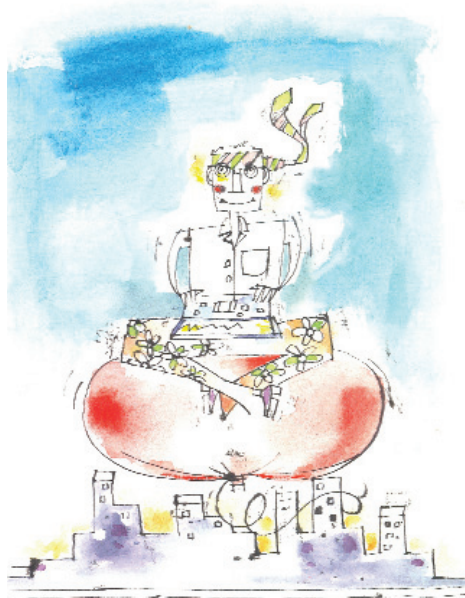


Groovy Baby?

The 1980s and 1990s were the best times to invest in stocks and bonds, particularly US stocks and bonds, in a century. The reason was that growth was strong and inflation fell persistently over the period. But today is not the 1980s and 1990s. In this issue of *Fundamentals*, Julien Garran, LGIM's chief investment strategist, suggests that global conditions are much more like the 1950s and 1960s, a period that was groovy to begin with, but ended in inflation. Julien seeks to answer the most fundamental investment question of all, could we see inflation emerge again?



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Swinging again

Earlier this year, Larry Summers highlighted a remarkable fact. We have just experienced the strongest five year period of global growth in all of recorded economic history. Such an extraordinary outcome suggests some extraordinary causes and extraordinary they are.

The initial cause was unprecedented policy loosening in the US. This happened in two ways; Firstly, the Fed cut rates to an all-time low of 1% as resource utilisation collapsed during 2001 and 2002. Secondly, the US

current account deficit exploded by five percentage points from 2000-2007 as the US consumer boosted demand for imports.

This generated booming growth but low inflation. The difference between this boom and previous booms was the starting point. Resource utilisation (that's an average of capacity utilisation and the employment rate) was at its lowest in more than 20 years (see Figure 1). That meant that the economy could accommodate a lot of growth before it started to generate inflationary pressure.

US RESOURCE UTILISATION VS CHANGE IN US RATES

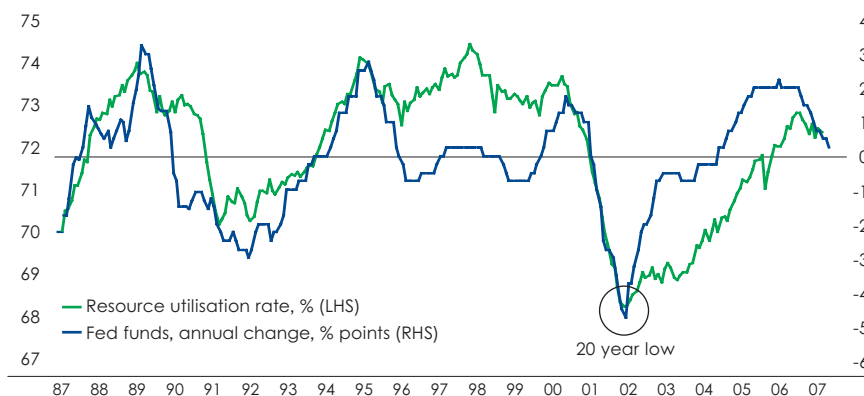


Figure 1

Source: LGIM, Bloomberg

US NOMINAL GDP GROWTH VS BOND YIELDS

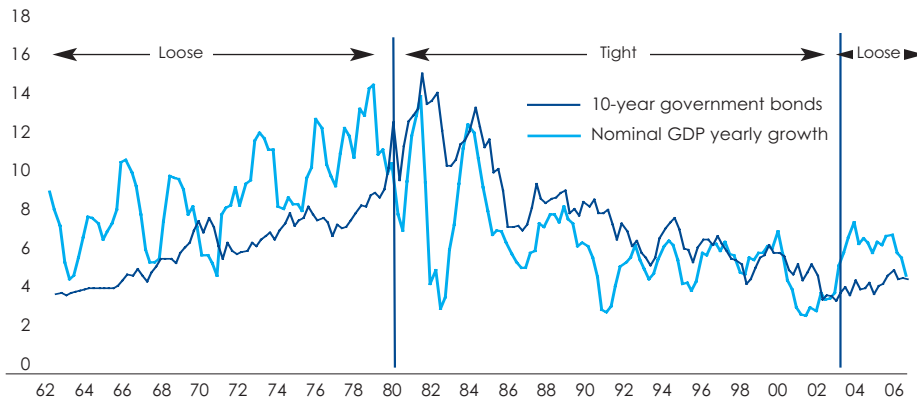


Figure 2

Source: LGIM, Bloomberg

So the boom continued and with a lag, it inevitably started to generate inflationary pressure. The Federal Reserve (Fed), just as inevitably, raised rates. This is where things started to get interesting, because the global macro economic template of the 1990s simply stopped working.

In the 1990s, whenever the US raised rates to head off inflation, it blew up an emerging market. From the former Soviet Union at the beginning of the 1990s, to China and Mexico in 1994, the Asian economies in 1997, and then Russia in 1998. At no time in the 1990s were all the global economies growing.

This had a profound effect on capital markets. The US went through a fantastic deflationary boom, strong growth with mild inflation. As the dollar strengthened in the late 1990s and as commodity prices slumped, the US saw a powerful improvement in the prices of its exports vs its imports. Consumers were better off and increasingly confident. The resulting deflationary boom of the 1990s proved the perfect time to own US stocks.

One thing is clear. This is not the 1990s. It's almost the opposite. The Fed's interest rate hikes from 2004-6 blew up a very different emerging market, US subprime.

That means the Fed is not in a position to raise rates and induce a deflationary bust in an emerging market. Instead we see downward pressure on the dollar, upward pressure on import prices and slowing productivity growth in the US.

If the global environment isn't like the 1990s, what is it like?

We think it's most like the 1960s. Here's why. The last four to five years has been the first sustained period since the early 1960s that bond yields have remained below nominal GDP (see Figure 2). This is the diametric opposite structural position to that in the 1980s and 1990s. Then, growth rates spent most of the cycle below bond yields. It was a period of sustained disinflationary pressure. A period when inflation expectations became anchored at lower and lower rates.

But compare this with the early 1960s. Then, as now, bond yields spent most of the cycle below nominal growth rates and corporate cashflow yields were very high, providing a further source of liquidity to fund growth.

That was at first a reflationary and then an inflationary period. The 1950s and 1960s were a remarkable period for Germany and Japan. Barry Eichengreen, in his new book 'The European economy since 1945' describes the golden era of the German economy. He characterises the growth as 'extensive', driven by powerful growth in industrial investment and rapid productivity catch-up with the United States. The German State institutions aided this growth immeasurably through their distribution of the latest training manuals, its command system driving industries into desired areas of development and its management of the social contract

between workers and the owners of capital. The growth in Japan was very similar, also 'extensive' and characterised by strong growth in the capital stock, rapid productivity catch-up, and the ever present guiding hand of MITI (the Ministry of International Trade and Industry).

In many ways, this growth model in Japan and Europe in the 1960s is evident in China today. We see incredible capital growth and powerful productivity catch-up. We also see the guiding hand of the Ministry of Development, which is driving infrastructure growth as well as setting incentives via import and export tax incentives, and directions on bank lending by sector.

A key question, then, is when did the economic model that worked so well in Germany and Japan in the 1950s and early 1960s start to go wrong? The answer is when the style of growth no longer matched the institutions. Eichengreen describes the transition from a need for 'extensive' growth as Germany and Japan rebuilt after the war and then caught up with US production techniques embodied in the new 'oil' economy', to the need for 'intensive growth'. This, he argues, is growth driven by innovation. Perhaps the best example of this is Silicon Valley in the 1990s. It is very clear that the cultures of Germany and Japan in the 1950s and 1960s were almost the opposite of the freewheeling managements of the Silicon Valley entrepreneurs. Indeed, Germany and Japan struggled to adapt to the more subtle incentives required to promote an innovation led economy. This struggle manifested itself in inflation.

When do we start to worry about China? Perhaps, as Alan Greenspan has suggested, when the pace of rural migration slows down. One of the major arguments against a re-emergence of inflation is the productivity boom in emerging markets.

EMERGING MARKETS PRODUCTIVITY GROWTH

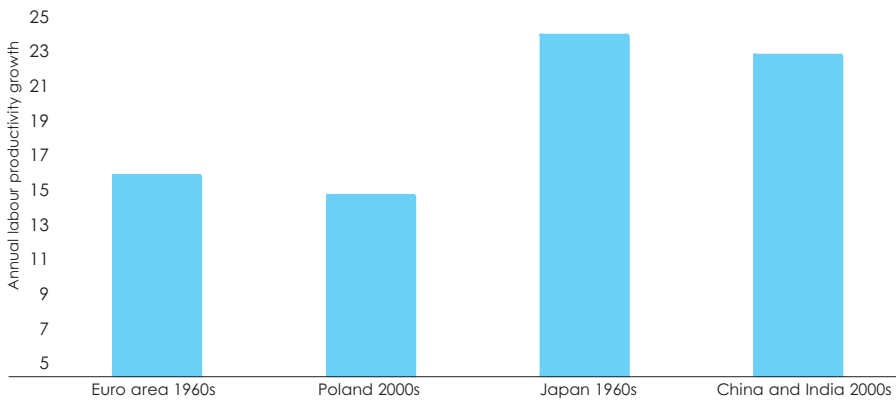


Figure 3

Source: LGIM, Bloomberg

Figure 3 shows the current productivity growth in selected emerging markets, and in the emergent markets of Europe and Japan in the 1960s.

This is vitally important, as emerging market productivity growth is very helpful in elongating the cycle. This is because productivity growth acts as a buffer between input prices, which rose in the 1960s and are rising now, and consumer prices.

Now look at the 1960s. The emergent economies, Japan and the euro area were seeing fantastic productivity growth. In fact productivity in Japan and the euro area grew faster than it is growing in China, India and Eastern Europe today.

What comes through clearly is that, while emerging market productivity growth in the 1960s delayed the pass through of inflation from resources to end prices, it was not enough to prevent it.

So the existence of strong productivity alone is no proof against inflation. If we are to argue that the current pattern of global growth is inflationary, where should we look for signs that we may be right? I think there are two key places; the labour force and global capital flows.

Inflation-a-go-go?

Now, one of the remarkable macro developments of the mid-1990s was that the US operated with high resource utilisation, but it generated relatively little inflation. This allowed the Fed to follow a relatively accommodative policy from 1995-1999. At

the time, many thought that the productivity gains from the internet revolution had rewritten the relationship between growth and inflation. As inflationary pressure built during 1999, it was clear that this theory was wide of the mark.

We are hearing a similar chorus again. But this time the argument is that globalisation will prevent inflationary pressure. We wonder whether the inflation doves may be falling into a similar trap. This is because whatever the proximate cause of inflation, the transmission is always through rising wages. At 70% of corporate costs, it is wages alone that make or break inflation.

Some argue that, in the new service dominated economies of the 2000s, inflation is dead. There is less unionisation, jobs are less homogenous, but skills are much more easily transferable between different jobs. All this suggests that it will be much harder for white collar workers to

insist on rising wages than was the case for their blue collar parents in the 1950s and 1960s. We wonder whether perhaps a different inflationary mechanism is at work. In a service based society it costs much more to lose an employee as many more diverse skills have to be learnt over time on the job and as the costs of interviewing skilled workers is so much higher. So while a workforce may not be able to threaten to down tools to get a pay rise, an individual can apply for a better paying job somewhere else. When labour markets are tight, the 'fluidity' of the workforce can work against the employer. The employer has to raise wages to stop their employees from wandering.

Perhaps the best current example of this is India. There we see wage growth among software engineers is running at 30%. There have been no strikes to mention. Just strong demand and a fluid but highly utilised workforce.

Now let's go back to the US, which has just experienced a year of sub-trend growth. Surely wages are under much better control than they were in the 1990s? We don't think so. With our new understanding of wage growth in a service economy, it is not so much the current level of employment that matters, it is the length of time the labour market has remained tight. The longer a labour market has remained tight, the more companies are forced into a bidding war for employees and the more confident workers are to put themselves up to the highest bidder.

CUMULATIVE LABOUR MARKET TIGHTNESS

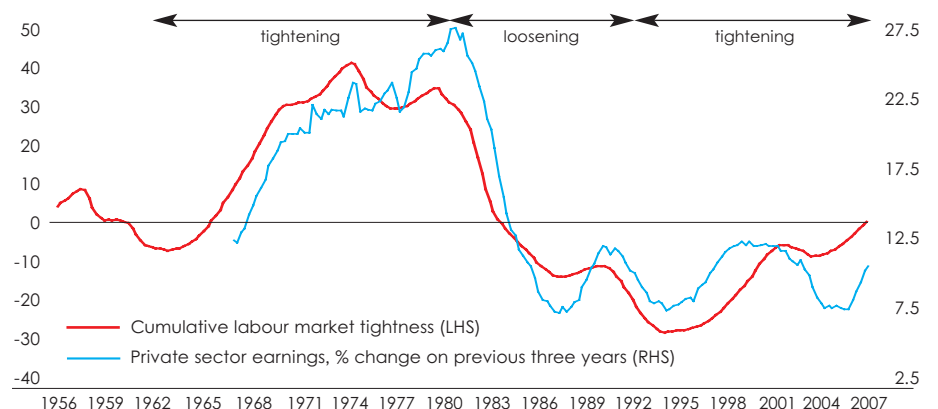


Figure 4

Source: LGIM, Bloomberg

Figure 4 shows what has happened in the US. The recessions of the early 1980s and early 1990s ‘reset’ labour market tightness, so that cumulative labour tightness and consequently wage pressure, never really started to bite until the end of each decade.

But the ‘quasi’ recession in 2001 never really reset the labour market because the Fed’s aggressive interest rate cuts supported a housing boom and consumer re-leveraging. So this decade, the labour market is already tight just past the halfway mark of the decade. That implies that the most powerful driver of inflation, wage growth, may generate problems earlier in this decade than in the past two.

Oil flows

A second potential cause of inflation is a change in capital flows. Oil flows were almost non-existent in the 1960s. In the 2000s they are all important. In our view, the impact of oil has been asymmetric since 2002. As oil prices started to rise from early 2002, this led to sharp rises in reserves among the major oil exporters; the Middle East and Russia.

These reserves typically went into paying off debt, and buying debt in the US, Europe and the UK. Warnock & Warnock, two Fed researchers, suggest that these capital flows, combined with those generated by Chinese exporters, are a major factor behind Greenspan’s ‘bond market conundrum’, the fact that bond yields are so low, relative to short rates and to growth. The oil exporters apparent conservativeness in importing (in stark contrast to the conspicuous Middle Eastern consumption boom of the 1970s) had the effect of dampening yields and easing global monetary conditions.

This position is changing. We are now seeing a powerful lagged increase in imports into the oil exporters. Russia and the Middle East are building up their infrastructure, and their commercial capital base, aggressively. Figure 5 shows the oil price, OPEC exports (which, unsurprisingly, track quite closely) and

OPEC IMPORTS, EXPORTS AND THE OIL PRICE

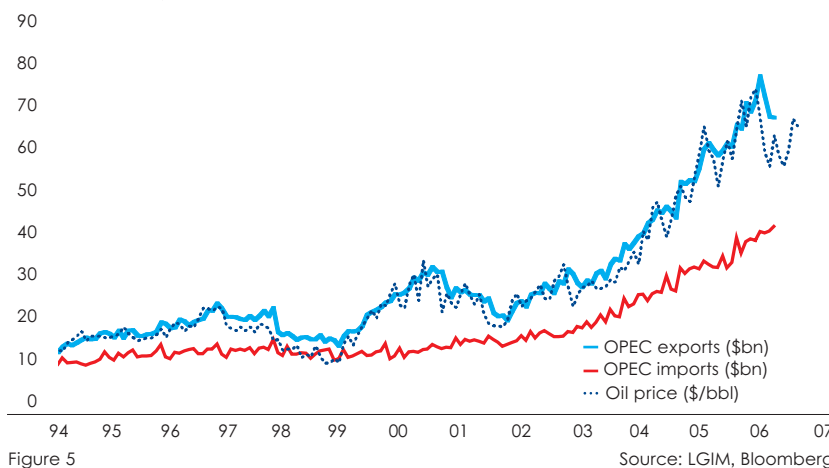


Figure 5

Source: LGIM, Bloomberg

OPEC imports. OPEC imports are now rising aggressively.

This is very significant – as it means that there will be much more competition for capital; with real investment taking a bigger slice, while financial capital takes a smaller one. That is a recipe for resource constraints and higher rates.

This infectious growth environment will, in due course, strain the world’s resources and cause inflationary pressure to build. When it builds sufficiently, it will be unequivocally bad for risk assets.

Investment recommendations

In a nutshell, rising inflation and good investment returns don’t mix. Figure 6 shows that the rating on the US equity market, the price to earnings ratio, has a powerful inverse relationship with inflation. So we would argue that, of all

the macro indicators, a call on inflation is the most important in driving expectations of returns.

So should we end it there and conclude that we face a greater inflation, convert all our assets to gold and come back in 20 years? No. In our view, the world economy will enjoy a state of grace for some time yet. Not least because rents, which provided a major boost to US inflation over the last three years, are now clearly turning down.

So, how do we invest in an environment such as this? We believe that it is right to be structurally long of risk, particularly equity and short of bonds. But we think that the global risk trade needs a new engine.

As the world recovered from its brush with deflation in 2002, it was Carry that

US INFLATION VS THE S&P HISTORICAL 500 PE

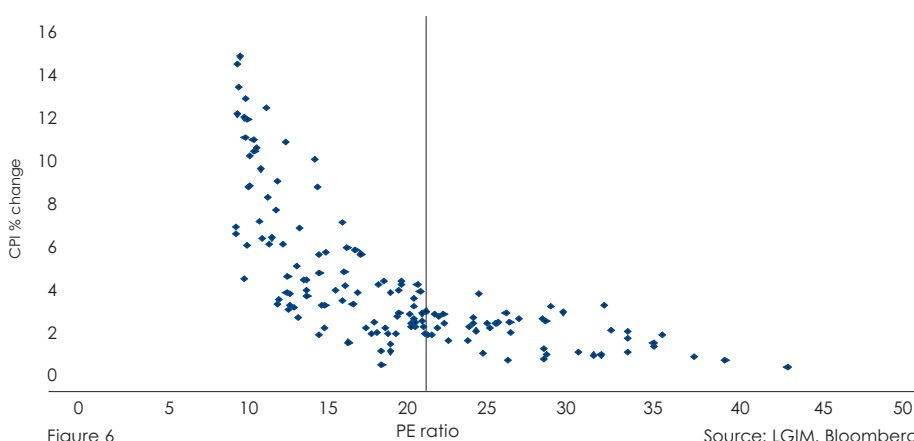


Figure 6

Source: LGIM, Bloomberg

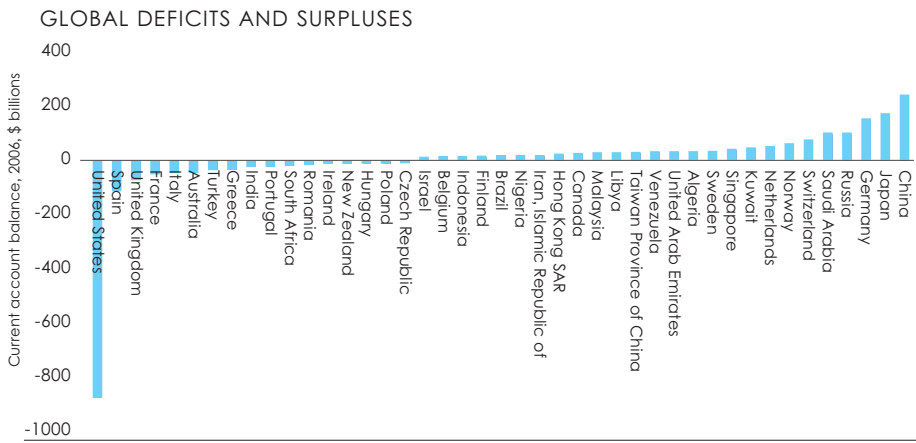


Figure 7

Source: LGIM, Bloomberg

funded the risk attraction trade. Carry from borrowing short and lending long. Carry from borrowing Yen and buying in dollars, sterling, Kiwi or Euros. Carry from borrowing anywhere and buying rights to corporate free cashflow yields, or equities to you and me. Or buying the benefactors of strong global growth, the emerging markets and the commodities.

But in the world we envisage, these carry trades will become harder and harder to

play. Higher risk-free interest rates will starve them of oxygen. Already it is no longer profitable to borrow short and lend long.

Instead we think that it will be a major shift in asset allocation that will drive the next leg of the risk trade. We are already seeing the first signs of that. Of the world's 10 major surplus countries (see Figure 7), seven have either formed, or recently announced, sovereign wealth

funds. These funds are modelled on the Government of Singapore, Adia (Abu Dhabi), and the Norwegian oil stabilisation fund. They seek to use these countries' burgeoning current account surpluses. Stephen Jen, of Morgan Stanley, estimates that there is currently \$2.3trn in these funds, and that they will be growing at \$500bn per year. This is significant relative to a US current account deficit around \$800bn.

A second source of asset allocation shift is the corporate sector, combined with private equity. Last year, US corporates returned 9% of market capitalisation to shareholders, through a combination of dividends, cash buyouts and buybacks. Recent data suggests that buybacks are currently running at around 50% higher than last year.

So we don't think that the bull market is over. But above all, we watch inflation, and the causes of inflation, for clues as to the next big move in markets.

Market Overview

US economy strengthens

The March to June rally in world equities will go down in the history books as large gains were made globally. Yet all things must come to an end and at the beginning of June overheating in the world markets caused a 30bp sell off in 10 year US treasuries, the largest move in over a year. Yields on the 10 year US treasuries broke above five per cent, last seen in August of last year, breaking a 20 year downward trend in bond yields. Stronger economic data coming from the US eased pressure on the Federal Reserve to cut interest rates and consensus forecasts now predict a holding of interest rates.

The move in the bond market caused jitters in the European and American Equity markets with most markets selling off in the region of 4-5 % from yearly highs. The utilities sector was the worst affected by the sell off, while the Energy sector paced the fall.

Emerging markets were not too badly affected by the bond market sell off as they had sold off heavily the week before as China stepped in to triple stamp duty on shares from 0.1% to 0.3%.

London

Massive Mergers

The UK equity market put in another impressive performance in May posting a total return of 2.8%. For the second month running the FTSE 100 index outperformed the broader market with a total return of 3.0%, whilst mid and small cap indices lagged with returns of 1.8% and 2.3% respectively. At the sector level Mining was the strongest performer boosted by rising commodity

prices, strong corporate results and takeover speculation. Conversely, Pharmaceuticals had another poor month due largely to safety concerns surrounding GlaxoSmithKline's leading diabetes drug, Avandia. General Retailers were also poor after weak retail sales data and disappointing trading updates for sector bellwethers, Next and Marks & Spencer. Corporate activity showed no signs of abating. Hanson agreed to a takeover from Heidelberg Cement, EMI received a bid approach from private equity firm, Terra Firma and Reuters agreed to a merger with Thomson Corp of Canada. We believe the fundamentals for the UK stock market remain sound, valuations continue to appeal and further corporate activity is in prospect.

Wall Street

Economy Acceleration

The S&P 500 was up 3.25% during May. Investor sentiment has been buoyed by better than expected earnings and economic data. Telecom services, Energy and Materials were the best performing market sectors.

The ISM Manufacturing Survey confirmed a turn in industrial activity. New order growth and production accelerated over the period. The Federal Reserve left interest rates on hold and reaffirmed concerns about the level of inflation.

The retail sector has suffered in recent weeks due to slower than expected sales. While the 3 month trend is only marginally worse than expected, unfavourable weather conditions and the housing slowdown impacted apparel and home improvement retailers. A housing induced slowdown in consumer spending has been a source of concern for economists. The negative impact of slower housing activity has so far only manifested itself in housing related categories. Investors are likely to focus on incoming economic data between now and the start of second quarter earnings. Analyst expect the S&P 500 to grow earnings 5% (year on year) during the second quarter.

Europe

Hello Sarkozy

Continental European equity markets have flirted with year highs, before profit taking after the US bond yield rose significantly. The gains up to this point were driven by excellent underlying economic strength as the low level of European interest rates finally bore fruit. Add to this a healthy level of corporate activity, with mergers and acquisitions in many sectors of the market, from banking to cars via all industries in between, and it is clear to see the solid foundations for market strength. There has also been a potentially positive shift in the political landscape of Europe, with the election of Nicholas Sarkozy as president of France. Having lagged behind the corporate and social restructuring that is starting to take effect in Germany, it may be

that France follows suit in the coming years, improving public sector finances and corporate sector efficiency.

Looking ahead, the key concern for markets will be the extent to which the ECB raises interest rates: given the current strength of demand, the sharp falls in unemployment rates across the region and the increases in asset prices, inflationary pressures can be expected to build. Some deflation will be imported from emerging countries, but we believe policymakers will be obliged to tighten progressively in the coming months. Thereafter, it will be the balance between higher borrowing costs and moderating demand that will determine whether European equities can sustain their excellent performance of the last twelve months.

Japan

Market still Lagging

Japanese equities, which have lagged the other major markets, started to stage a catch-up rally on slightly more encouraging economic releases. Cyclical stocks remain in the lime-light as beneficiaries of currently strong global growth. Defensive sectors in Japan including utilities have continued to lag.

Japanese government bond yields have soared alongside US treasuries, in recent weeks, as the market prices in rate hikes. However, inflationary expectations are to be welcomed in Japan, which continues to see mild deflation. It will also be difficult for the Japanese authorities to push through a rate hike ahead of the upper house election in July, and with a lack of inflation forecast for the rest of 2007. The upcoming election will become a focal point for the market as Prime Minister Abe's popularity has seen a sharp decline in recent months, leading to greater uncertainty for the ruling Liberal Democrat party and their ability to push through reforms.

Pacific Basin

Chinese Roulette

In May the FTSE AW Asia Pacific ended the month up 5.7% in sterling terms. Regional leaders this month were the Philippines up 11.1%, South Korea up 10%

and China up 9.8%. Elections in the Philippines Senate and House of Representatives resulted in President Arroyo gaining sufficient support to complete her presidential term and pursue reforms. Large domestic inflows of over 2.5bn US\$ boosted South Korean equities this month. China's domestic exchanges were booming in May prompting the central bank to tighten; it raised the one year benchmark lending rate to 6.57% from 6.39% earlier and will allow the RMB to appreciate at an increased daily rate of 0.5% (versus 0.3%).

Australia and Hong Kong underperformed the index but were up 2.9% and 3.7% respectively. Australian equities have paused for breath after a strong run in materials, the Australian dollar and target companies for private equity funds. Hong Kong's progress was influenced by fears over the impact of Chinese monetary tightening.

One of the major pre-occupations of external investors is currently the parabolic rise in the Shanghai A-share stock market. Having watched share prices quadruple in less than two years, in recent weeks over 100,000 Chinese have been opening trading accounts every day and, in a nation where the cultural urge is to gamble, the stock market has sometimes come to resemble a casino.

The economy is performing very strongly with real growth in the second quarter expected to be a sizzling 11+%. It is now expected that the central bank will continue to gradually tighten the banking system's capital asset ratios and push rates up by a further 54bps over the next 6 months. However, given the lack of alternative asset classes, it appears likely that the market will remain well supported provided that interest rates rise in an orderly manner, as deposit rates remain low in absolute and real terms. The key piece of data that could undermine this picture is inflation.

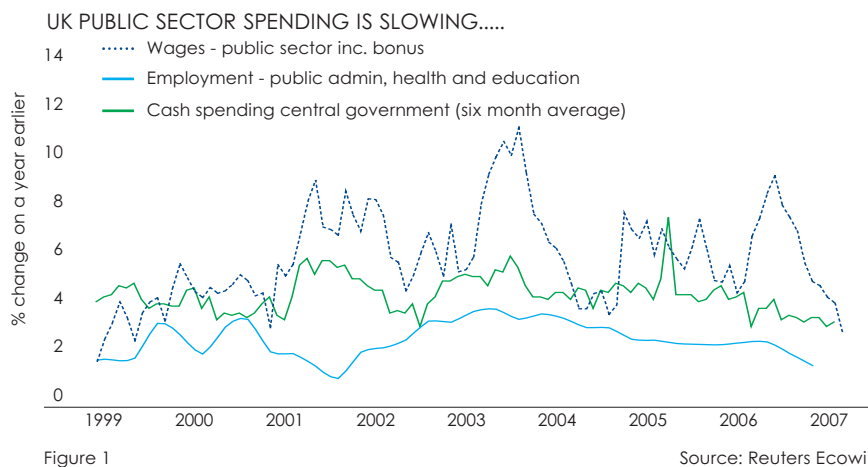
We believe that it is the management of the Chinese economy that is key to regional sentiment. Essentially if the Chinese economy were to squeeze the rest of the region would catch pneumonia. However, given our current confidence in the Chinese economy to easily withstand any sharp stock market fall, we feel that the region's markets will continue to climb this wall of worry.

Snapshot

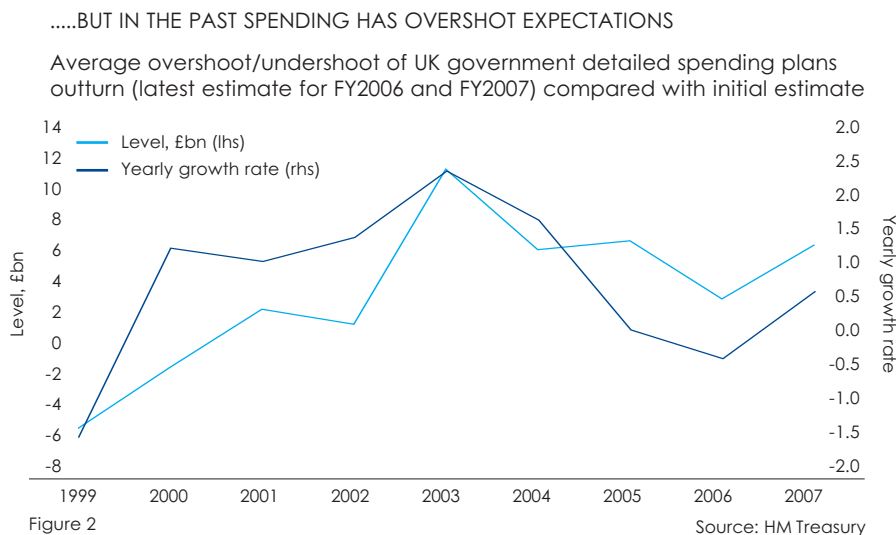
The man who cried prudence

In recent years, rapid public sector spending growth has made an important contribution to UK economic growth. But public sector spending now appears to be slowing and this could subdue economic activity. Weaker public sector wage inflation and employment growth could depress consumer spending against a backdrop of higher interest rates. But the downside risks to public spending could be limited. In his March budget, Gordon Brown actually revised up his spending forecast for this year by £4bn (0.3% of GDP). This continued the trend of the past decade, where spending has consistently overshoot expectations.

Monthly government spending data are erratic. But if we smooth the data, spending is currently growing by around 3% YOY, down from 5% a year earlier. This slowdown concurs with other data. Public sector wage growth has fallen to 3% YOY from just over 4% a year ago and a proxy for public sector employment (public admin, health and education) is currently growing by 1.25% YOY, down from just over 2% a year before (Figure 1).



In our economic forecasts we cautiously assumed that spending slows further. But the risks appear to be to the upside. Spending could actually reaccelerate. In his March Budget, the Chancellor announced that he intends to increase spending by 6.2% YOY in FY2007, up from an original estimate of 5.6% and stronger than FY2006's 5.5% growth rate. Over the past decade public spending has overshoot the forecasts that we made two-year's prior by an average of £3.4bn and the YOY growth rate has come out an average of 0.7% faster than originally anticipated (Figure 2). Of course, the Chancellor promises to slow spending further from FY2008 and beyond, to a 4.5% growth rate. But with a general election due against a revitalised opposition, it is unclear whether that slowdown will be delivered.



Views Commentary

Rate fears continue

	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	3.30	2.90	3.00	2.70	6.50	7.00	5.30	-	6.00	6.00	2.11	2.13	0.67	0.68	7000
Citigroup Smith Barney	-	-	3.00	2.80	5.30	6.60	5.43	5.35	5.75	5.75	2.00	2.00	0.66	0.67	6800
CSFB	2.80	2.60	2.90	2.90	-	-	-	-	5.75	5.75	1.95	1.90	0.69	0.69	6800
Deutsche Bank	2.40	1.90	2.70	2.20	6.20	7.70	5.40	-	5.75	-	1.88	-	0.72	-	6700
Goldman Sachs	2.50	2.80	2.70	2.70	5.00	8.50	5.20	5.00	5.75	5.50	1.95	1.95	0.69	0.71	6833
HSBC Securities	2.50	2.20	2.40	2.20	7.00	5.00	4.70	4.60	5.75	5.25	1.93	1.83	0.72	0.74	7000
JPMorgan	2.30	-	2.90	2.80	-	-	-	-	-	-	-	-	-	-	-
L&G Investment Management	2.60	2.40	2.90	2.60	8.00	8.00	5.25	5.25	5.75	6.00	2.00	2.00	0.69	0.69	6750-6850*
Merrill Lynch	3.10	2.60	2.80	2.30	6.00	8.00	4.40	-	5.75	5.25	1.97	1.82	0.69	0.71	6750
Morgan Stanley	3.40	2.80	2.40	2.30	6.00	6.00	5.30	5.30	5.25	5.25	1.91	1.79	0.67	0.67	6550
UBS	2.60	2.80	2.70	2.60	4.40	9.40	5.20	5.25	5.75	5.50	1.93	1.88	0.70	0.71	7000
Median (ex L&G Inv Mgt)	2.60	2.70	2.75	2.65	6.00	7.35	5.25	5.25	5.75	5.50	1.95	1.89	0.69	0.70	6800
Last Month	2.50	2.65	2.80	2.55	5.20	7.00	5.00	5.15	5.50	5.50	1.91	1.88	0.69	0.71	6750
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 have raised their interest rate assumption for the end of 2007 for the second month in a row. They previously expected the Bank of England to hold rates steady till the end of the year but now expect a 25bp rise, falling back in 2008.

Higher rates of course affect the currency markets and alongside the higher interest rate forecast, respondents have also revised up their forecast for the pound against the dollar.

Estimated earnings growth has also increased this month from 5.2% to 6.0% for 2007. RPIX was revised up after falling last month and now stands at 2.6% from 2.5% for 2007.

For further comment on Fundamentals, or for additional copies, please contact Harriet Moore at harriet.moore@lgim.co.uk
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