

## Mixed messages

Looking back, it's not too difficult to attribute the roller coaster ride equity market returns have demonstrated during the past two calendar years. In 2008, markets went into freefall as the global economy sank into deep recession and a credit crisis swept through the financial system. In 2009, markets bounced back as policy makers responded with force and signs of improvement emerged. The first half of 2010, however, has been particularly perplexing. Despite the global economy returning to growth and strong corporate earnings results, equity markets have declined as political uncertainty has shaken investor confidence. In this edition of Fundamentals, LGIM's Equity Strategist, Georgina Taylor, explains the conflicting forces shaping equity markets and what is likely to be in store for the remainder of the year.

### Trying to fit a square PEG into a round hole

There has been a marked increase in the level of equity market volatility during the past few months (Figure 1). This will not come as a surprise to anyone who has been watching recent news headlines. Each day investors have been charged with processing a plethora of conflicting messages – from positive economic data and survey results to concerns surrounding

political tensions, election uncertainty and sovereign defaults. For investors accustomed to evaluating equity market opportunities based on more traditional measures (such as price earnings ratios, profitability, company growth prospects for example), these types of externalities create significant uncertainty and attempting to make sense of recent movements can at times feel like trying

to fit a square peg into a round hole. In broad terms, the rise in financial market volatility can perhaps be rationalised by the conflicting signals coming from three core sources of information – Politics, Earnings and Growth. There have been some periods of significant strength yet equity markets are currently lower than where they began this year despite very good earnings news flow and economic data which have broadly



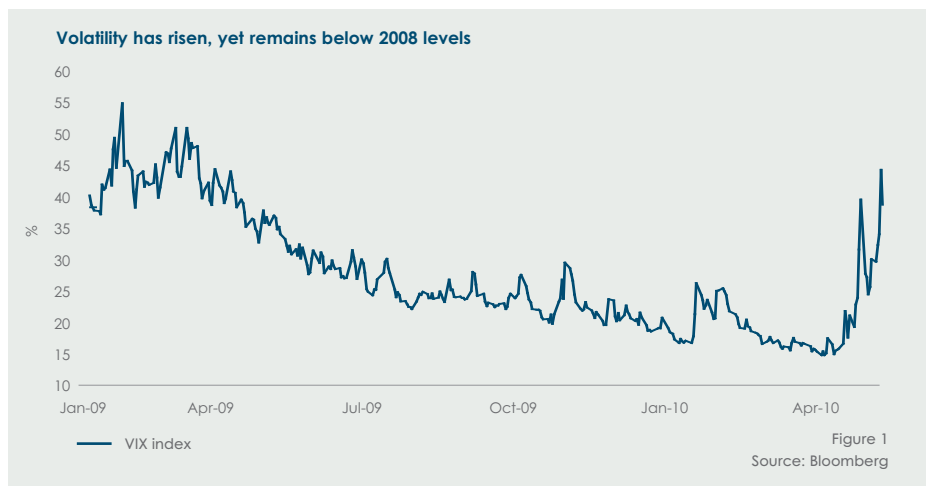
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surprised market participants with their strength. This suggests uncertainty surrounding the fiscal and political backdrop has dominated market performance and has temporarily changed the landscape for investing in financial markets. In order to understand why there have been such mixed signals, we will now look at each of these three areas in more detail.

### Politics

Politics have started to play an ever more dominant role in determining financial market movements during recent months. For domestic equity investors, the two key sources of political uncertainty have been in regards to Greece and the UK.

### Part I – Greek tragedy

The Greek debacle has brought the future of the Eurozone to the fore and been a major headwind for financial markets. The main issue here is in regards to the size of their deficit and the way in which it has and will be financed. An olive branch has been offered from the European Central Bank (ECB), however this is only a temporary solution and it comes with strict conditions attached, requiring Greece to reduce the size of its deficit over the next couple years.

With many European banks heavily linked to Greece through their holdings of Greek government bonds (Greek debt), policy makers in a number of developed European nations have had to make a decision over whether to support the Greek

government directly, or ultimately have to help the banks of other Eurozone countries who have lent money to Greece. Politically perhaps, it appears that it has been easier to help support Greece directly.

The impact on financial markets has been both direct and indirect. Firstly, Greek equities have underperformed and Greek bond yields have moved considerably higher (Figure 2). Another direct consequence has been the sharp devaluation in the Euro.

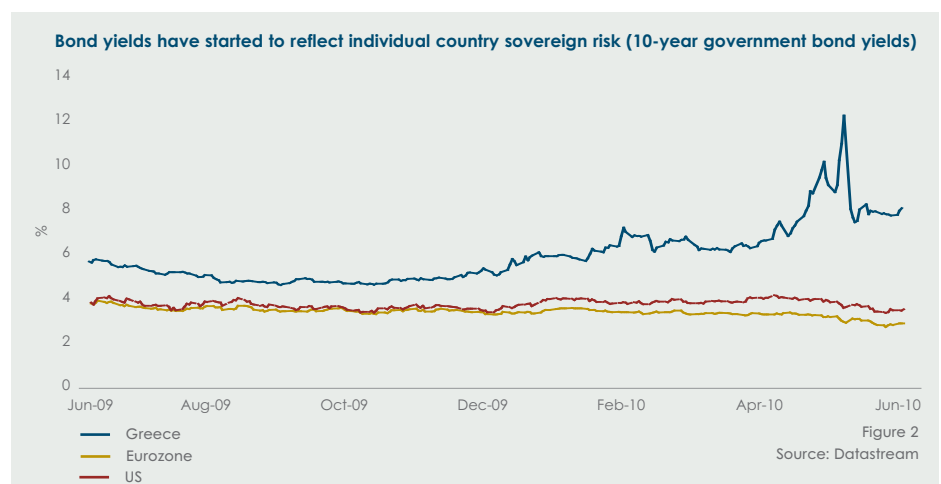
The indirect effect has been the overall impact on investors' risk appetite. Equities performed poorly at the beginning of May as the Greece issue unravelled and memories of 2008 came back to haunt markets. The crisis sparked by the collapse of Lehman Brothers is still raw in many investors' minds. As a result, just the suggestion that money markets and

bank financing may again freeze-up, prompted investors to switch away from equity markets towards the relative security of bonds and cash. Unfortunately this is an issue which will probably be with markets for the next few months as the ongoing global fiscal concerns are addressed.

These events hold a couple of key consequences for equity markets. Firstly, a two-speed Europe appears inevitable. If Greece remains in the Euro, policymakers cannot allow a devaluation of its currency to aid economic recovery – a typical response to this type of crisis – therefore growth will remain very weak as the austerity measures imposed by the ECB are implemented. At the same time Eurozone policymakers will likely have to keep rates on hold to help support the economically weaker countries such as Portugal, Italy and Spain alongside Greece. As rates stay low and the currency remains weak, exporting countries such as Germany and France are likely to see an acceleration of growth and the growth differential between them and the rest of Europe will continue to widen.

### Part II – the UK sets the stage for longer term adjustment

In the run up to the UK election, uncertainty surrounding the outcome dominated markets. Now that a coalition government has been put in place there are many grey areas surrounding which policies from each manifesto will now be implemented and how. The budget has been announced and



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once this is out of the way, consumers and the corporate sector can take a longer term view on the UK economy and make important decisions regarding both saving and investment. The implication for equity markets in this regard comes most directly from the influence of the value of sterling. Sterling has been relatively volatile year-to-date and in our view is likely to remain weak until there is a clear path and plan of action to reduce the UK's deficit.

Recent events have also reintroduced the impact of country influences on any investment decision. The relative outperformance of the German equity market (as measured by the DAX index) is a clear reflection of the importance of picking relative winners and losers against a backdrop which is likely to remain export friendly and where monetary policy will remain incredibly loose for an extended period of time. This is a key time to remember that the market is not the economy (as discussed in the March edition of Fundamentals, "Navigating Unpredictable Markets") and therefore for many parts of the UK and European equity markets, a weaker currency may be a welcome boost for competitiveness (Figure 3).

### Earnings

Through this period of political uncertainty, earnings releases from companies have generally come as welcome positive surprises for financial markets. The first quarter earnings season surprised analysts in regards to the strength of the results and importantly these surprises have been for both earnings and sales. This is important when thinking about the sustainability of the profits recovery. Throughout 2009 earnings improvements were greater than expected, however they were driven by dramatic cost cutting by corporations trying to remain in business through the severe economic downturn, not by increased sales. Cost cutting can obviously only go so far in boosting profits of companies, therefore, sales growth had to kick in again at some point.

However, despite positive news regarding corporate earnings, equity markets have been falling. To best understand why, it is vital for investors to understand how earnings news is processed by financial markets. In aggregate, the market moved from huge downgrades throughout 2008 and the first part of 2009 to a period of analysts beginning to upgrade their profits forecasts during 2009 which led to the impressive rally in equity markets from March 2009 lows. However equity markets are forward looking. At the beginning of this year expectations from the average market participant ("consensus") had already started to reflect a fairly typical cyclical recovery in profits in both 2010 and 2011. Based on these earnings numbers, markets were trading at around average valuation levels (based on traditional price-to-earnings ratios) implying that it would take something very significant for markets to move any higher from those levels (Figure 4).

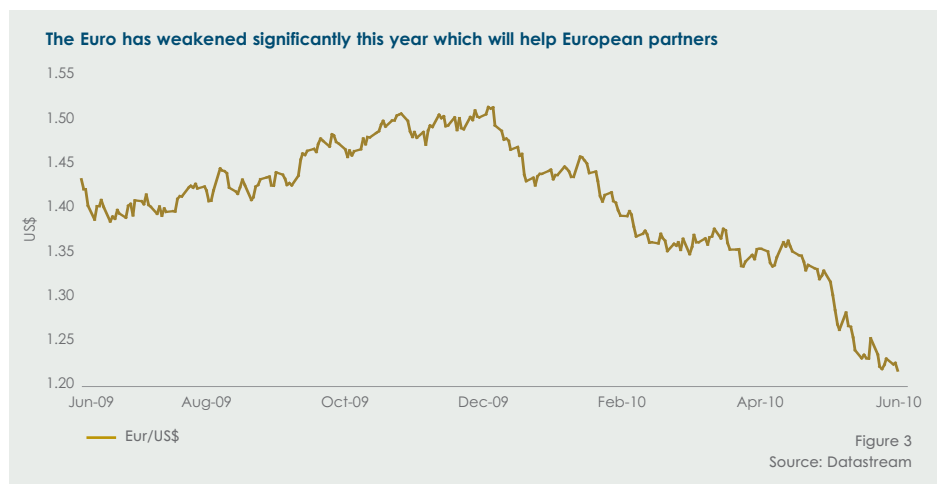
Since market participants re-rate earnings, (i.e. place a higher value on the future cash flow of a company or companies) if there is visibility and confidence in that earnings stream the converse is true when there is a high level of uncertainty. This has been the case with investors ultimately questioning the future of the Eurozone as an economic and fiscal union.

In addition to the fiscal risks in Europe, the outlook for earnings and how we value the earnings stream in aggregate at a market level will also be significantly hampered by

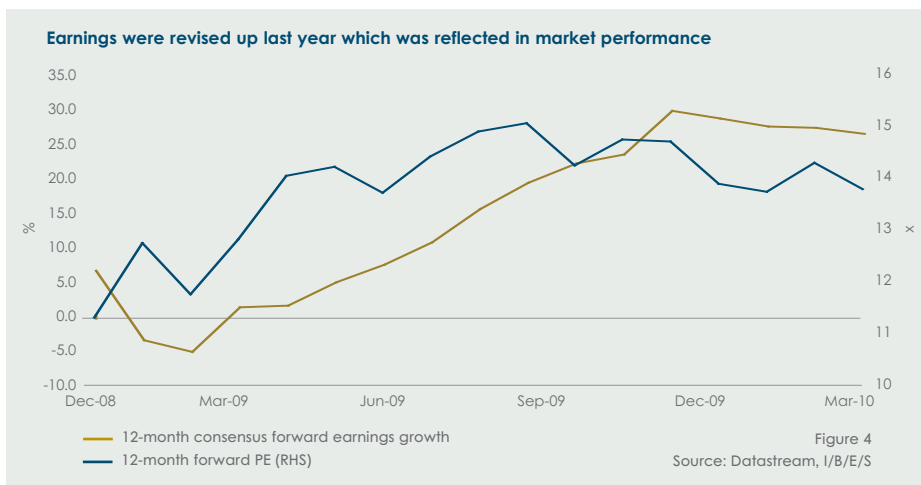
the outlook for financial regulation and its impact on future financial sector profits growth. It appears financial regulation can only go one way and therefore we need to adjust our market assessment to take account of a very different landscape for this still significant area of the equity market. Financials account for 24% of market capitalisation in Europe and 18% in the US.

Another spanner in the works for putting forward a strong valuation case for equities is a reassessment of the 'risk free rate' (which is typically measured by the yield on 10 year government bonds). If sovereign risk is being questioned by markets, and a risk free asset such as a Government bond provides the basis for any risky asset valuation framework, how can market participants have confidence that their base assumption is correct if a so called 'risk free asset' itself now requires its own risk premium? This is an ongoing debate and one that is likely to haunt markets over the coming months until there is more clarity over the outlook for sovereign risk.

Our view, therefore, is that markets will stay around what their 'fair value' is, based on the outlook for corporate profits and versus valuation levels over the past twenty years, rather than significantly re-rate whilst uncertainty remains this high. In particular, we believe markets will remain constrained because consensus growth estimates are already very optimistic, forecasting in excess of 60% earnings growth for both the US and UK over the next couple of years.



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Since the beginning of the year we have had a target for the FTSE100 of 5600. The market briefly headed higher than this level back in March of this year and then as uncertainty increased, the market rapidly headed back below that level. Markets very rarely stay at fair value for very long – they either over or undershoot for periods of time. However, in our view these fair value targets should remain an anchor to taking any view on equities over the coming months.

### Growth

The performance of equities over the past few months is perhaps puzzling since economic data has been fairly positive. Global manufacturing data has gone from strength to strength and critically there appears to be growing evidence that companies are actually starting to re-stock which suggests some increased confidence in the longevity of the economic recovery.

The biggest surprise has come from the contribution to growth from consumers throughout the developed world, particularly in the US. US consumers have once again come to the rescue by continuing to spend and have started to run down their savings – again. However, we urge a word of caution regarding the sustainability of the strength of US consumer spending which we have witnessed this year. US personal income is still being supported by government transfer payments with little evidence of

increased wages supporting increased consumer spending.

This positive economic news flow has been accompanied by continued reassurance from policy makers in the developed world that interest rates will remain low for an extended period of time – which is a core part of our own economic roadmap.

However, the biggest support behind financial market performance has come from the turnaround in economic growth expectations during 2009. Markets are forward looking and therefore a re-pricing of the economic recovery occurred last year. If anything, the risk now is that market participants have extrapolated the positive economic data which we have seen to date and are now too optimistic about the sustainability of the economic recovery going forward. This scenario helps explain the vulnerability of markets to the situation in Europe over the past month. Global Gross Domestic Product (GDP) growth forecasts are now closer to 3.5% for 2010, up from close to 1.5% 12 months ago. Consensus earnings growth forecasts now expect in excess of 60% earnings growth over the next two years in the UK and the US. The conclusion of this observation is that while strong relative gains could be made during 2009 by switching between asset classes, this large spread of performance between investment types is largely

behind us. Instead, 2010 is likely to be about different regional trends, country performance and themes which will drive equity market performance.

### Putting the pieces together

In our view, the influence from politics most clearly translates into a view on currencies. For European and UK exporters with final demand outside Europe this is a positive driver for earnings outperformance therefore country credentials are critical. One negative impact is the upward pressure on the US dollar which could act as a drag for US exporters, in particular those US companies who have a high proportion of sales to parts of Europe where final demand is likely to remain weak.

Earnings translate into a view on risk appetite in our view. We believe markets are only just below fair value based on fairly optimistic earnings forecasts and therefore remain hostage to confusing fiscal and political news flow. Markets will only re-rate once there is clarity and confidence in the longevity of the profits recovery. Therefore we believe that equity markets will remain range bound near term, struggling to push much ahead of our fair value targets such as 5600 for the FTSE 100 and 1150 for the S&P500.

Growth is all about relative opportunities globally and taking a view on future policy. In the emerging world, inflationary pressures are continuing to build, which in our view will lead to further policy tightening and currency strength. In the developed world, rates need to remain lower for longer in order to support weaker economies. This will support stronger economies such as France and Germany within Europe who will benefit from loose policy and a weaker currency. At a stock level, cash rich companies which can take advantage of investment opportunities but can also offer an attractive dividend yield will do well in our view, in particular relative to the very low returns investors can expect from cash.

## Market Overview

Worries surrounding Europe's mounting debt problems and the impact of austerity programmes on economic growth knocked equities backwards during May. Although corporate earnings remained broadly encouraging, investors became increasingly concerned that the repercussions of Europe's debt crisis are far from over. This in turn prompted a fresh round of aversion to riskier assets.

Following severe belt-tightening measures recently forced on Greece as a condition of European Union / International Monetary Fund emergency loans, a flurry of 'me too' austerity programmes from countries such as Portugal and Spain have flagged that the eurozone's hesitant economic recovery may be in jeopardy. A clear output of these fears was shown in the euro falling to its lowest level against the dollar in four years. A gloomy report from the European Central Bank (ECB) even raised the spectre of another banking crisis in Europe. However, despite the upturn in volatility as markets have turned tail, global equities have mostly held above levels seen at the end of January as generally positive corporate earnings newsflow has partly offset the developed markets' macro economic concerns.

## Equity Overview

### UK

#### Coalition pledges action on deficit

Whilst the new government was keen to 'kitchen sink' bad news on the state of the government finances they had inherited, May brought some relatively encouraging news of the state of the economy. Revised data showed that the economy grew by 0.3% during the first quarter of 2010, compared to the original 0.2% estimate, thanks to a recovery in industrial production. Even the budget deficit for last year was scaled back marginally from £163bn to £156bn, albeit with the deficit total remaining the biggest since the World War II. Meanwhile a modest rise in April's retail sales numbers suggested that consumers are not yet batten down the hatches for personal austerity programmes, despite the prospect of hefty state spending cuts. However, the jump in consumer price inflation to a 17-month high of 3.7%, partly due to higher imported commodity prices, reignited talk of an interest rate rise before the end of this year.

UK equities, as shown by the FTSE All-Share index, suffered their biggest monthly fall since February 2009, shedding 6.2%. Though concerns that the broadening debt crisis could hamper medium-term corporate earnings growth

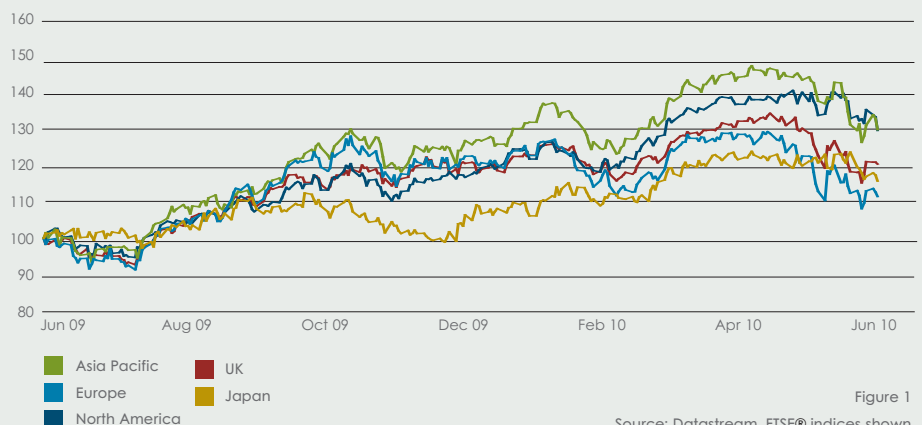
### EQUITY OVERVIEW

as at 31 May 2010

Total return (denominated in £)	May (monthly) return %	Calendar year-to-date (5 months %)
UK	-6.2	-1.6
US	-3.1	9.6
Europe	-8.1	-8.2
Japan	-3.1	10.7
Asia	-8.0	0.8

Source: Datastream, FTSE® indices shown

#### Major Equity Markets – Total Returns £ 2009/2010



weighed on wider sentiment, in sector terms, oil & gas producers were hit by a slide in BP as the cost of the ongoing Gulf of Mexico Deepwater Horizon disaster soared to at least £1bn. Given the dark clouds appearing for the global economic outlook, cyclical sectors such as industrial metals and mining broadly underperformed, while more defensive sectors such as tobacco and fixed-line telecoms performed relatively well.

### US

#### Growth positive but slowing

Revised data showed that the US economy grew at an annualised rate of 3.0% during the first quarter of 2010, compared to the original estimate of 3.2%. This disappointed pundits who had predicted that growth would be upgraded to 3.4%. The latest relatively sedate quarterly growth number compared unfavourably to the lively 5.6% annualised growth achieved during the final three months of last year. Meanwhile the latest employment report showed that the jobless rate actually rose to 9.9% in April, compared to 9.7% in March. With consumer and

business spending growth data for the first quarter also revised lower, evidence mounted that the US economy remains on track for a relatively sedate recovery.

US equities lost ground on unease that the global economic recovery could come under pressure as the debt crisis deepens. The FTSE All-World North America index fell by 3.1% for sterling-based investors.

Signs that the global economic recovery has yet to achieve self-sustaining momentum weighed on cyclical sectors during the month, with mining giant Alcoa and industrial heavyweights General Electric and Caterpillar among the main fallers. Banking stocks also followed their global peers lower on concerns over the impact of the European debt problems and pressure for more stringent industry regulation. However more traditionally defensive areas held up relatively well, with foods group Kraft and household products firm Procter & Gamble suffering only modest declines.

## Equity Overview Contd.

### ▶ EUROPE

#### Taking the bitter pill of austerity

Emergency aid facilities to the tune of €750bn in an attempt to ringfence the Greek debt crisis briefly shored up investors' confidence early in the month. However, doubts soon re-emerged about how robust and tangible the aid would actually be in times of market stress and under what conditions it would be made available. German Chancellor Angela Merkel paid a price for her decision to use up to €148bn of German taxpayers' money as part of the rescue package, with the centre-right coalition defeated at May's North Rhine-Westfalia state election.

The latest eurozone unemployment statistics clearly highlighted the economic fault line splitting the 16-nation bloc. Eurostat numbers showed that seasonally-adjusted eurozone unemployment reached an all-time high of 10.1% in April. At 7.1%, German unemployment has actually fallen over the last year, while unemployment in the Netherlands is Europe's lowest at around 4%. In contrast, Spanish unemployment is flirting with 20%, with a narrowly-approved €15bn austerity package likely to put further pressure on the struggling Spanish economy. European equities, as shown by the FTSE AW – Developed Europe (ex UK) total return index, lost 8.1% in sterling terms over the month.

### ▶ JAPAN

#### An unsteady recovery

The Japanese economy grew by 1.2% during the first three months of 2010, its best performance for three quarters. Car makers demonstrated how export-orientated Japan is continuing to benefit from the upturn in global demand, reporting strong rises in sales and production in April. Toyota revealed a 61% leap in production compared to a year earlier, while Nissan produced 57% more cars. With the bulk of Japan's exports going to Asia, the country should be cushioned to some extent by its relatively limited exposure to any drop in demand from Europe as the eurozone debt crisis rumbles on.

However, Finance Minister Kan noted that though the Japanese economy has continued to gather momentum, he warned that financial market turmoil and ongoing deflationary forces could yet threaten the recovery. Private consumption by Japan's notoriously cautious consumers has shown some moderate improvements over recent months, though this has been partly driven by state-funded financial incentives for low-emission electronic goods – with these subsidies now being phased out, the economy is set to become increasingly reliant on overseas demand. Japanese equities, as demonstrated by the FTSE AW – Japan total return index, shed 3.1% during May in sterling terms as the pound fell against the yen.

### ▶ ASIA/EMERGING MARKETS

#### Slowing the Chinese economic train

The Chinese authorities continued to introduce new measures intended to slow the runaway economy. With house prices still soaring in major cities – some by 40% over the last year – the authorities have imposed higher capital adequacy ratios on banks while seeking to clamp down on speculative buyers with more stringent regulations on multiple home purchases. Though loan growth has slowed recently, the total value of outstanding loans has risen by around 18% over the last year or so. With pay rises in some industrial areas averaging 20% this year, concerns have also risen that the official inflation rate of 2.8% materially underestimates the price pressures the country is experiencing.

China has introduced a raft of measures to slow economic activity since news that first-quarter Gross Domestic Product leapt by 11.6% from a year earlier, yet further steps look necessary to prevent serious economic overheating. Elsewhere data showed that India's economy grew by an impressive 8.6% during the first quarter compared to a year ago, while the IMF predicted that the Brazilian economy is on course for growth of 7% this year, underlining the important role that emerging economies are playing in supporting the global economy as some developed economies begin to falter.

## Fixed Income

Major government bond yields fell sharply during May as the turmoil in the eurozone capital markets continued to spook investors away from riskier assets and into safer havens. Though Greek bond yields fell in response to the bailout from extreme levels seen at the end of April, yields rose in Italy and Spain as markets sensed that these countries could yet be drawn into the eye of the debt storm. In contrast, UK 10-year yields fell by around 0.44% as investors were encouraged by the coalition government's initial moves to tackle the hefty deficit.

In the credit markets, bonds issued by European and US banks sharply underperformed government bonds during the month amid concerns over potential losses resulting from exposure to the eurozone debt crisis. Regulatory pressure in the US for bond investors to assume a greater share of the impact of any bank failure could potentially hit the credit ratings of banks, leading to further adverse sentiment towards the financial sector during the month.

#### Major Bond Markets – Total Returns £ 2009/2010

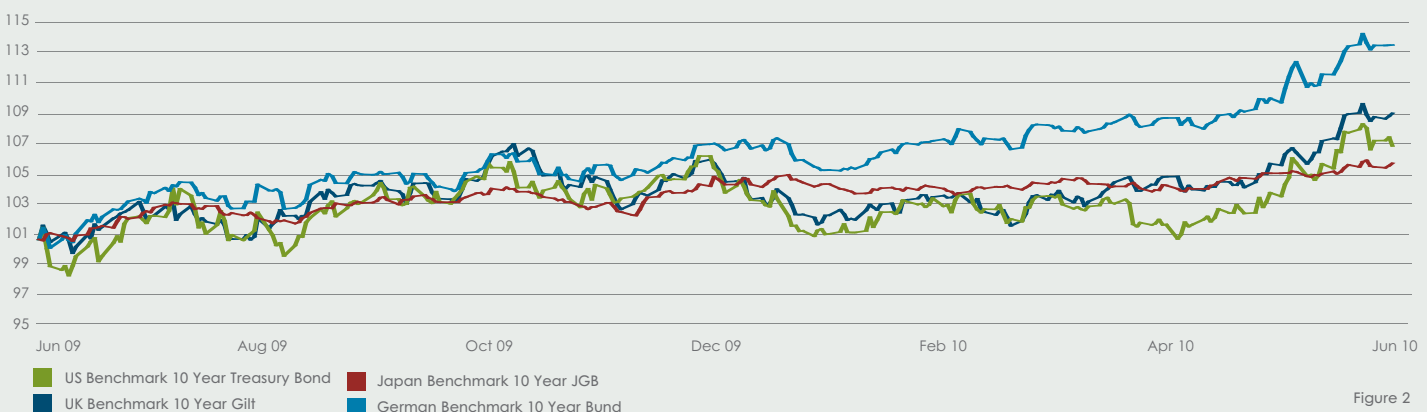
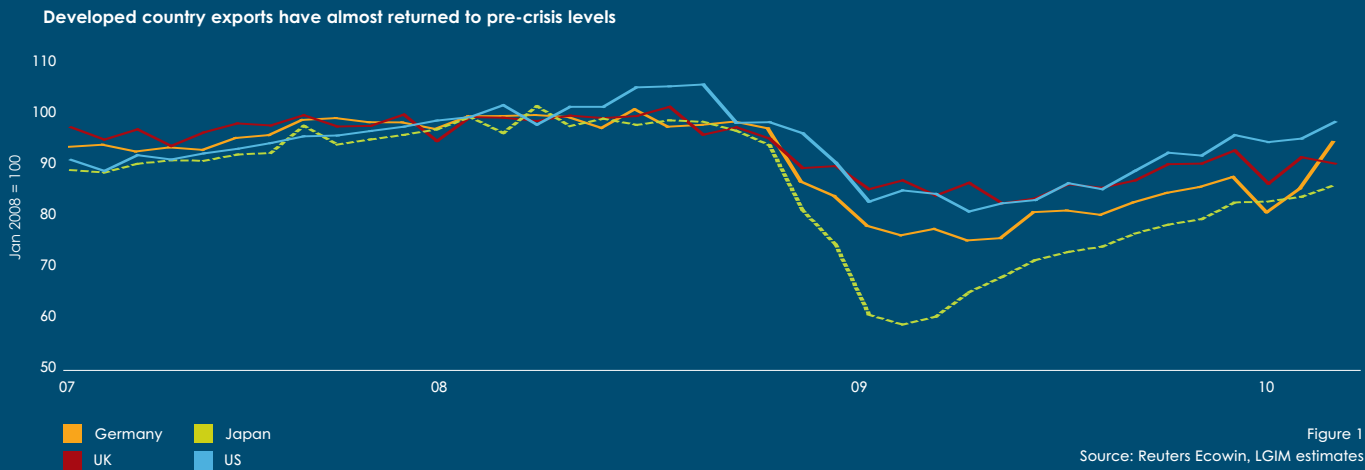


Figure 2  
Source: Datastream

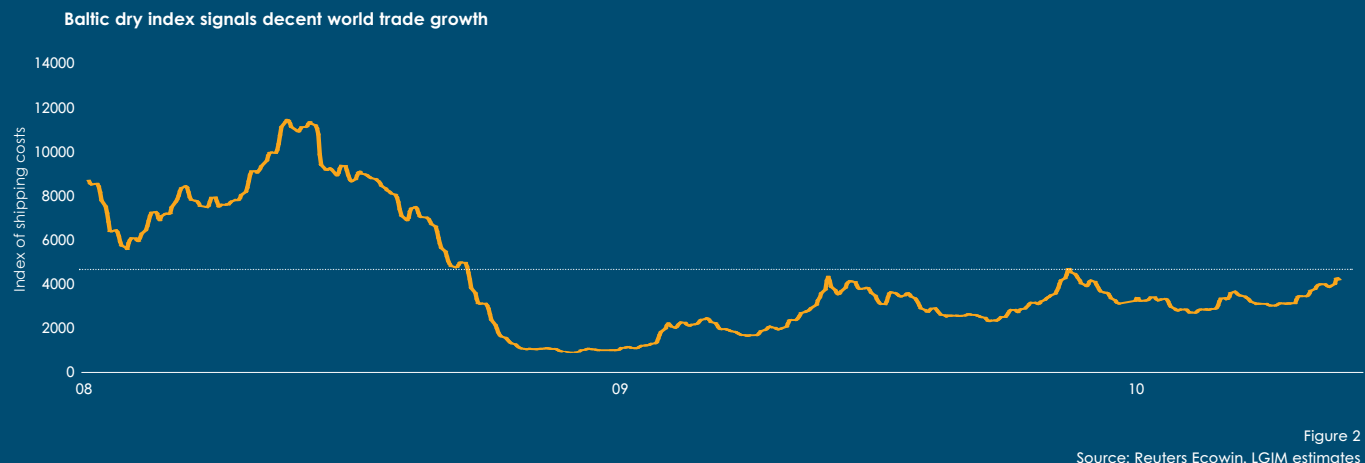
## Snapshot

# Global trade is flourishing

We do not believe the current period of heightened financial market volatility will culminate in a repeat of a 2008-style decline. The main reason for this is due to the fact that the global economy is now expanding briskly. In 2008, global growth had lost momentum ahead of the collapse of Lehman Brothers, with many countries already in recession. Instead, the strength of emerging market growth is well known and loose monetary conditions have boosted domestic demand and intra-regional trade. Less appreciated is the performance of developed country exports. After plunging towards the end of 2008, exports have almost returned to pre-crisis levels (Figure 1). Export dependent Germany and Japan were hardest hit, but both countries have enjoyed a sharp rebound. UK exports appear to have lagged the US somewhat, but given the depreciation of the pound, volumes should begin to pick up more appreciably in the months ahead.



Sovereign debt concerns across the euro area have led to a sharp fall in the euro and this should further boost German exports. There will be some negative impact on the US, but OECD modelling work suggests that a 10% fall in the euro should only subtract 0.1% from US GDP per year over the next couple of years. Clearly there is a danger that if the turbulence in markets escalates it might begin to affect business confidence and restrain the credit necessary for trade flows, but there is little evidence of this so far. The most timely measure of global trade activity is the Baltic Dry Index (BDI) which measures the cost of worldwide international shipping prices of various dry bulk cargoes. This series has continued to grind higher (Figure 2). This is encouraging, particularly as it is based on US dollars which given the dollar's recent strength should act to curb price increases. The usefulness of the BDI as a lead indicator is that it is totally devoid of speculative content, but it can still be fairly erratic. So we also need to monitor business confidence surveys closely. We expect some moderation to occur anyway as we believe the global inventory cycle has peaked, but sharp falls would be a warning that there could be an impact from sovereign debt concerns on global activity.



## UK Forecast

## Rates lower for longer

UK Economy		Price Inflation (HICP)		GDP (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro	
		2010	2011	2010	2011	End 2010	End 2011	End 2010	End 2011	End 2010	End 2011	End 2010	End 2011
Market participants forecasts		%	%	%	%	%	%	%	%				
	High	3.50	2.70	1.50	3.00	5.10	5.10	1.00	2.00	1.62	1.65	0.90	1.00
	Low	2.40	0.70	0.90	1.50	3.60	3.50	0.50	1.50*	1.29	1.22	0.78	0.72
	Median	3.10	1.90	1.20	2.25	4.50	4.42	0.50	1.75*	1.44	1.50	0.83	0.80
	Last month median	2.70	1.65	1.30	2.00	4.47	4.78	0.75	2.00	1.53	1.56	0.86	0.83
<b>Legal &amp; General Investment Management</b>		<b>3.10</b>	<b>1.90</b>	<b>1.60</b>	<b>1.90</b>	<b>4.50</b>	<b>5.00</b>	<b>0.50</b>	<b>0.50</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>

\*Based on a small sample size at time of going to print

Source: Bloomberg and LGIM estimates

The forecasts above are taken from Bloomberg and represent the views of between 20-40 different market participants (depending on the economic variable). The 'high' and 'low' figures shown above represent the highest/lowest single forecast from the sample. The median number takes the middle estimate from the entire sample.

UK economic growth for the first quarter of 2010 was recently revised upward from 0.2% to 0.3%. While the domestic economy has returned to growth, the recovery is likely to remain lacklustre as the initial boost from the inventory cycle fades. After cutting back production fiercely during the global downturn, inventories were reduced to extremely low levels. When the global economy returned to growth late in 2009 (spurred on by extraordinary support from policy makers) demand picked up and factories reopened, trade resumed and production rebounded. We anticipate a 2010 GDP figure of 1.60% and with the UK about to embark upon the biggest cumulative fiscal policy tightening potentially seen since the second world war, our GDP estimates for 2011 remain modest (and below the median market participant "consensus") at 1.90%. We estimate that higher taxes and spending cuts (particularly in investment) is likely to amount to roughly 2% of GDP in 2011 alone.

Consumer Price Index (CPI) inflation continues to track well above the Bank of England's (BOE) target of 2%. The combination of the Value Added Tax (VAT) returning to 17.5%, higher oil prices and devaluation of sterling have all contributed to higher inflation. While we believe inflation will remain at around 3% until the end of 2010, our model suggests prices will fade as economic growth weakens, easing inflationary pressures from 3.10% in 2010 to 1.90% in 2011. Consensus revised their inflation expectations for 2011 from 1.65% to be in-line with our estimate of 1.90%. While our Bank of England model indicates the possibility of rate hikes in 2011, this is because the BOE has traditionally reacted to the change in unemployment rather than the level. However, we suspect the BOE will not raise interest rates if economic growth remains muted and unemployment remains high and that they will tolerate inflation in order to see a rise in asset prices to support the financial sector (which remains weak).

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