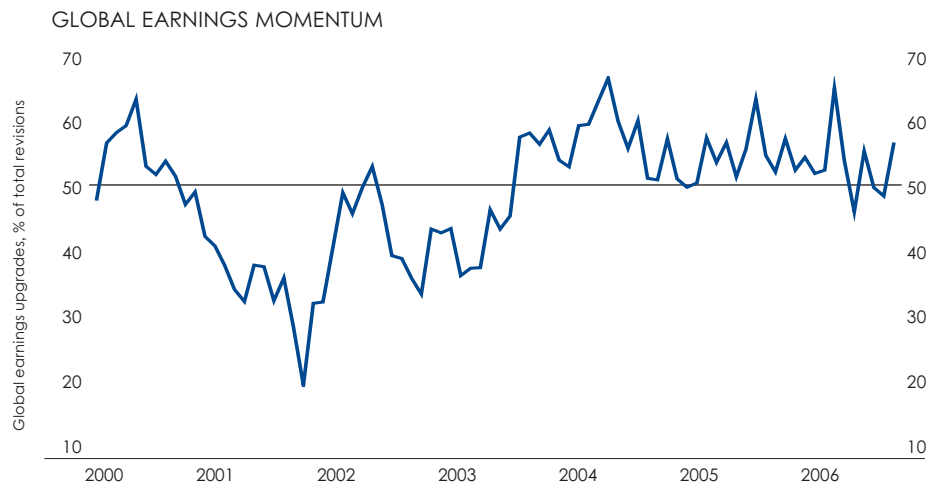


Figure 2

Source: Thomson Financial

Views Commentary

Slight downward revisions to 2006 expectations

	Price Inflation (RPIX)		GDP (Growth)		Earnings (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro		FTSE 100
	End 2006 %	End 2007 %	End 2006 %	End 2007 %	End 2006 %	End 2007 %	End 2006 %	End 2007 %	End 2006 %	End 2007 %	End 2006	End 2007	End 2006	End 2007	End 2006
ABN Amro	3.40	2.60	3.00	2.60	-	-	4.60	5.10	5.00	5.50	1.94	1.97	0.68	0.68	-
Citigroup Smith Barney	-	-	2.60	2.70	14.10	6.20	4.65	4.69	5.00	5.25	1.82	1.86	0.68	0.67	6400
CSFB	3.40	2.40	3.00	2.70	10.00	7.50	4.30	4.40	5.00	5.25	1.84	1.78	0.67	0.66	6200
Deutsche Bank	2.30	2.20	2.60	2.30	8.40	5.40	4.70	4.60	5.00	5.00	1.88	1.86	0.69	0.72	-
Goldman Sachs	3.40	2.40	2.80	2.40	13.00	6.70	4.50	4.20	5.00	5.00	1.87	1.87	0.67	0.70	6250
HSBC Securities	3.30	2.30	2.50	1.50	9.00	6.00	4.50	4.20	5.00	4.50	1.89	1.92	0.69	0.75	6250
JP Morgan	3.20	2.40	2.60	2.70	-	-	4.40	4.50	5.00	5.00	1.83	1.94	0.68	0.66	-
L&G Investment Management	3.10	2.20	3.00	2.60	12.70	7.00	4.75	4.50	5.00	5.00	1.80	1.65	0.69	0.72	6100-6300*
Merrill Lynch	3.50	2.90	2.60	2.70	12.40	6.70	4.65	4.55	5.00	5.00	1.94	1.75	0.69	0.74	6100
Morgan Stanley	3.30	2.40	2.60	2.50	8.00	6.00	5.00	5.30	5.00	5.00	1.82	1.79	0.68	0.67	6150
UBS	3.50	2.50	2.60	2.50	14.90	10.20	4.85	4.65	5.00	5.00	1.94	1.99	0.68	0.69	-
Median (ex L&G Inv Mgt)	3.40	2.40	2.60	2.55	11.20	6.45	4.63	4.58	5.00	5.00	1.88	1.87	0.68	0.69	6225
Last Month	3.35	2.40	2.70	2.60	12.65	6.45	4.70	4.60	5.00	5.00	1.87	1.87	0.68	0.70	6150
Actual end :															
2005		2.00		1.70		22.7		4.10		4.25		1.72		0.69	5618
2004		2.50		2.90		6.71		4.53		4.75		1.92		0.71	4814
2003		2.60		2.80		10.14		5.05		3.75		1.78		0.70	4476

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 2006, not a point forecast.

As we approach the end of 2006, respondents to our survey have revised down their outlook for the year. GDP and equity earnings growth expectations have been revised down marginally, yet they remain at elevated levels. The economy is expected to expand by around 2.6% both this year and next, although earnings growth is expected to moderate from 11.2% to 6.5%. Meanwhile gilt yields are forecast to fall slightly through 2007.

Despite a slightly weaker economic outlook for 2006, respondents' median FTSE forecast for the end of the year is slightly higher than last month at 6225. The Bull-Bear gap has narrowed further to 300 index points.

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For all IFA enquiries or for additional copies, please call 0845 273 0008 or email cst@landg.com

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www.lgim.com

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