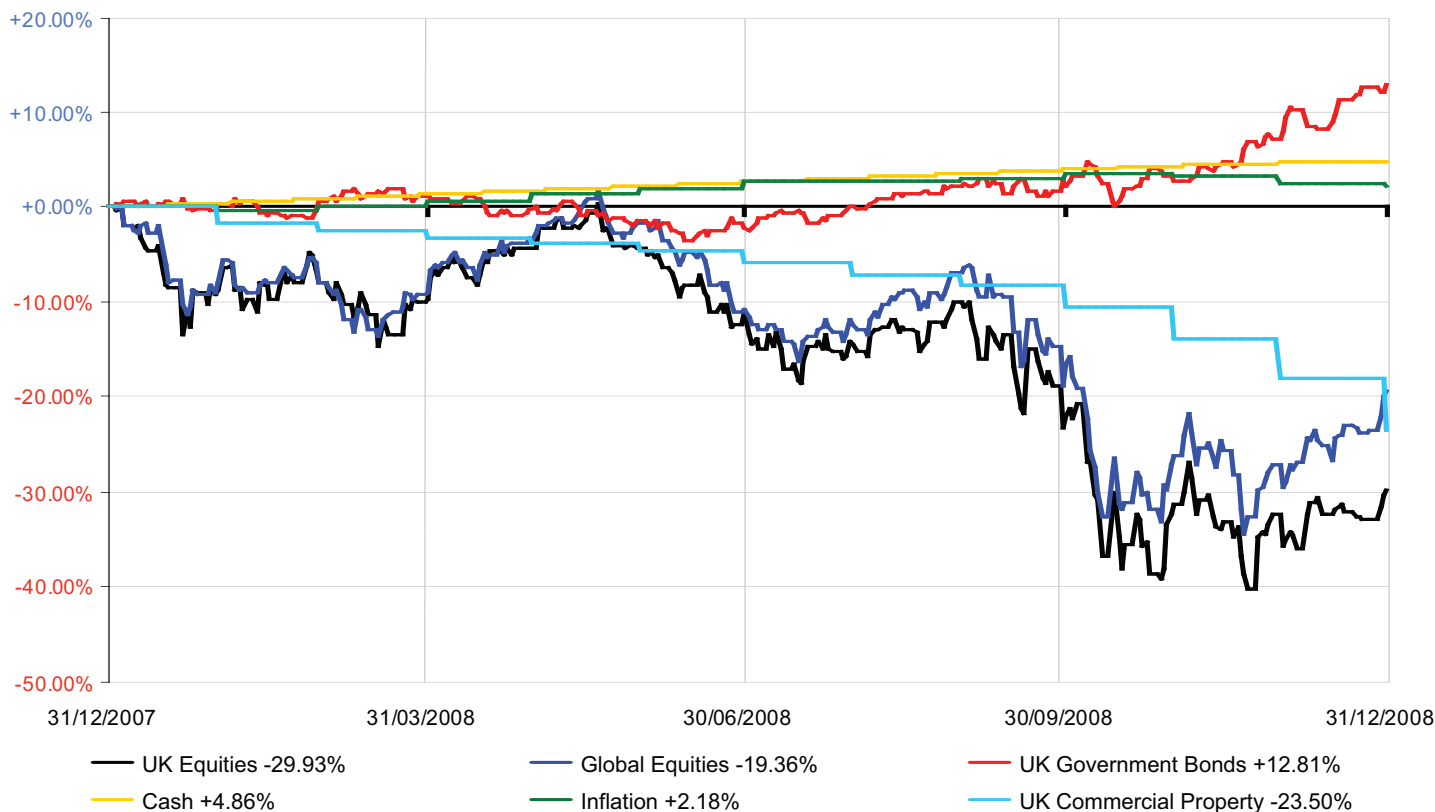


CCLA INVESTMENT MANAGEMENT LTD

Market Review of 2008

In 2008 equity and property markets declined substantially with most of the weakness coming in the final months of the year. Fixed interest securities performed better, with reasonable gains from UK government stock and top quality corporate issues. Sterling was a very poor performer on international currency exchanges. The most important themes of the period have been the loss of growth and fall into recession of the world economy, the fleeting surge of inflationary pressures and the extraordinary and profound crisis in the financial sector.

Investment market returns over the past year



Sources: Bloomberg, IPD: FTSE All-Share Total Return Index, FTSE All-World Total Return Index, FTSE UK Govt All-Stocks Total Return Index, IPD Monthly Total Return Index*, 7 Day LIBID, Retail Price Index* (*lagged a month to give a contemporaneous picture).

The period began with mounting evidence that growth momentum in the world economy was slowing as consumer spending, particularly in the US and the UK, came under pressure from tighter credit conditions. Signs of a developing crisis in the housing sector, falling manufacturing output and early indications of rising unemployment compounded these fears. The result was a crisis of investor confidence and a rush of selling which caused equity markets to fall sharply. The authorities responded with cuts in interest rates but these were seen as reactive and of an insufficient scale to stem an economic downturn where cyclical weakness was being exacerbated by powerful credit related factors. In February equity markets stabilised but this marked the start of a trading pattern where periods of moderate strength were followed by further declines, the effect, visible in the chart above, was a pattern of lower highs and lower lows. The background concerns over the strength of the world economy were aggravated in the late spring by a surge in inflationary pressures which saw raw material prices rise by 30%, UK 'factory gate' prices by 10% and sharp upward moves in the price of fuel and food. Although worrying at the time, this proved to be only a temporary phenomenon and raw material prices were soon easing back. Inflation measures, such as the RPI, rose until the autumn but then began a weakening trend which is expected to see the index declining on a year-on-year basis by the fourth quarter of 2009.

As the summer ended the dominant and most significant single event of the year, the crisis in the financial sector, came to the fore. The epicentre of events was in the United States but the UK was also heavily exposed to developments. These were of a magnitude and importance to require government intervention to provide basic stability to the sector and maintain the confidence of savers. In the UK, and in the space of just a few weeks, Bradford and Bingley had to be rescued, Alliance and Leicester agreed to a takeover by Santander and HBOS was forced into a merger with Lloyds TSB.

In the US, AIG, once the largest insurance company in the world, required government support, as did Fannie Mae and Freddie Mac, the two companies at the heart of the US mortgage system. Merrill Lynch, a giant investment bank, was forced into a takeover by Bank of America and support had to be arranged for Wachovia and Washington Mutual. As the weeks passed it became clear that major banks did not have the capital strength to withstand the crisis and sustain their key role in the economy. In the UK the government provided fresh equity to RBS and Lloyds TSB, Barclays chose to strengthen its balance sheet from private sources.

Equity markets weakened further in October and November as continued economic fears were compounded by distressed selling resulting from margin calls, retrenchment by hedge funds and customer withdrawals. In December prices rallied from very low levels but this was despite rather than because of economic news. There was a feeling that most selling programmes had been completed earlier to avoid the liquidity problems which occur in the run-up to the holiday period and year end.

Over the year the FTSE All World index gave a negative return of -19.4% to a sterling based investor but -41.8% to a one based in US dollars. The domestic equity market returned -29.9% with large companies (-28.3%) comfortably outperforming small companies (-48.3%). Sterling converted returns from international markets were: Europe, -23.8%; USA, -12.5%; Japan, -1.1%; Asia, -33.1%. Over the period the markets in Greece, Austria, Ireland and Pakistan fell by more than 50%. The returns were worse without the benefit of conversion into the weak pound. In local currencies the market returns were as follows: Europe, -42.6%; USA, -36.8%; Japan, -42.1%; Asia, -44.7%.

The commercial property sector was not immune from the deteriorating environment. Valuations fell in the early months of the year and remained under pressure throughout. A major problem was the lack of transactions which resulted from a stand-off between cautious investors and sellers unwilling to accept lower prices. This meant that valuations were increasingly untested by the usual flow of buying and selling. As the economic environment became increasingly difficult rental growth slowed and then began to go into reverse. In the final quarter the pace of decline in prices accelerated with the IPD Monthly Index estimated to have fallen by 14.5%, of which 6.5% occurred in December. The later weakness reflected continued concerns over rental prospects, tenant defaults and the availability of bank finance to indebted developers.

In contrast to the trends in equity and property markets, fixed interest performed relatively well. Supported by investors seeking a safe haven, and against a backdrop of expected and then actual interest rate cuts, government securities (gilts) were the best performers. The total return on the FTSE Government All Stocks Index was +12.8%. Corporate bonds did less well as trading liquidity in this segment deteriorated and as investors became concerned that corporate defaults would rise. The highest quality stocks gave positive returns (iBoxx Sterling Non-Gilts index AAA +7.1%) as did bonds with only a short period to maturity (iBoxx Sterling Non-Gilts index 1-3 years +5.2%) but lower rated issues and those with long periods still to run lost value.

Sterling declined substantially, particularly in the later months of the year. Investors became concerned about a number of factors including scale and likely longevity of the decline in interest rates, the relatively weak economic outlook and the huge amount of new debt which the government will be issuing in the next few years. The decline, relative to the US dollar, was 26.5% over 2008 as a whole, 18.0% in the final quarter. Against the euro the decline overall was -23.1%, of which 17.3% occurred in the final three months, and for the yen the numbers were -40.2% and -29.9% respectively.

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